CHAPTER 4 SPECIFIC CLASSIFICATION PROBLEMS IN FINANCIAL STATEMENTS

4.1 Introduction

In the previous chapter some aspects regarding the classification of accounting information were considered; in this chapter various problems currently present in financial statements are discussed. Classification may take place at various stages in accounting, starting with the decision as to whether an amount is to be recorded as a debit or a credit, then the recording of a transaction, up to the final classification stage when accounts are classified in the financial statements of a company (i.e. reporting). There are, however, certain problems during the classification of this information. For example, items like deferred taxation are called 'accounting hybrids' because they have attributes of more than one class (Wild, Bernstein and Subramanyam 2001). In the *current/non-current* classification, different measurements (Gilman 1944; Schroeder *et al.* 2005) are used for different items, resulting in non-homogenous information being classified together.

4.1.1 Goal of this chapter

The goal of this chapter is to consider some general problems underlying the classification of accounting information. These classification problems ultimately manifest in the financial statements of a company. In this regard problems specific to the classification of information in the balance sheet and income statement are identified and discussed.

4.1.2 Layout of this chapter

In Section 4.2 some of the general criticisms in the literature regarding the classification of accounting information (i.e. recording) are discussed. Included in this section is the problem of reclassifying information at year-end (i.e. reporting). Classification in the balance sheet is discussed in Section 4.3. Criticisms of the classification of items in the balance sheet are highlighted in Section 4.3.1. Also in Section 4.3.1, general and specific problems related to classification in the balance sheet are discussed. Problems surrounding the liquidity concept in the balance sheet are investigated. Next some suggestions on the reclassification of items in the

balance sheet are explored. These suggestions include reclassification of assets, specifically the reclassification of R&D and of long-lived assets to be sold; reclassification of liabilities; and the reclassification of *current assets* and *liabilities*, specifically inventory. In Section 4.4 the focus shifts to classification problems in the income statement. Consideration is given in Section 4.5 to the way analysts reclassify accounting information portrayed in the financial statements. Section 4.6 focuses on the role of classification in the window-dressing of financial statements, and in Section 4.7 the role of time in classification is discussed. A summary concludes the chapter.

A visual representation of the layout of this chapter is shown in Figure 4.1.
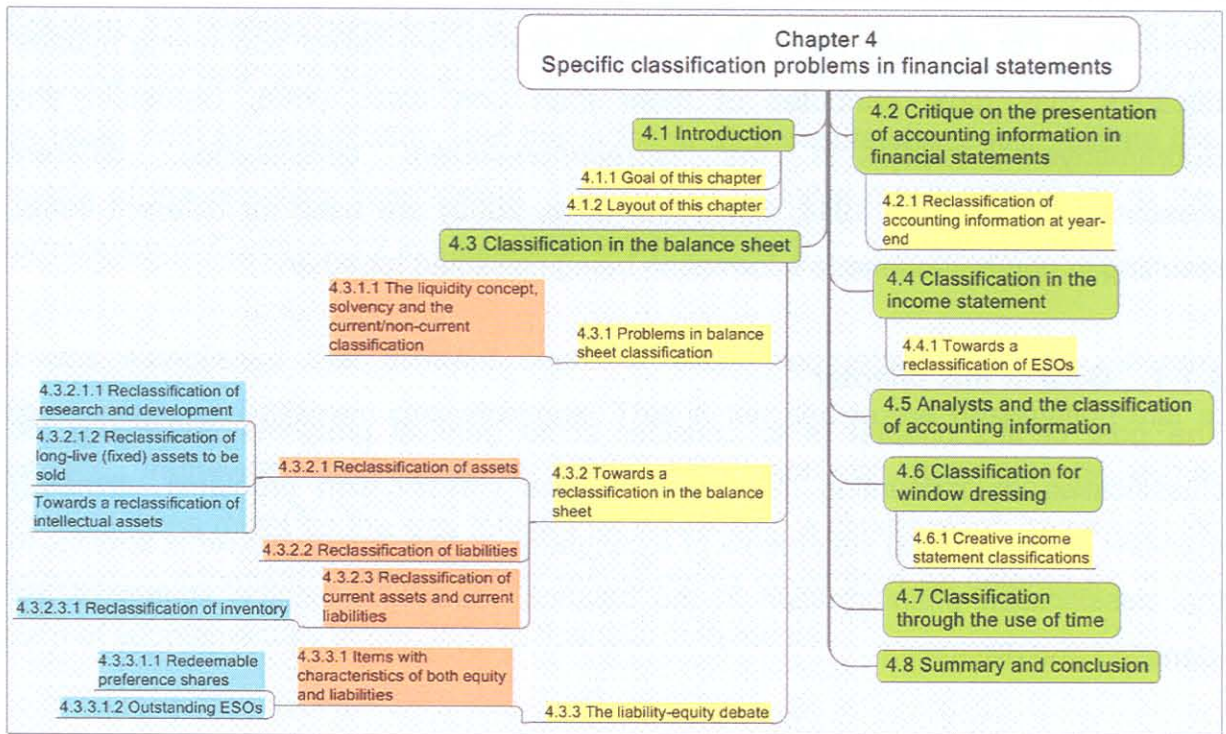

Figure 4.1   A visual representation of the layout of Chapter 4

4.2 Critique on the presentation of accounting information in financial statements

As far back as 1974, Lev (1974) claimed that the efficient capital markets theory implies that financial statement analysis is a rather futile activity. He also wrote that the "dissatisfaction with currently reported financial data is widespread among both the users and the preparers of the information" (Lev 1974:75-76). The structure and

content of the balance sheet were criticised by Fitzgerald (1936:74) in his argument that "others who have read balance sheets and who are not infected by accountancy concepts are often critical of the form and content of these statements". He further maintained that users often feel that the statements fail to portray useful information. Although the work of Fitzgerald (1936) and Lev (1974) is rather dated, the above criticisms of the information in financial statements is still applicable as, more recently, Miller and Bahnson (2002:50) claim that users know they cannot rely on "GAAP financial statements to be fully informative", hence the development of a classification framework for accounting information, especially for the balance sheet, may be in order. A conceptual framework for the classification of accounting information - aimed at improving the utility of such information - may be arrived at when all the known and relevant attributes of transactions are taken into account during the recording process, and re-evaluated at a later stage. This is necessary since attributes may change over time, e.g. at the time of reporting or in the future. The introduction of a normative subframework to identify attributes of transactions takes place in Chapter 7 of this thesis.

The chart of accounts is a tool used in accounting classification. According to Goldberg (2001:42) the "imposition of the accountant's classification, usually by means of a pre-designed artefact, (the chart of accounts)" may "preclude, or at least inhibit" users from the information they need. In the instance where unclassified data may be revealed to users interested in the company in a format not useful for their purposes, they may have to re-classify and summarise the information in a format of their own. The human mind, however, can only manage a reasonable amount of data simultaneously typically seven individual facts at any one time (Miller 1956, Jones 2002). In the case where a classification and summaries are presented, a choice is made beforehand for the users of which information is important and which parts are not important (Hendriksen and van Breda 1992). Hence, making classification decisions on behalf of users might not be in the best interest of the said users. Therefore, requirements of users have to be taken into account whereafter a classification framework for accounting information could be developed based on these requirements. However, the establishment of all user requirements is a time consuming and complex task and as a result only a strict subset of the suggestions

made by AICPA (1994) were taken into account in the development of the classification framework for accounting information in this thesis.

Next a brief discussion is presented on the reclassification of accounting information at the time of reporting, namely, year-end.

4.2.1 Reclassification of accounting information at year-end

At year-end, an artificial position in a company's lifecycle, companies perform a special classification exercise to display unrecognised classes of expense and revenue, which results in reclassification and summarising by the double-entry method (Paton 1962). Littleton (1958:56) states that "the task of compressing a mass of transaction facts into an intelligible enterprise statement is too great to be fulfilled by initial classification". Initial classification where data is classified into accounts at the time of recording is based on kinds and qualities whereas reclassification is based on fiscal periods or operating departments (Littleton 1958). In some instances facts are classified preliminary until a better picture can be formed as to where they fit into the company's activities. A clearer picture is formed at a later stage, often because attributes that were not known at the time of recording become known at the reporting stage. Clear guidelines additional to the standard classification framework ought to be provided to the accountant or the classifier for reclassification. The development of such guidelines warrants the input of a number of stakeholders and is beyond the scope of this work.

Following the introduction of generic problems inherent in the classification of accounting information, classification in the balance sheet is now addressed. This is done by first stating various requirements and generic problems as gathered from the literature, and then discussing specific classification problems in the balance sheet and the income statement.

