Statement 14: The accountant’s classification may preclude or inhibit others from using much-needed information (Goldberg 2001:42)

![Response to Statement 14](image)

**Motivation:** This statement follows from a claim by Riahi-Belkaoui (2004:364) with regard to the conventional accounting model: “Its classification schemes are not always appropriate. The chart of accounts for a particular enterprise represents all of the categories into which information concerning economic affairs may be placed. This will often lead to data being left out, or classified in a manner that hides its nature from nonaccountants”. According to Miller and Bahnson (2002), information supplied in GAAP financial reports do not provide information which users need and this may be based on the way the information is classified. The objective of financial reports is to provide useful information, but if it is classified in a manner that hides the nature of the data or even omits data, then the objective may not be reached.

**Discussion:** The response to this statement indicates a need for a proposed classification framework for accounting information, with 55% of the financial managers, 53% of the analysts and 63% of the academics agreeing with the statement. Goldberg (2001) gave the following simple example: A person buys a filing cabinet for $500 from a company. Some users may need information on the
colour, number of drawers, size or even the manufacturer of the cabinet, while other users may need information about the selling price or even the replacement price, to give just a few possibilities. (Note that these features of a filing cabinet may be viewed as attributes that the cabinet has). The message conveyed by this example is that some information is discarded when classification takes place. Wheatley (1993) also states that information is lost when it is collected and organised since the observer focuses on the accuracy and loses part of the information when choosing some aspects and ignoring others. In accountability one observes the past and its relationships whereas decision-making observes the future and its relationships. This may lead to the drawing up of a balance sheet and the supplying of additional information to the users to enable them to make their own classification based on their own needs.

The AICPA committee (AICPA 1994) calls for more user-friendly information reporting. However, in the list of responses to this question, a financial manager argued that, because of the complexity of accounting statements it does not matter how information is classified: it is becoming less meaningful for the investor in any case. This response seems to imply that a comprehensive classification framework satisfying all the needs of all the users may not be the way to go; neither is the introduction of two or more different classifications. Another solution may be to take a distributed union of all needs of all stakeholders and remove conflicting requirements. This is the approach advocated in this thesis (refer to Example 1.1).
Statement 15: Definitions of classification should change when the needs of society change (Heath 1978:52)

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</table>

Figure 6.18 Response to Statement 15

**Motivation:** In this thesis it is argued that classification is performed for reasons of accountability or decision usefulness. The semantics and awareness created by these concepts are functions of society. For example, as the needs of society change, the degree to which a certain piece of accounting information is useful or not, also changes. The same may hold true for the semantics or even the definitions of these two concepts. Heath (1978:52) has the following to say about definitions: “A definition is a means of identifying the partitioning attribute or attributes of a class of items, concepts, qualities, or events”. In essence, society may attach different definitions to the same concepts over time. Hence classifications may change over time.

**Discussion:** A total of 59% of financial managers, 73% of analysts and 77% of academics agree with this statement. The positive response may be as a result of the fact that respondents understand that the classification system for accounting information should be flexible to accommodate various interest groups. Part of the driving force behind classification is to satisfy the needs of the user of financial
Chapter 6 – Results of the research

statements. Heath (1978:52) used the example of human death to explain the change in definition. For clarity the author includes the following non-accounting example: a new definition of death was essential when society had to decide when a vital organ could be removed for a transplant from a dead body. Society’s needs changed and, therefore, the definition needed to change. The same may hold for definitions in accounting.

The responses to Statement 4 (new types of transactions emerge continually, rendering the current classification system inadequate) appear to contradict responses to Statement 15. A possibility is that respondents could not construct scenarios where new kinds of transactions (as in Statement 4) would necessitate changes (additions, deletions and amendments) to present classification mechanisms, but could easily foresee situations where changing societal needs necessitate change. This result (i.e. negative response to Statement 4 but positive response to Statement 15) may indicate a shift from technical awareness to issues of humanity in the South African context.

