

# Comparable Accounting

NHH—The Norwegian School of Economics  
September 2011

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# Overview

- From an accounting standard setting perspective, what does “comparable accounting” mean?
- Why does comparability matter in accounting?
  - What makes comparability a desirable characteristic of decision-useful financial reporting information?
- What causes financial reporting information to be comparable, or not-comparable?
  - Standards that permit or require not-comparable accounting
  - Implementations of those standards that yield not-comparable outcomes
- Is it possible to measure (quantify) comparability?
- Concluding observations

# What does “comparable accounting” mean?

- Comparability is described conceptually by standard setters (the FASB and IASB) as a qualitative characteristic of decision-useful information
  - In Concepts Statement 8, comparability enhances the usefulness of information that is relevant and representationally faithful
  - “Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items” [Concepts Statement 8, para QC21]
  - “Although a single economic phenomenon can be faithfully represented in multiple ways, permitting alternative accounting methods for the same economic phenomenon diminishes comparability” [Concepts Statement 8, para QC 25]

## *Observations and a question to consider:*

- Comparability means similar economic phenomena are accounted for the same way; dissimilar economic phenomena are accounted for differently
- The characteristic “comparability” is applied to an economic phenomenon (an event, a transaction, an arrangement, a financial statement item) as opposed to a summary performance indicator such as earnings
- What determines whether two economic phenomena are “similar”?

# Why is comparability important?

- Selected IASB/IASC statements about comparability
  - The IASC's *Constitution*: the objectives of the IASC Foundation include “to develop...accounting standards that require high quality, transparent and **comparable** information....” [IASC Foundation Constitution para 2(a); emphasis added]
  - The *Preface to IFRSs*: “The IASB’s objective is to require like transactions and events to be accounted for in a like way....[t]he IASB intends not to permit choices in accounting treatments” [Preface to IFRSs para 13]

## *Observations and a question to consider:*

- If comparable accounting does not matter, there is little reason to have authoritative accounting guidance (standards). Management could select the accounting treatments it prefers and (possibly) disclose those choices
- Investors’ capital allocation decisions involve choices among alternatives
  - Those choices require assessing/evaluating current performance and forming expectations about future performance, *across the alternative investment possibilities*
  - Using the language of Concepts Statement 8, investors identify similarities in, and differences among, possible investments
  - To what extent does non-comparable accounting hinder this process of assessment and evaluation of alternative investments?

# Analyzing economic similarity in the context of an implementation decision: WorldCom

- Comparable accounting means economically similar items and arrangements are accounted for the same way
- WorldCom paid for the right to use other companies' communication networks, under arrangements that act like leases
  - In 2001, payments for these "line charges" exceeded 40% of revenues (about \$17-18 billion). Also in 2001, WorldCom classified approximately \$3 billion of line charges as capital expenditures (assets not expenses)
    - The justification was that the costs were incurred in anticipation of future revenues, to which expenses would be "matched"
    - The cost deferrals were viewed as arising from arrangements that allowed WorldCom to expand its capacity to serve customers
    - WorldCom concluded the costs were future economic benefits (assets)

## *Questions to consider:*

- Are there two types of line charges that are economically dissimilar?
- Analysis of WorldCom's 2001 financial report would indicate that WorldCom added \$3 billion to its own capacity (capital expenditures)
  - How would this affect an assessment of WorldCom's future performance?
  - How would WorldCom's competitors respond to this capacity expansion?<sup>5</sup>

# Analyzing economic similarity in the context of authoritative guidance: Guarantees

- Are these two guarantee arrangements economically similar?

*Arrangement 1:* Entity A transfers the right to receive 100% of the cash flows of Financial Asset X to Entity B and provides a guarantee of the credit quality of those cash flows, in exchange for arms-length, market-value consideration

*Arrangement 2:* Entity C guarantees the credit quality of 100% of the cash flows of Financial Asset X (which Entity C has never owned and Entity B has always owned), in exchange for arms-length, market value consideration

Outcome of the arrangement: A and C have guaranteed the credit quality of an asset whose cash flows are owned by B. Neither A nor C has access to those cash flows

*Observation and questions to consider:*

- Authoritative guidance typically requires different accounting treatments for these two arrangements
- Are these two arrangements economically similar, so that comparable accounting would require they receive the same accounting treatment?
- Does similarity depend on whether the guarantee is written by an entity that once owned (controlled) the guaranteed assets versus an entity with no previous association with the guaranteed assets?