4.3 Classification in the balance sheet

Before addressing the classification of items in the balance sheet, a good definition of the balance sheet is required. This calls for an initial measurement as prescribed by Corollary 3.2. Most (1982) sites the definition of a classified balance sheet from accounting terminology as a statement that identifies subclasses of *current assets*

and *current liabilities*. Unfortunately, however, there has been little discussion in the accounting literature on attempts to solve the classification problems which face the compilers and users of balance sheets. In this section these problems are highlighted.

The "two-sided" form of the balance sheet as suggested by equation 3.1 in subsection 3.3.1 is understood by some users but "undoubtedly also many find it a source of confusion and [they] must physically or mentally rearrange the balance sheet before its whole meaning becomes evident to them" (Fitzgerald 1938b:163). Currently this two-sided form of the balance sheet still prevails and continues to be a source of confusion to some users. Fitzgerald (1938b) and Stickney *et al.* (2004) further argue that even the users who understand the balance sheet need to rearrange it to bring out the significant relationships before a useful analysis can be performed and before information (concealed or otherwise) can be interpreted correctly. Therefore, since users often need to reclassify items in the balance sheet to meet their own objectives, a generic classification framework containing most of the accounting information needed by users may be a viable option to reduce the necessity to reclassify. However, eliciting the needs of users is an activity that requires input from users and standard setters, and arguably the best way to achieve this is through a joint committee. Another way to enhance reclassification could be to supply additional information to users based on requirements established during one or more JAD workshops (Wood and Silver 1995) and consultations.

Some items are classified together in accounting although they do not share the same attributes. Canning (1978) points out that users of financial statements ought to be conscious of the fact that items classified in the financial statements of a company are not always homogeneous in nature despite a given interpretation of the said facts in a particular arena. An example is the classification of items like inventory, accounts receivable and cash together as *current assets* in financial statements even though they have different valuation methods. In the proposed classification framework for accounting information in Chapter 7 the homogeneity of items is addressed through the use of attributes.

Assets are valued using different methods. According to Higgins (2004:19) total assets may, therefore, be seen as an "artificial accounting construct" and not economic reality. This is because of the recurring problem of market value versus book value. A revised classification framework for accounting information ought to have categories that include valuation methods and measurements of the same kind. These measurements form part of a second round of measurement.

The balance sheet is a summary of various activities within a company. Littleton (1958:81) claims that "the balance sheet is not a clear cut report on financial stewardship". He bases this argument on the fact that the balance sheet contains a combination of results from the financing as well as operating activities of a company. The balance sheet is, therefore, "not very informative about either one separately". Hendriksen and van Breda (1992:468) support this claim when they state the following: "as a device for describing the operations of the firm, the current/non-current classification is defective". An illustration of this claim by Hendriksen and van Breda (1992) is found in interest receivable that does not arise from operating activities of the company. Hence, the balance sheet may need to separate financing activities from operating activities.

According to Hendriksen and van Breda (1992), a balance sheet classification ought to meet the following objectives:

- *Presentation of solvency to creditors.* This was one of the earliest objectives of the balance sheet but the importance of solvency has changed over time. The credit grantor is no longer the main user of financial statements.
- *Description of company operations.* It should be clear to users what the company's operations entail. This requirement is normally addressed by additional reports prior to the presentation of the balance sheet and will therefore not be addressed as part of the proposed classification framework for accounting information in this thesis. Having said this, one should note that splitting the activities of a company between core and non-core in the proposed framework is also a way to describe the operations of the company.
- *Highlighting of valuation models.* This has to do with a second round of measurements and although such measurements are important in further

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classification work, these are beyond the scope of this thesis and may be catered for in supplements to the financial statements as suggested by ASOBAT (Wolk *et al.* 2004). These supplements could be columnar representations of the different measurement methods and values.

- *Illumination of management's intentions.* If users are aware of management's intentions, it may influence their decisions. For example, a plan to sell a fixed asset is one intention of management that is highlighted in the proposed framework in Chapter 7. If, however, an intention cannot be accommodated in the statements, it is proposed that information about such intention form part of supplements to financial statements and is, therefore, not addressed as part of the proposed classification framework for accounting information in this work.

- *Prediction of cash flows.* Users need to know whether a company has a reliable positive or negative cash flow to enable them to make useful decisions. In the proposed classification framework for accounting information more information is added to the financial statements with the aim of helping users to make their own future predictions.

If all the above objectives are met, the classification framework for accounting information together with additional information provided will prove to be a highly descriptive framework.

In the following section specific problems with regard to the classification of information in the balance sheet are discussed. In particular, problems of accounting hybrids, liquidity, solvency and the *current/non-current* classification are addressed.

4.3.1 Problems in balance sheet classification

The present classification system for accounting information results in accounting hybrids, i.e. items which do not fit into any specific category. In the balance sheet the categories *assets* and *liabilities* are used. According to Fitzgerald (1936), there are items in the balance sheet which are neither of the two. The balance sheet also does not suggest that assets are included at their present realisable value. Sprouse (1966:46) named certain deferred credits in the balance sheet "what-you-may-call-its". These are: 1) the purchase of a company at a cost less than the book value of equity acquired; 2) gains arising from sale-and-leaseback transactions, and

3) deferred investment credits. Wolk *et al.* (2004:319) have added to the debate by including another type of deferred assets and liabilities: "by-products of income statement rules" which result from the revenue-expense approach of the income statement. These deferred items do not conform to *current asset* and *liability* definitions. These items are difficult to classify under the normal classification rules of accounting because they have attributes of more than one class.

Despite the fact that the work of both Fitzgerald and Sprouse is dated, their claims above are still valid, since these views are shared by Goldberg (2001). Accounting hybrids are items that have attributes which may result in them possibly being classified into two or more groups, but they do not have all the qualifying attributes to be classified into any one of these groups exclusively. Hence the classification framework for accounting information currently in use should be revised to include these "what-you-may-call-its" or accounting hybrids. This may be done by a comprehensive identification of attributes, as suggested by Corollary 3.2.

Leasing is another controversial activity of companies. The reasons are 1) off-balance-sheet financing becomes possible, and 2) it has tax advantages (Wolk *et al.* 2004). Off-balance-sheet financing has the advantage of 1) better debt ratios and 2) higher accounting rates of return. Since lease liabilities and lease assets are not displayed in the financial statements, the information supplied to users may be less complete and may result in users being misled and incorrect decisions being taken based on more favourable ratios. These items may need to be classified in the additional information supplied to users to enable them to incorporate it into their analysis of a company's financial health. An alternative is that leases may need to be classified as liabilities in the financial statements.

4.3.1.1 The liquidity concept, solvency and the current/non-current classification

One of the classifications in the balance sheet is working capital with two sub-classifications, namely, *current assets* and *current liabilities*. The purpose of working capital is to supply information about the solvency and liquidity of the company (Kam 1990). Kam (1990) points out that the classifications in the balance sheet should be

judged on whether it is useful in helping to assess a company's solvency. The issue of solvency and liquidity is highly controversial, as discussed below.

Originally the classification carried out in the balance sheet was based on the influence of the short-term credit granter. It was presumed that the interest of the short-term credit granter was based on *liquidity,* this presumption resulted in the categories *current assets* and *current liabilities,* which are the components of net working capital (Gilman 1944; Moonitz and Jordan 1963; Goldberg 1964). The proposed classification framework for accounting information should address the informational needs of all stakeholders as far as possible. This could be done through a distributed union minus conflicting requirements as described previously (refer also to Example 1.1).

The classification of assets and liabilities in the balance sheet is done based on liquidity. The liquidity concept has always been in "conflict with the going concern concept" according to Moonitz and Jordan (1963:526) since no company is seen as heading for early liquidation: instead companies are expected to carry on indefinitely. They continue their argument stating that it "has been proved virtually impossible" to prepare a balance sheet according to the liquidation concept without "distorting the accounts themselves". The ranking of assets and liabilities according to their liquidity is a "crude ranking of liquidity" and actually reveals very little about liquidity (Wolk *et al*. 2004:423). Wolk *et al*. (2004) also claim that the *current/non-current* classification is a very basic indication of a company's liquidity. If the way liquidity is currently addressed in financial statements leads to distorted information or is in conflict with the going concern concept of accounting, then a change in the classification of accounting information is warranted.

The classification and liquidity of inventory are also open to criticism. Kempner (1960:266-268) states that the traditional classification of inventory is a muchdiscussed topic, and gives a summary of the disadvantages of the way inventory is classified:

1. *Inventories are not nearly as liquid as are the other current assets such as cash, marketable securities and receivables.* A certain part of inventory may be

viewed as fixed since a company needs to have a minimum inventory level which may need to be classified as a *non-current* item. Since the operating cycles of companies differ, it follows that the inventory in companies with a short cycle (typically those less than a year) needs to be classified as *current* where in the case of long cycles inventory needs to be classified as *non-current*.

2. *The degree of liquidity varies with the industry and even within the same company.* The type of item being manufactured may influence the liquidity of the inventory. If a company manufactures and sells an item in less than a year it is more liquid than an item which is manufactured and sold over a period of two or more years. However, inventory consists of items in various stages in the manufacturing process, for instance work-in-process and finished goods. These also differ in liquidity and may, therefore, need to be classified based on how far they are from cash.

3. *Inventories that will not be converted into receivables or cash for some time must be removed from any short-term calculation of funds.* Currently an inventory item such as raw materials is less easily converted into cash, since such materials first have to be converted into a finished product before they can be sold (i.e. converted into cash). Therefore, the classification of finished goods will necessarily be different from that of raw materials, even though both of these are currently part of inventory.

Points 1 to 3 above are addressed in Chapter 7 through the development of a classification framework for accounting information.

The critical cash flow position cannot be determined with the use of *current assets* as the operating cycle of companies differ and may be longer than a year according to Goldberg (2001), Wolk *et al*. (2004) and Stickney *et al*. (2004). The deferred charges and credits contained in the *current assets* do not affect current cash flows and therefore ought not to be included in the assessment of the cash flow position of a company. Wolk *et al*. (2004) suggest that other classification systems to assess the liquidity of a company are to be employed, for example combining two classifications, namely, the one for monetary/non-monetary items and the one for *current/non-current* items. Since the *current/non-current* classification is part of much debate and criticism it follows that a classification other than *current/non-current* may need to be

developed. For instance, items could be classified according to the three time frames - past, present and future - rather than the one-year rule. To this end a classification framework for accounting information which takes time into consideration is developed in Chapter 7.

Hendriksen and van Breda (1992) argue that the classification of assets and liabilities as *current* and *non-current* as a method to present the solvency of a company is less relevant than other forms of classification. Some reasons for their claim are presented and discussed below:

- *Other financial statements: Income statements and cash flow statements may provide better information regarding the solvency.* If the income statement and the cash flow statement are currently better barometers of a company's solvency than the balance sheet, it follows that a new approach to the classification of the *current/non-current* items in a balance sheet may be needed. One way to achieve this could be through the determination of attributes of transactions at the time of recording, the time of reporting and also when attributes change in the future.

- *External financial reports: Used more by investors and other groups than creditors.* From this statement one may deduce that the demands and needs of all the relevant users have to be taken into account rather than just the demands of creditors when classifying accounting information. Therefore requirements of users need to be established through, for instance, a JAD workshop, which include standard setters.

- *Demand for favourable working capital ratio: Management is forced to take certain actions. For instance, pay current liabilities immediately preceding balance sheet date.* Because companies strive to meet the demand of the capital markets they tend to take certain actions which may not always have the best interests of users at heart. However, when companies ignore the pressure for a favourable working capital ratio, it follows that more reliable information is revealed in the financial statements, i.e. reclassifications may be minimised.

- *Places pressure on accountants to permit reclassifications to make the working capital appear more favourable. Companies are becoming highly complex and no predetermined working capital ratio can be deemed necessary for adequate solvency.* Predetermined working capital ratios may be of limited use in different sectors, because (for example) companies' operating cycles differ in length. As a result of these pressures on companies, reclassification may be undertaken for the wrong reasons. In this thesis it is argued that reclassification is done based on the fact that the attributes of transactions change over time and, therefore, reclassification becomes necessary at different stages in time, for instance at year-end.

A proposed classification framework for accounting information addressing the above problems is the topic of Chapter 7 in this thesis.

The Accounting Research Bulletin No.30 of 1947 introduced the *current/non-current* classification of assets and liabilities. Currently this practice is still being used in financial statements according to Miller and Bahnson (2002). Since there have been many developments in the financial sector since 1947, the classification framework for accounting information presented in Chapter 7 of this work addresses, amongst others the problem of *current/non-current* classifications. This is done through the identification of attributes and the use of time (i.e. past, present and future).

A precise definition of prospective members to be classified into classes based on their attributes is necessary for accurate classification to take place. In this regard Heath (1978:44) argues that "current assets and current liabilities are so poorly defined that proper classification is difficult for a number of items". Therefore, correct definitions of all the members of a classification framework should be established before proper classification can take place. In essence a classifier has to first identify attributes of transactions and items through an initial measurement as discussed in Section 3.9 before adequate definitions are developed.

Current liabilities as well as *current assets* contain items with a variety of characteristics. Kam (1990) claims that *current liabilities* include the following ill-

sorted components verbatim: 1) financing obligations, such as loans from banks, 2) operating debts, such as accounts payable and wages payable and 3) deferred credits, which in many cases will be discharged by conveying goods or services rather than cash. From the above it may be deduced that financing, operating and deferred items need to be classified separately based on the attributes that distinguish them from each other. Kam (1990) further points out that *current assets* include a number of dissimilar items, namely, cash, cash equivalents such as receivables, non-monetary assets and deferred charges such as unexpired insurance. Picking up on this claim, assume that cash, non-monetary assets and deferred charges all have different attributes. During classification these items will then be divided into separate groups as follows: cash is classified simply as cash, non-monetary assets are classified according to their measurement method and deferred charges are classified according to the future benefits they will yield. Therefore, dissimilar items in *current assets* need to be classified into a number of subclasses where each subclass is defined by the set of similar attributes of its members (refer step 5 of Algorithm 3.2 in subsection 3.8.1). This principle is applied through the use of a normative subframework as discussed in Chapter 7 of this work.

Hendriksen and van Breda (1992) also have the following critique on the *current/non-current* classifications:

- *It assumes that working capital items are closely related to current operation.* Working capital items may not always be closely related to the current operation of a company. For example, current borrowings (part of working capital) used to finance a retail company are not closely related to the current operations of the company, namely, the selling of retail items (e.g. shoes). In essence these differences stem from the fact that items classified as working capital have different attributes from those describing the current operation of the company and should, therefore, be classified differently.
- *Interest receivable, accounts receivable and inventories are all grouped together as current assets although they stem from different operating activities in the company.* Suppose that 1) interest receivable is earned on an investment, 2) accounts receivable includes an amount payable by a debtor who bought redundant computer equipment from the company and 3) inventories are kept

by the company to execute their core activity, namely, to manufacture tissue paper. These three items originate from different operating activities and it follows that their attributes and their subsequent classification may therefore differ, as suggested in Chapter 7.

- *It assumes that long-term assets and liabilities are related to the long-term planning of the company.* This assumption is incorrect, since long-term assets and liabilities are not always related to long-term planning. There are practices where companies use long-term borrowings to finance short-term liabilities, e.g. dividends. The classification of long-term assets and liabilities may need to be based on either the short- or the long-term plans of a company depending on the intention of the company.

The claims made by Hendriksen and van Breda (1992) above are essentially that in many companies, working capital is often not strongly related to the current operations of the company. The classification of items as *current* and *non-current* in the proposed classification framework for accounting information takes the above comments into account when focus is placed on the attributes of transactions in the normative subframework defined in Chapter 7 of this thesis.

When a bank uses the classification of *current assets* and *current liabilities*, they re-classify the items and add other items to the analysis (Gilman 1944). Some figures are written down by the bank while others like the cash value of life insurance are added. This is confirmed by van Tonder (2006); he also adds that banks revalue assets, for instance, livestock for credit granting. Because banks need to reclassify and even add items before they can do an analysis, it follows that the current classification of *current assets* and *liabilities* is not useful and does not facilitate decision-making. Therefore, current classifications for these entities may have to be revised.

The previous section considered various problems with the way information is presented in the balance sheet. The following section takes the next step, namely, suggesting ways in which the information may be reclassified to address these problems.

4.3.2 Towards a reclassification in the balance sheet

Since 1920, various researchers in the literature have suggested reclassifications of assets, liabilities, *current assets* and *current liabilities*. These are elaborated on in the following subsections.

4.3.2.1 Reclassification of assets

In an attempt to address the criticisms against the classification of *current/non-current assets* Wolk *et al.* (2004) suggest a sub-classification of assets. The aim is to supply much needed information about uncertainties regarding realisation and in particular how economic benefits are to be realised:

- Assets held for sale.
- Assets held for use.
- Assets representing deferred charges.

A classification framework for accounting information based on the above may well be able to communicate useful information and indicate the relative risks attached to the realisation of the benefits (Wolk *et al.* 2004). Users will have the benefit of more information supplied to them to enable predictions of the future if they are able to distinguish between assets that will be sold, assets that are still going to be used by a company and assets that have future consequences. The reclassification of assets according to the *realisation of economic benefits* may be needed to enable communication of more useful information to the various users of such information. These issues are addressed in Chapter 7.