# Analyzing economic similarity in the context of business models

- Management is expected to operate the firm's business model
  - Management intent for the use or disposal of an asset, or the continued owing or transfer or settlement of a liability, reflects the business model and management's operation of the business model
- Do differences in management intentions for two otherwise similar items (asset or liability) make those items economically dissimilar, so that comparable accounting would require they be accounted for differently?
  - If yes, would WorldCom management's intent for incurring line charges affect how those line charges should be accounted for?
- Management intentions for an asset reflect how management expects to realize value from that item
  - Value realization for an asset = generate cash flows from holding/using or selling the asset
  - Do differences in management's intentions for value realization make otherwise similar items (assets, liabilities) economically dissimilar and therefore subject to different accounting treatments if there is to be comparable accounting?

# Example 1: Disaggregated disclosures

- IFRS 8 bases the identification of segments and the information to be provided on the entity's business model
  - Identify operating segments “on the basis of internal reports that are regularly reviewed by the entity's chief operating decision maker in order to allocate resources to the segment and to assess its performance” [IFRS 8 para IN11]
  - A component that sells “primarily or exclusively to other operating segments of the entity is included in the IFRS's definition of an operating segment if the entity is managed that way” [IFRS 8 para IN12]
  - “...financial information is required to be reported on the same basis as is used internally for evaluating operating segment performance and deciding how to allocate resources to operating segments” [IFRS 8 para IN5]

## *Observations:*

- The Basis for Conclusions refers to this approach as the management approach [IFRS 8 para BC9-BC17]
  - The objective is to view the entity's operations from the same perspective as management, including the information used for decision making
  - Two outcomes of this objective are to reduce preparation cost and to reduce comparability of information (because the disclosed accounting amounts are not calculated by applying the same guidance)

## Example 2: Asset classification

- Authoritative guidance for classifying nonfinancial (operating) assets as inventory or as fixed assets (plant property and equipment)
  - From IAS 2, inventories are assets held for sale in the ordinary course of business, or used in production of inventories
  - From IAS 16, property plant and equipment (PPE) are tangible assets that are held for use, for more than one period, in the production or supply of goods and services or for rental to others or for administrative purposes
- A given item could be classified as inventory or fixed assets depending on the entity's business model
  - *Example:* Heavy construction equipment is inventory to a dealer and PPE to a construction company
  - *Example:* Trucks are inventory to a dealer and PPE to a trucking company

### *Observations:*

- The classification of the asset is linked to management's plans and intentions for how the asset will be used to create and deliver value to customers
- The accounting (including impairment) for inventory and PPE is different. Should it be?

# More on value realization

- Applying the value realization criterion suggests that *how* management uses an item to create value would be pertinent to its measurement
  - *Example 1:* A brand, acquired as part of a business combination, that management intends to discard (does not intend to use or sell)
    - Cash to be realized = zero (there could be an indirect defensive value)
  - *Example 2:* Debt that management intends to owe to maturity
    - Cash paid to settle = contractually specified amount (the principal)
  - *Example 3:* A debt security that management intends to hold to maturity so as to collect all the contractual cash flows
    - Cash received = contractually specified amounts
  - *Example 4:* A noncurrent nonfinancial asset that management intends to use until its service potential is exhausted
    - Cash is realized indirectly through using the asset during its service life.  
What is the best way to capture this realization of value?

## Questions to consider:

- Does the way an item is used alter its economic characteristics (its commercial reality) and make it dissimilar to the *same item* used differently?
- If a faithful representation captures economic characteristics, what is the measurement that provides a faithful representation?

# More on value realization

*Observations on the examples and questions to consider:*

- A current exit value exists for each of these items (it may have to be estimated)
- The current exit value captures a variant of the opportunity cost of holding the asset or owing the obligation, given current conditions
  - Opportunity cost = amount foregone by holding an asset not selling it and owing an obligation not settling or transferring it
  - Opportunity cost for an item is not determined by management's intent for that item and does not capture the outcome of management's intent for the item
- Concepts statements of the IASB and FASB state that relevant information contributes to the assessment of future cash flow prospects and the evaluation of past performance
  - Is the opportunity cost (exit value) of recognized items relevant for:
    - Assessing an investment in the entity?
    - Assessing management's performance?
    - *Example:* If management collects all the contractual cash flows of a 4% debt security when the market rate is 5%, does the entity have a loss?
    - *Example:* What is the most relevant measure of assets in a calculation of Return on Assets (ROA)?