Assets need to be classified according to their attributes and to this end Mauriello (1963) suggested a more comprehensive classification of assets based on their attributes as displayed in Figure 4.2. The content of Figure 4.2 is discussed below.
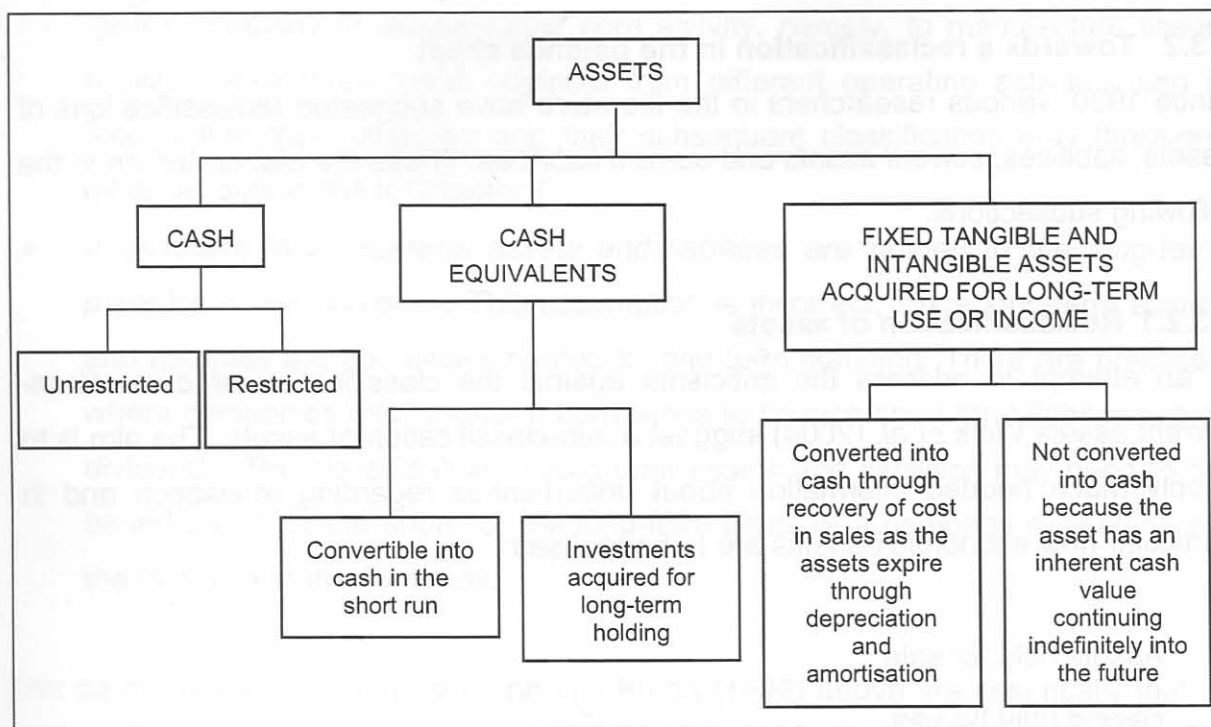
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                              ┌──────────┐
                              │  ASSETS  │
                              └──────────┘
        ┌──────────────┬───────────────┴──────────────────┐
   ┌─────────┐   ┌──────────────┐              ┌────────────────────────┐
   │  CASH   │   │    CASH      │              │ FIXED TANGIBLE AND     │
   └─────────┘   │ EQUIVALENTS  │              │ INTANGIBLE ASSETS      │
                 └──────────────┘              │ ACQUIRED FOR LONG-TERM │
                                               │ USE OR INCOME          │
                                               └────────────────────────┘
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| Unrestricted | Restricted |

| Convertible into cash in the short run | Investments acquired for long-term holding |

| Converted into cash through recovery of cost in sales as the assets expire through depreciation and amortisation | Not converted into cash because the asset has an inherent cash value continuing indefinitely into the future |

Figure 4.2 Classification of assets according to characteristics (Adapted from Mauriello 1963)

According to Mauriello's (1963) classification, assets are partitioned into cash; cash equivalents and fixed tangible and intangible assets acquired for long-term use or income. Taking basic characteristics of assets into account when conceptualising a classification framework for accounting information is one of the properties of classification as discussed in Section 3.6. The use of the two categories of cash, namely, unrestricted and restricted, will enable users to see which cash is available for use in the company. This issue is addressed in Chapter 7 where a classification framework for accounting information is proposed. Cash equivalents are subdivided into convertible in the short run and investments acquired for long term holding. This subdivision allows users to determine which cash will be available in the company for future use. The classification of fixed tangible and intangible assets based on whether they will be converted into cash or not, aims to supply more relevant information that will assist a user in the prediction of future cash flows.

4.3.2.1.1 Reclassification of research and development

Various companies engage in *Research and Development* (R&D) activities to achieve future economic benefits. Research is expected to yield useful results over a period of time and could, therefore, be classified as a deferred asset. Governing

bodies, however, raise the following three, closely related, objections: 1) there seems to be uncertainty on whether the investment made will yield the necessary results, 2) the relationship between expenses laid out and the benefits gained is often not clear, or appears to be absent and 3) it is difficult to measure the future benefit of the proposed research (Solomons 1986). Miller and Bahnson (2002) refer to R&D classification as a practice that started in 1974 and is still in use. To enable the correct classification of R&D all the relevant attributes of the transactions and objections raised above need to be considered carefully when developing a classification framework for accounting information. Example 7.3 in Chapter 7 indicates the various classification possibilities of R&D based on the changing of attributes over time.

4.3.2.1.2 Reclassification of long-lived (fixed) assets to be sold

Fixed assets that are to be sold in the next 12-month period of a company are with current practice classified as fixed assets. However, since these fixed assets have a shorter life expectancy in the company and their liquidity increases during the following year, they should not be viewed as fixed assets. Meeting and Luecke (2002) suggest that long-lived assets (fixed assets) held-for-sale should be reclassified using the following preconditions:

- Management has to commit to the selling of the asset.
- The asset is in a condition to be sold immediately, subject only to the terms and conditions normally in force when selling such an asset.
- The company is actively marketing the asset at a reasonable price, compared to its current fair value.
- A high probability exists for the sale of the asset within one year. Also, the transfer of ownership can be completed in the same year.

The above preconditions are in accordance with the Financial Reporting Exposure Draft (FRED) 32 – July 2003 (Accountancymagazine 2003). Since the original intention of using the asset to generate income has changed to selling the fixed asset it follows that its classification will change. In reclassifying assets to be sold in the next financial period, more useful information regarding a company's economic facts is revealed to users of financial statements. This is because users will be able to see

the decrease in fixed assets based on the intention to sell the assets. This requirement is addressed by the proposed framework in Chapter 7.

4.3.2.1.3 Towards a reclassification of intellectual assets

A number of attempts (Skandia 1994, Brooking 1997, Edvinsson and Malone 1997, Roos, Roos, Edvinsson and Dragonetti 1997, Gröjer 2004 and OECD 2006) have been made at classifying and measuring intellectual assets but some conceptual, methodological and practical difficulties were experienced. Methodological difficulties are experienced as intellectual assets are also known as intellectual capital, intangibles or even knowledge capital (OECD 2006). It therefore follows that it is difficult to classify an item which has different names and no fixed taxonomy. Globally there appears to be no accepted definition or classification of intellectual assets. However, there appears to be some agreement on the following three core characteristics: 1) a probable source of future economic profit, 2) a lack of physical substance, and 3) it can be traded or retained by a company (OECD 2006). Therefore, there is a need to research the attributes of intellectual assets whereafter a comprehensive definition can be developed which will lead to a more fitting classification of intellectual assets.

Some accounting bodies (e.g. FASB, IASB, SAICA) use the term intellectual assets while some researchers (e.g. Brooking 1997, Edvinsson and Malone 1997, OECD 2006) talk about intellectual capital. Hence, further research is needed to establish a classification for *intellectual capital* in order to determine whether these two groups are talking about the same thing or whether they are talking about two different concepts. In this endeavour an investigation ought to be launched to decide whether intellectual capital is current source or future source of funds.

Currently, R&D, patents and trademarks are commonly included in the classification of intellectual assets. However, the definition needs to be broadened to include human resources and capabilities, organisational competencies and relational capital (OECD 2006). The Measuring Intangibles to Understand and Improve Innovation Management (Meritum) project classifies intellectual capital into three classes:

1) Human capital: knowledge, skills, and know how, i.e. that which employees take with them when they leave the company.

2) Relational capital: Resources from outside the company, e.g. customers, suppliers and R&D partners.

3) Structural capital: knowledge that stays with the company when employees leave (OECD 2006).

A possible division of intellectual capital (IC) into various other forms of capital is presented in Figure 4.3.
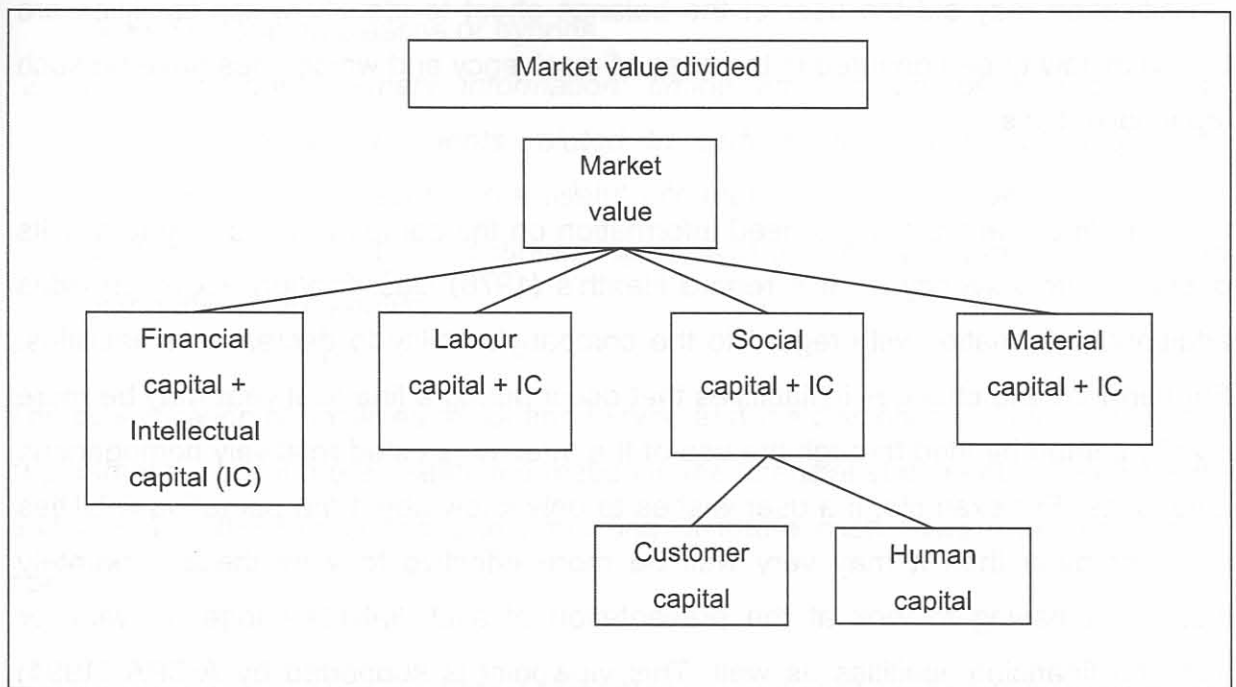

Figure 4.3   A possible division of market value (Source: Gouws 2007)

In Figure 4.3 market value is divided into four classes, namely, financial capital, labour capital, social capital and material. Intellectual capital is included in each of these. Labour capital is viewed as all capital involving employee-related activities. Social capital is viewed as customer-related items, e.g. satisfaction, repeated business, price sensitivity, etc. An example of human capital is knowledge, skills and the abilities of employees that can "leave" the company, while material capital may include items such as brand names, patents, copyrights and so forth.

4.3.2.2 Reclassification of liabilities

Heath (1978) suggests that liabilities be classified into three types, namely, operating, taxation and financing liabilities. If one assumes that the attributes of transactions leading to the classification of liabilities are taken into account, it follows that the classification will differ for the three suggested types. Wolk *et al.* (2004) support Heath's suggestion when they propose the following separate classification of liabilities based on the types listed above: 1) contractual liabilities, 2) constructive obligations, 3) equitable obligations, 4) contingent liabilities and 5) deferred credits. According to Wolk *et al.* (2004) this will enable users to evaluate the inherent attributes of the various kinds of obligations attached to each liability. Such classification may aid the user of the balance sheet to identify which liabilities are bound by law to be honoured in the case of insolvency and which ones have no such legal obligations.

Users of financial statements need information on the company's capacity to pay its debts, i.e. its solvency. In this regard Heath's (1978) classification above provides additional information with regard to the company's ability to decrease its liabilities. Furthermore, the changes in liabilities that occur during a financial year may be more readily comprehended through the use of the three suggested relatively homogenous categories. For example, if a user wishes to only know about the operating liabilities of a company then it may very well be more effective to view these separately instead of having to look at the presentation of such liabilities together with for instance financing liabilities as well. This viewpoint is supported by AICPA (1994) when they state that the users whom they interviewed wish to see a split between core and non-core liabilities. The classification of liabilities according to type may aid in the reporting of more useful information to users of financial statements.

4.3.2.3 Reclassification of current assets and current liabilities

The operating cycles of companies differ and in this regard Hendriksen and van Breda (1992) claim that the *current/non-current* classification does not provide the information needed by users. Their claim is based on difficulties with regard to 1) the interpretation of the operating cycle and 2) the lack of evidence that the *current asset* classification is relevant to any specific user's needs. Hendriksen and van Breda

(1992) call for other classification methods to be researched. They suggest two alternatives:

1. *Classify liabilities based on the type of credit sources available to the company.* If the type of credit sources available to a company is internal capital (funds) and external capital, it follows that more useful information is supplied to users because they can determine whether the company can fund itself through internal funds or if the company has to rely on external credit sources. When liabilities are classified according to the type of credit sources, their different attributes are taken into account and they are partitioned accordingly, resulting in no overlapping classes or hybrids.

2. *Disclose supplementary information: timing and amount of expected cash receipts and disbursements related to certain assets and obligations.* By following this suggestion more useful information will be disclosed to users to enable more accurate predictions, especially if the time and amount of cash in and outflows are known.

The classification of liabilities according to type and the disclosure of information in a supplement present more useful information in the financial statements of a company and assist in the forecasting and predicting of future cash flows (refer to point 2 above).

In a dated reference Gilman (1944:113-114) claimed that "the current classification is not a good classification, considered either on its own merits or from the special viewpoint of accounting". Certain items classified as *current assets* or *current liabilities* need to be excluded from the current classification. In this regard Gilman (1944) suggests that it makes sense to exclude the items in Table 4.1 from the classifications in use:

Table 4.1 Suggestions for the exclusion of items from traditional classification

Item excluded	From
1. Early maturity of a long-term debt	Current liabilities
2. Cash held in anticipation of purchasing a fixed asset	Current assets
3. Receivables from the sale of fixed assets	Current assets
4. Inventories in excess of one year's normal requirements	Current assets

Adapted from Gilman (1944)

The practice suggested by item 1 in Table 4.1 is already employed in financial statements. The classification of item 2, *cash held in anticipation of purchasing a fixed asset* as not being part of *current assets* would lead to a better forecast of cash available for other operating activities. The reason is that companies need cash to replace or expand their fixed assets and this cash usually gets absorbed by other operating activities. Using this classification to earmark the cash may be much needed. The exclusion of *receivables from the sale of fixed assets* (item 3) from *current assets* is necessary because it does not usually form part of the core activities of the company. When inventory, item 4, is used during a period that is longer than the operating cycle of 12 months, a classification other than current is needed (refer to Section 4.3.2.3.1). Suggestions 2 and 4 in Table 4.1 are taken into account in Chapter 7 in the proposed classification framework for accounting information.

It is plausible that a classification framework that supplies more useful information to the users of financial statements than the *current/non-current* classification could be defined. In this regard Heath (1978) also calls for an alternative to the *current/non-current* classification, aimed at providing more useful information for evaluating a company's solvency. Heath's recommendations are summarised below:

1. *Attributes of specific assets and liabilities should be disclosed as a supplement.* Supplying additional information like attributes (for example core, restricted, deferred, etc.) may guide users in their decisions but one should guard against information overload.

2. *Sources of credit available to companies may be used as a basis for the classification of liabilities.* Hendriksen and van Breda (1992) both put forward this recommendation, and it is discussed in the first paragraph of this

subsection. Users may need this information to enable them to predict the company's future as they will be able to see if the company uses internal or external sources of funding.

3. *The traditional method of asset classification according to their order may still be used but not classified as current/non-current.* The order for classifying assets is currently based on either increasing or decreasing liquidity. According to Wolk *et al.* (2004) the current liquidity measurement is a very coarse metric. Nevertheless, in the absence of a better technique, the classification of assets according to liquidity, either increasing or decreasing, can still be used provided one has a correct measure of liquidity.

The above recommendations suggest a revision of the *current/non-current* classification and this is in part the topic of Chapter 7.