# Why base the accounting on value realization?

- Value realization is linked to relevance in FASB/IASB discussions
  - A relevant measure contributes to the assessment of future cash flow prospects and to the evaluation of past performance
  - Therefore, a relevant measure would be based on how the flows an item will generate will arise (that is, how value will be realized)
    - Management's operation of the business model determines how the flows an item will generate will arise—how value will be realized
- Does this reasoning suggest that:
  - An entity's business model and the way management operates that business model determine the value realization method and
  - Classification/measurement based on the value realization method will result in the most relevant measurement because
  - Value realization determines cash flows to/from the entity and relevance is defined in terms of assessing cash flows regardless of
  - Effects on comparability?

## *Question to consider:*

- In setting authoritative guidance, can we evaluate the benefits, in terms of decision useful information, of basing the accounting treatment of an item on<sub>12</sub> how management expects to realize value?

# Research on accounting comparability

- Examples of ways accounting researchers define comparability
  - Focus on an entity's description of the accounting methods it uses
    - Comparability = Use of the same accounting methods, as indicated in the footnote on accounting policy
    - Observation: The approach intentionally does not consider how the accounting method is implemented, for example, the judgments and estimates that lead to the reported accounting numbers
  - Focus on reported amounts
    - Comparability = Similarity of reported amounts conditional on similar economic outcomes
    - Reported amounts can include earnings, book value of equity, and specific line items
    - Economic outcomes can include stock returns and cash flows
    - Observation: The focus is on the link between a reported amount and an observable economic outcome, not on the reported amount and a specified economic phenomenon (event, transaction, arrangement, asset, liability)

# Research on accounting comparability

- Examples of ways accounting researchers measure comparability
  - Focus on descriptions of accounting methods
    - Indexes of similarity in accounting methods
  - Focus on reported amounts, often, earnings
    - Homogeneity in properties of accounting earnings (e.g., persistence, predictability, smoothness)
    - Co-movement in earnings
    - Similarity in the statistical association between cash flows (an outcome indicator) and accruals (a defining feature of accounting)
    - Similarity in the statistical association between returns (an outcome indicator) and earnings

## *Observations and a question to consider*

- Standard setters' characterizations of comparability focus on one arrangement/event/item at a time, in terms of similar accounting treatment of similar economic phenomena
- Researchers focus on similarity in properties of reported amounts, in the presence of similar economic conditions/outcomes
- Will these two approaches lead to similar inferences?

# Research on accounting comparability

- Examples of questions related to accounting comparability addressed by accounting researchers
  - How did voluntary or mandatory adoption of IFRS affect accounting comparability?
    - Uses a before-and-after design, with IFRS adoption the intervening variable
  - In terms of achieving comparability, what matters more: the standards themselves or the way they are implemented?
    - Often uses a cross-sectional design, in which observations from jurisdictions with similar accounting standards and differing implementation incentives are compared

## *Questions to consider*

- How much does comparability enhance the decision-usefulness of accounting information?
- What are the effects of basing the accounting treatment on management intent?
  - Enhance relevance and impair comparability? Or something else?
- Researchers tend to focus on how incentives affect implementations and therefore comparability. What about other effects, such as competence?

# Observations on standard setters and accounting comparability

- Standards contain two variants on the notion of basing accounting measurement on management intent, as opposed to the characteristics of the thing being accounted for
  - Free choice, possibly constrained by meeting conditions
    - *Examples:* The fair value options for certain financial items currently in IFRS and US GAAP
    - Management can choose fair value or cost for a qualifying item. There are no specific constraints on the choice (unless the “accounting mismatch” criterion qualifies)
  - Choice that specifies as a *necessary condition* meeting certain business-model-based or intent-based conditions
    - *Example:* The accounting for certain financial assets at amortized cost under IFRS 9 *requires* that management intend to hold the assets to collect contractual cash flows

## *Question to consider:*

- What are the costs and benefits, in terms of the provision of decision-useful information, of these intentional departures from comparability?