4.3.2.3.1 Reclassification of inventory

In 1944 Gilman (1944) proposed that fixed assets and inventories be classified as deferred charges to revenue. His argument was that both represent a credit facility, namely, future revenue that could be used to cover present costs. When classifying fixed assets as deferred charges to revenue, one should take into account that only fixed assets used in the operations of the company may yield future revenue to cover the costs. Inventory may be classified as a deferred charge to revenue as it will most certainly be sold in future, resulting in revenue to cover the present costs with the exception of obsolete stock. Fitzgerald (1951) argued that inventory should be classified as fixed assets rather than as *current assets*. If inventory is to be classified as a fixed asset, only a portion will be viewed as fixed since a company always needs a minimum inventory level to carry on with its operations. Fitzgerald (1951) also views inventories and plant as charges kept over to be covered by future income which should therefore be classified in the same way. The idea of the reclassification of inventory as fixed assets is shared by Kempner (1960) based on the fact that a company needs to have a minimum inventory level to operate. This classification will be accurate if the items are valued at cost. Kempner (1960) suggests that inventory be classified directly below *current assets*. For the sake of argument, minimum level inventory, slow moving inventory and finished goods all have different attributes which may result in a different classification. The classification of inventory needs to

be done in accordance with its defining attributes, using the proposed initial measurement in line with Corollary 3.2 in Chapter 3.

4.3.3 The liability-equity debate

There is an ongoing debate as to whether some financial instruments should be classified as equity or as liabilities since they possess characteristics of both. The FASB (2003), in their FAS 150, provide some guidelines in this regard but there are researchers (e.g. Clark 1993, Forker 2003, Balsam 1994, Bohan 2003, Kirschenheiter, Mathur and Thomas 2004) who have questioned the outcome of these guidelines. Some of the items in question have attributes of both equity and liabilities, hence a possibility may be to create an entirely new class in which such items may be placed, since items classified together need to have the same attributes and may not share attributes of two or more different classes.

The FASB (2003) oppose the creation of a new class. They argue that before FAS150 was issued, the statement of financial position classified certain financial instruments between the liabilities and equity section. Concept Statement 6 does not permit classification outside the classes of assets, liabilities, and equity. If an item does not fit into a class, it would necessitate that the Board define a new element in the financial statements. However, the Board decided not to follow this course of action, partially because, among other concerns, an undesirable precedent would be created where classes are added whenever new instruments are developed that are difficult to classify. In essence therefore the FASB (2003) warns against following an easy route by simply classifying an item into the new class whenever it becomes difficult to choose between equity and liabilities. However, the classification of the FASB rests on the current accounting equation 3.1 which may need to be revised to include a new class. In July 2003, the FASB (FASB 2004) launched phase 2 of FAS150 to reclassify single-component financial and other instruments. They make the distinction between equity and liabilities based on both the following characteristics: 1) whether it has a settlement requirement and 2) whether it is an ownership instrument. They classify perpetual instruments, direct ownership instruments and indirect ownership instruments as equity and all other instruments as liabilities or assets. The fact that the FASB is developing FAS150 in phases may also lead to classifications which may be more adequate, since a phased development

allows for iteration and a possible revisit of previous decisions, hence a better outcome.

According to IAS 32 (AC 125) "the issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definition of a financial liability, a financial asset and an equity instrument" (IASB 2004:para 15). Coupled with this claim is the view that it may be scientifically justified to extend the current accounting equation 3.1. The IASB (2004) guideline recognises that an *initial* recognition is to be applied to the item to be classified, in essence agreeing with the initial measurement proposed in Chapter 3 of this thesis (refer to Corollary 3.2).

Accountants are obliged to disclose the nature of the elements of a company's capital structure to enable users to evaluate (Clark 1993):

- how debt and equity instruments will influence the availability and allocation of a company's resources;
- the gearing, return on equity and the cost of resources and
- the risk and uncertainty on the company's value (FASB 1978).

Naturally in the classification of items belonging to the classes of equity or liabilities or even a new class between these, it is of the utmost importance that the needs of users of financial statements ought to be taken into account.

Whether an item is classified as a debt (i.e. a liability) or equity has an impact on the cash flow, value and risk of a company. According to Clark (1993:15) financial economic literature provides a basis for the following conclusions:

- Capital structure affects future cash flow: therefore, the distinction between debt and equity is important to users for decision-making.
- Options on a company's own shares are liabilities.
- Preferred shares are a liability in most cases.

- Separating compound instruments into fundamental financial components has information content.

The distinction between debt and equity is of importance to users of financial statements since they base their decisions on the future cash flow of a company which in turn is influenced by the company's capital structure.

Components of the capital structure of a company have an impact on the cost of capital of a company. According to Clark (1993:22), the capital structure of a company has a "long-run" influence on the future cash flow of a company and will, therefore, influence distributions to investors. Hence it is important that items be classified as uniquely as possible and not forced into a particular category. This may necessitate the creation of a new class for the classification of items with characteristics of both equity and liabilities i.e. items which do not fit exclusively into the class of either liabilities or equity.

The FASB suggested that, in order to supply useful information to users regarding liquidity (a liability may have a liquidity level) and ownership (part of equity), there needs to be a classification based on ownership criterion and settlement criterion (FASB 2003).

Next some examples of items with characteristics of both equity and liabilities are presented.

4.3.3.1   Items with characteristics of both equity and liabilities:

In this section two such items are discussed, namely: 1) redeemable preference shares and 2) outstanding employee stock options (ESOs).

4.3.3.1.1 Redeemable preference shares

A practice applied constantly by financial managers is the attempt to keep debt off the balance sheet. One relatively new example of this is redeemable preference shares. In essence these may be viewed as debt trying to pass as owners' equity. Nair, Rittenberg and Weygandt (1990) together with the SEC (Securities and Exchange Commission) propose that it is a liability based on the "mandatory

redemption feature". Hence redeemable preference shares currently fit into a so-called no-mans land (Wolk *et al.* 2004: 343) and may be an ideal candidate to be classified into a third in-between class.

4.3.3.1.2 Outstanding ESOs (Employee Share Options)

According to the IASB's (2004) IF2 BC, outstanding ESOs are classified as equity. Balsam (1994), Bohan (2003) and Kirshenheiter *et al.* (2004) regard outstanding ESOs as liabilities. "An equity instrument is only issued on the exercise date as opposed to the grant date" (Sacho and Oberholster 2005:94) and ESOs are therefore to be classified as liabilities because these reflect the economic substance of ESOs best. Although the IASB's classification of ESOs as equity is consistent with its conceptual framework, it has the disadvantage that it fails to comply with its stated objectives of providing transparent and comparable information to the users of financial statements (Forker 2003). Paying the employee creates a potential obligation and therefore ESOs need to be classified as liabilities.

The conventional finance relationships in terms of the level and growth of profitability and cash flows are maintained when outstanding ESOs are classified as liabilities (Kirschenheiter *et al.* 2004:137). The classification of ESOs as liabilities provides economically reliable and useful accounting information to investors and shareholders, but is in contrast with SFAS 123 and 128 which suggest the classification as future equity holders. The classification as equity distorts the financial statements (Kirschenheiter *et al. 2004)*. They base their argument on three reasons: 1) the deferred taxes associated with the ESOs are treated as liabilities, 2) diluted EPS is based on intrinsic value rather than fair value, and 3) the implicit cash flows paid to option holders at exercise are never recognised. There are two issues to be considered in the classification of ESOs: 1) time with regard to future equity holders, and 2) the capitalistic model, which regards current shareholders as the only "owner".

In the next section focuses on classification issues in the income statement.

4.4   Classification in the income statement

It is general practice to partition the income statement into two categories: *above-the-line* representing operating income, and *under-the-line* representing non-operating income (McKee 2005). The items classified *under-the-line* may affect the valuation of the shares of a company. According to Ellis and Williams (1993), when the Accounting Standards Board (ASB) issued Financial Reporting Standard (FRS) 3, companies were no longer able to smooth Earnings Per Share (EPS) by moving unusual items below the line or using their own discretion on which items are exceptional and which are extraordinary. The classification system of accounting should not allow for income smoothing. An analysis of income smoothing and big baths and their effect on the integrity of information portrayed in the financial statements is presented by van der Poll (2003). Classifying items above-the-line and then again under-the-line according to the needs of the company management may not be in the best interest of users as any classification of accounting information needs to be done objectively and not on the basis of subjective intentions.

Revenue is currently classified according to time and actions, namely, 1) during production, 2) when the product is completed, 3) when the product is sold, and 4) when cash is received (Wolk *et al.* 2004). When the classification of an item is made on temporal attributes it needs to be disclosed as additional information to users as it may guide them in their decisions. The classification of costs is based on the matching assumption. Wolk *et al.* (2004) state that, if possible, costs are matched with revenue directly produced as a result of the cost. If there is an indirect cause-and-effect relationship, then cost is matched in a relational and systematic manner. Lastly, costs are classified as period expenses if there is not even an indirect cause-and-effect relationship. Relationships and attributes are the building blocks of a classification framework, as stated in Chapter 3.

The classification of items as expenses (an outlay that cannot be directly related to the core activities of a company) or as costs (a sacrifice made by a company when conducting their core business) influences the net income of a company. Hendriksen (1982) indicates that net income may be presented as: 1) value added, 2) company income, 3) net income to investors, 4) net income to residual equity holders, and 5) net income to shareholders. The presentation of net income is

influenced depending on whether deductions from income are seen as expenses or income distributions. In a proposed classification framework for accounting information, deductions from income need to be clearly identified as expenses or income distributions (costs) to enable the correct presentation of income. This classification model is developed in Chapter 7 of this work.

Costs and revenues may be classified using different methods. Thacker (1962) suggests the following useful methods of classification of costs and revenues:

1. *Functional classification: The classification of costs and revenues are based on how they influence the final product.* Since companies have activities that can be divided into core and non-core activities it follows that the classification of costs and revenues according to their influence on the final product may lead to a financial statement containing information that is much more useful to the user. In this thesis the functional model of the income statement is used.

2. *Object classification: Costs and revenues are classified based on the type of expenditure or revenue. The income statement in which such classification manifests is called an object income statement.* Further consideration of an object income statement is beyond the scope of this work, since in this thesis an accounting classification for the functional model of the income statement is developed in Chapter 7 (see also point 1 above).

3. *Management efficiency classification: Shareholders choose a management which will, in their opinion, maximise profits and return on investments.* This statement claims that shareholders will invest with a company whose management displays an ability to maximise profits. The maximising of profits can take place, quite possibly because different classifications for different purposes are employed by management.

Any of the functional, object and management efficiency classifications for the income statement can be taken into consideration when the proposed classification framework for accounting information is developed, but in this thesis the functional model is chosen in Chapter 7.

happens because the acquired service assets have been consumed, thereby decreasing the entity's equity (IASB 2004). Share-based compensation has an inverse relationship with the company's share price, indicating that investors recognise such compensation as an expense (Aboody, Barth and Kasznik 2001:2-3).

The granting of share options to employees is an internal transaction since no outsiders can participate and, because ESOs can never be sold, they cannot be recognised as expenses (Derieux 1994:41). According to Sacho and Wingard (2004), this statement by Derieux (1994) is unsubstantiated because employees of a company and even its shareholders are separate from the company. Companies are seen as separate legal personae that exist apart from their shareholders and employees in most countries.

In the following section, the view of analysts on accounting classification and, in particular, the reclassifications done by analysts are discussed.

4.5 Analysts and the classification of accounting information

In accounting, accounts are divided into three categories: assets, liabilities and owners' equity (refer equation 3.1). If an account does not fit into any of these categories, Sprouse (1966: 45) calls the account a "what-you-may-call-it". According to Sprouse (1966), analysts who determine whether these accounts are contra assets or an element of stockholders' equity, and who reclassify these accounts are almost certain to have less information than the accountant in doing so. It may be deduced that this reclassification of accounting information is necessary because the known attributes of items or transactions are not taken into account when the items are classified. Therefore, a classification framework for accounting information that takes attributes of items and transactions (as proposed in Chapter 7) as well as users' informational needs into account is a possible solution to the problem of erroneous reclassifications or items not fitting into a specific category.

Analysts often reclassify accounting information to be able to perform a different analysis of the said information. Naturally they need precise assumptions when they reclassify the information to enable them to correctly interpret the content of financial statements (Stickney et al. 2004). Stickney et al. (2004) continue by claiming that, if

analysts cannot make assumptions that are reasonably precise they should resist the temptation to make or use any such assumptions. Analysts should be aware of the differences in the classification of accounts when interpreting the analysis based on the financial statements of a company. Since analysts rely on the information supplied to them for the analysis of financial statements, a comprehensive classification framework for accounting information that supplies additional information, for example, operating cycles and even the attributes used when the classification took place, may result in analysts having to make fewer assumptions and reclassifications.

Accountants tend to be more conservative when confronted with uncertainty. For example, when an exceptionally high income is expected an accountant may decide to delay the display of such an amount in the financial statements until its realisation is certain. However, such conservatism tends to result in a lack of good quality information for the analysis of financial statements (Stickney et al. 2004). This idea is supported by Miller and Bahnson (2002) since they suggest that quality financial reporting should entail more complete information to reduce uncertainty, as described in Section 3.4. A possible solution to this uncertainty is to reveal on a pro-rata basis the uncertain items in the classification framework (e.g. if the probability of the realisation of an exceptionally high income in the above case is 20% (say), then only 20% of the expected amount is displayed and classified as income), or, as suggested by Miller and Bahnson (2002), the inclusion of more complete information.

According to Higgins (2004), there is a difference between economic and accounting earnings, leading to a valuation problem and resulting in possible misrepresentation of earnings and market value information of a company. Although the financial statements have their limitations, they may still prove to be a good foundation for the analysis of a company's information (Higgins 2004). Assuming that all known and relevant attributes of transactions are taken into account, it follows that differences between economic and accounting earnings may be addressed effectively. Therefore, the classification framework for accounting information developed in Chapter 7 takes the attributes of transactions into account as well as the requirements of more than one group of users.

Share prices of companies are influenced by many factors. According to Lev and Thiagarajan (1991), quality adjusted earnings for non-sustainable gains and losses provide a better explanation of changes in share prices than reported income. Since earnings are adjusted for non-sustainable gains and losses, it follows that investors who adjust the financial statements, reclassify certain information to reflect economic reality. For the sake of argument, non-sustainable gains and losses could have the attributes which classify them as exceptional or non-core earnings, and thereby lessen the necessity to reclassify the information. Therefore, accounting information that is classified according to the known attributes of transactions may provide information that is more useful to the user.

The emphasis of analysts has moved from which items are classified as working capital to how much cash will be received and when, according to Heath (1978). This view is shared by Schroeder *et al.* (2005) when they claim that the total of *current assets* reveals the amount of cash that might be received in the next financial year. However, the user has to decide how much will be realised based on his or her own judgement. Classifying according to cash and cash realised is encouraged by Mauriello (1963) and Wolk *et al.* (2004). Since a company has first-hand information on when and how much cash will be received, it follows that analysts may benefit from the classification of items according to the time of realisation and the amount realised. This may be achieved when attributes of transactions are taken into account at the time of recording (past) and revised at the time of reporting (present and future).

Next the problem of classifying financial information for window dressing purposes is discussed.

4.6 Classification for window dressing

Window dressing in the financial statements may influence the integrity and quality of such statements. Griffiths (1995) states that the preparation of financial statements is often based on subjective judgements that influence the quality of the final product, despite enhancements and positive improvements made to accounting guidelines. Such subjectivity may lead to window dressing in the financial statements of a company through the classification of accounting information. "It is not just the figures

themselves which can be adjusted to suit a company's particular requirements. For the creative accountant the way the numbers are packaged can also have an important influence" (Griffiths 1995:1). When figures are classified in different ways, the outcome can be seriously affected and so are decisions, e.g. the integrity of information based on book entries may differ from the integrity of information based on real transactions. Book entries are used to classify figures in different ways and may be used to classify accounting information in such a way that the figures appear more favourable for the company (van der Poll 2003). Therefore, a classification framework for accounting information which takes the attributes of transactions into account could have as an aim the reduction of possibilities of classification for window dressing.

The creative accountant may use many different techniques, namely, "delay and defer", or "accelerate and allocate" (Griffiths 1995:187; Mulford and Comiskey 2002). The first technique pretends that there is no cash around, while in fact there is cash available. The second technique creates the illusion of available cash, while in fact there is no surplus cash. This phenomenon is reminiscent of the first law of Newtonian physics which states that matter and energy cannot be destroyed; neither can it be created if it did not exist in some or other form beforehand (Halliday, Resnick and Walker 1997). The cash flow of a company is arguably one of the best barometers in assessing a company's financial health since no amount of window dressing can influence the absence or availability of cash. It is plausible that a classification for accounting information revealing the *real* cash flow of a company may help to prevent this kind of window dressing.

Companies like to treat long-term funding i.e. off-balance-sheet finance and borrowings, as equity rather than debt because it has positive implications for the gearing ratio of a company (Griffiths 1995). It may be deduced from this claim that companies can classify items based on their own intentions rather than on good practice even though it is not in the best interests of the user. Therefore, a classification framework for accounting information may aim to diminish the ability of management to decide where to classify an item simply to allow for a better financial picture to be reported. Companies can inflate their cash position by deferring payments or classifying payments to the next financial year. These payments can

include staff bonuses, redundancy payments or paying creditors without sending out the cheque (Griffiths 1995). Since the deferring of items is also a way of classification, deferred items need to be classified separately in the financial statements to enable users to identify future-related items.

Quality financial reporting should portray all the important details of a company and its operations. Miller and Bahnson (2002) prescribe that financial reporting should be done concretely, i.e. no important details should be left out. Reporting should also be done at the time when a transaction occurs. Both these two requirements facilitate sound financial analysis. In particular, the smoothing of financial information should not be performed to enhance the financial health of a company, but if it does become necessary to smooth information, then analysts should be the people responsible for applying any smoothing operators on the financial information (Miller and Bahnson 2002). Classification ought not to be used for the enhancement of company figures and, therefore, a classification framework for accounting information needs to take time, i.e. past, present and future into account. This is one of the topics of Chapter 7.

4.6.1   Creative income statement classifications

The process of classificatory smoothing is discussed by Riahi-Belkaoui (2004). It is the process of smoothing income statement statistics other than net income; such activity can reduce variations over time in the income statement statistics of the company. Classificatory smoothing is done by management when they classify intra-income statement items. An example of intra-income classificatory smoothing is when the recognition of income is deferred from a particular year to the following year. The classification of transactions should take place as and when they occur based on the known attributes at the time of recording, and reclassification may take place as time passes and attributes change or more attributes become known.

The manipulation of a company's earnings is not a good practice and may be suspected by the market and users. Kam (1990) opposes what is called earnings manipulation. Generally, analysts and markets are not easily misguided by the devices of management to display economic facts to suit their own goals. An example of earnings management is reporting a subsidiary's acquisition as the pooling of interest instead of as a purchase. Another example is when expenditure is

capitalised instead of being recorded as an expense. Earnings management is, however, in line with GAAP but the manipulation of earnings is not supported by GAAP (Stickney *et al.* 2004). Earnings management is when management chooses accounting policies within GAAP to maximise earnings whereas the manipulation of earnings is viewed as a way to misrepresent earnings in ways outside of the scope of GAAP. The manipulation of financial information may need to be prevented or at least diminished by the development of a high-quality classification framework for accounting information.

The "financial numbers game", as it is called by Mulford and Comiskey (2002:37) manifests in various forms. In the financial statements, numbers may be reported in such a way as to portray another message regardless of how the transaction was recorded. For example, companies may classify nonrecurring gains as *recurring* to enable the reporting of higher earnings. In this context a nonrecurring gain is seen as a once-off opportunity or gain which will not occur again in future. The opposite, namely, when a nonrecurring loss is classified as *recurring* to lower the earnings of a company, also happens. Analysts may subsequently be prepared to exclude the loss from core earnings (McKee 2005). When a company wants to protect their earnings, they make use of provisions where-after the cash flow statement partially reveals the effect of provisions on the profile of a company (Griffiths 1995). The misuse of provisions and nonrecurring gains may be reduced if a classification framework for accounting information presents book entries more prominently. This is addressed in the normative subframework presented in Chapter 7.

The reporting of unusual items in the financial statements is governed by GAAP, and should be classified as part of continuing operations (McKee 2005). Management may, however, disagree with GAAP, and stay with the practice of disclosing unusual items as unusual. The rationale behind this decision is that analysts may view unusual items as not having any effect on the future operations of the company. Earnings management is made possible by the "number of grey areas in classifying" (McKee 2005:173). An example of a grey area is given at the beginning of this paragraph, namely, unusual items classified as part of continuing operations according to GAAP, but not agreed on by management. The so-called "grey areas" in the classification of accounting information is addressed in the proposed

classification framework for accounting information through the use of attributes to classify transactions.

Window dressing takes place in the income statement when individual items are classified under different subheadings, resulting in the changing of important sub-totals and manipulating the users' perception of the financial health of the company (Mulford and Comiskey 2002:295). Table 4.2 presents some examples of the process of classificatory smoothing:

Table 4.2 Classificatory smoothing in the income statement

Smoothing operation	Result
Item moved to or from operating expenses.	Increase or decrease in operating income.
Expenses moved from cost of sales to selling, general and administrative expenses.	Increase in gross profit.
Operation sold at a gain – out of discontinued operations. Operation sold at a loss – into discontinued operations.	Higher levels of income from operations.
Gains or losses classified as extraordinary.	Target level of income from continuing operations is met.

Adapted from Mulford and Comiskey (2002).

If classificatory smoothing is based on the intentions of management it follows that the diminishing of classificatory smoothing will not easily be brought about by a classification framework. For example, under current practice a company has the freedom to interpret GAAP in two ways, for example, because of non-strict rules as indicated by the first row of Table 4.2. This row suggests that an item, for example, an administrative expense, may be classified either as part of operating expense or not. However, creative income statement classifications can be reduced when the framework is built on the classification of transactions based on the relevant and known attributes.

4.7 Classification through the use of time

Time plays a crucial role in accounting. Events from the past are recorded in the current financial statements, and management uses these figures to predict the future. "The many transactions whose effects are reported in the balance sheet or

which themselves are reported in the income statement or statement of retained earnings are all, at the balance sheet date and at the date investigated by the auditor, past events" (Mautz and Sharaf 1961:82). In this thesis three (accounting) time zones, the past (recording), the present (reporting) and the future (events that have future effects at date of reporting) are addressed. "The past is based on reality (i.e. transactions, events and occurrences that already took place), whereas the future is based on mind creation. The integrity of information based on reality and the integrity of information based on a creation of the mind may therefore differ in quality" (Van der Poll 2003:48). In a classification framework for accounting information, time may need to be taken into account as attributes of transactions may change over time, leading to reclassification at the time of reporting.

Figure 4.4 indicates various timelines, namely, the past, present and future, that exist in accounting transactions. However, these temporal attributes are largely ignored in present accounting practices, resulting in different values and unlikely items being grouped together.

ARROW OF TIME PRESENT		
	PAST	FUTURE
Created by Accounting Phenomena	• Real (pure) events • Physical happenings • Occurrences • Transactions	• Artificial (non) events • Simulated happening • Predictions • Contingencies • Allocations • Provisions and reserves
Method	• Double entry (DE)	• Book entry through DE
Orientation	• Matter-orientated • Resource flow-orientated	• Mind-orientated • No flow
Outcome	• Certainty	• Uncertainty
Paradigm	• Accountability	• Decision usefulness

Figure 4.4   Accounting's time paradigm (Gouws 2003)

The past is certain; it is measurable and in accounting it is based on transactions. The future is uncertain; it is not measurable and it contains no transactions (only artificial transactions). Uncertainty about the future has its origin in the present. The integrity of yesterday's information is much higher than the integrity of information about the future (van der Poll 2003). These three time zones are reflected in the proposed classification framework for accounting information presented in Chapter 7, and are further elaborated on below.

Revenue recognised prematurely in the income statement may lead to the influencing of expectations about earning power (Mulford and Comiskey 2002; McKee 2005). Since transactions need to be classified as and when they occur, a classification framework for accounting information has to take the effect of time into consideration. For example, a classifier may need to identify attributes relevant to the past (recording of a transaction), the present (reporting) and transactions with future consequences.

The proposed classification framework for accounting information developed in Chapter 7 has a temporal component since a transaction is analysed for possible past, present or future effects using its attributes.

4.8 Summary and conclusion

A critique on the presentation of accounting information in financial statements has been put forward together with a discussion on the reclassification of information at year-end. The specific problems with regard to classification in the balance sheet are numerous and widespread. The biggest problems in the balance sheet seem to be the liquidity concept together with the *current/non-current* classification owing to the different valuation methods and time frames. Some authors called for selected reclassifications, and analysts also made a contribution. The reclassification of assets, liabilities, *current assets* and *current liabilities* has been suggested. A call for the reclassification of inventory was also made, based on the idea that it is a deferred charge to future income. An exposure draft developed to suggest the reclassification of fixed assets to be sold in the next 12 months after the balance sheet date was discussed. This will undoubtedly lead to fewer problems with the classification of accounting information in the balance sheet.

A discussion aimed at the reclassification of intellectual assets led to the question of whether intellectual assets and intellectual capital is the same item. This question presents a need for further research in this area. The liability-equity debate was also highlighted in this chapter, and the conclusion reached was that there are some items with characteristics of both equity and liabilities which may suggest the need for the development of a new class in the accounting equation (3.1). Specific reference was made to redeemable preference shares and outstanding ESOs.

The income statement has classification problems related to accrual accounting and matching. A reclassification of ESOs as expenses was discussed and argued for in contrast with the equity view of the FASB. It is shown that analysts have to reclassify the information portrayed in the financial statements before they can do a meaningful analysis of the company's information. A proposed classification framework for accounting information may reduce the problem of window dressing in financial statements. Classificatory smoothing is one of the instruments used by management to send different messages to users of the financial statements, and this ill practice may also be alleviated through a proposed classification framework for accounting information. The use of time in accrual accounting and matching also leaves a loophole for the smoothing of information, and a proposed classification framework for accounting information should address this problem.

Chapter 5, which follows next, is a discussion on the research methodology used in this thesis.