Statement 16: Presenting accounting information to assist in determining relevant relationships forms part of ascertaining the truth (Goldberg 1964:6)

![Response 16](image)

<table>
<thead>
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Figure 6.19 Response to Statement 16
Chapter 6 – Results of the research

Motivation: Financial managers as well as analysts need to be reasonably certain of the truth when analysing the statements of a company and when predicting the future. In a way this statement makes a claim which may be regarded as an obvious consequence of determining relevant relationships among entities. A relationship that indeed exists between two entities certainly brings about new knowledge of the system and, therefore, contributes to establishing a larger body of true claims about the system, i.e. it ascertains truth.

Discussion: A total of 71% of the financial managers, 88% of the analysts and 75% of the academics agree. Respondents seem to recognise the importance of establishing true relationships. There may be too many relationships among accounting entities to reveal them all but great care and effort should be exercised to discover those relationships which have the largest impact and relevancy. Gordon (1999:1) states that the process of classification is involved in the exploration of relationships among a “set of objects” to enable the confirmation of whether or not the data can be represented reliably in a small number of classes of related objects. The objective of classification is to reveal relevant relationships which in turn will reveal the truth, thereby changing data into information. The positive responses to this statement are rather similar to that of Statement 8, namely, classification is a way of making meaningful relationships visible, which was very positive.
Chapter 6 – Results of the research

Statement 17: New classifications must be developed to facilitate any new statements

![Response 17 Diagram]

**Figure 6.20** Response to Statement 17

**Motivation:** There may be two schools of thought on this idea. On the one hand there may be those who believe that current classifications ought not to be changed and that any new statements brought about by policy or otherwise should be forced into existing structures. On the other hand there may be groups who believe that new structures are necessary to accommodate new statements. The idea of Statement 17 was to determine how respondents feel about these two alternatives.

**Discussion:** A total of 70% of the financial managers and 55% of the academics agree whereas only 34% of the analysts agree. Accounting is in a process of continuing renewal, resulting in classification being an ongoing process. In retrospect, however, this question could have been interpreted in a number of ways: The phrase “new statements” in Statement 17 could refer to 1) new statements of GAAP or 2) new financial statements, e.g. a new kind of income statement or 3) any new GAAP-like statement that is needed to make new information more useful. The income statement may need to be revised according to AICPA (1994:50) because changes in the environment “threaten the relevance of financial statements”. Revised
new statements, for instance, deferred taxation, could lead to the development of a new way to classify deferred taxation.

**Statement 18: Classification principles should be disclosed**

![Response 18 Diagram](image)

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**Figure 6.21**  Response to Statement 18

**Motivation:** To enable users of financial statements to use the information contained in the financial statements for decisions, they may need to know which classification principles were used. If a user assumes that a certain classification principle was used which may not have been used, it could lead to a misinterpretation of the information.

**Discussion:** A total of 80% of the financial managers, 100% of the analysts and 71% of the academics agree. The positive response indicates that there may be a need to disclose the classification principles that were used. For example, when a relationship is revealed, the principle on which it relies ought to be disclosed as well, leading to the creation of new knowledge. If a user knows which classification principle was used, more meaningful decisions may be inferred. Otherwise, the user may take a decision based on an incorrect idea, assuming the use of a different classification principle.
Motivation: This statement attempts to determine whether different classifications ought to be used for intentions which are in contrast with normal business practices. In some cases the accounting practice has already been amended to make provision for such alternate classifications. Two examples are in order: suppose that at year-end a company knows that a fixed asset is going to be sold within the next 12 months. Therefore, the fixed asset should be disclosed as a non-current asset to-be-sold (directly after the other non-current assets still held for use) if based on the company’s intention. Another example is where the current portion of a long term liability is shown as a current liability based on the intention to repay this amount within the next 12 months.
**Discussion:** The general response was positive as 69% of financial managers, 64% of analysts and 80% of academics agreed. When a decision to classify an item is based on an intention, the result may differ from a classification of an item based on normal business practices. According to the Company Act 1973 (Butterworths 2006), any excessive provision should be regarded as a reserve instead of a provision when based on the correct intention.

**Statement 20:** Working capital classifications are not indicators of success

*(Beaver 1968:117)*

![Response 20](image)

Figure 6.23  Response to Statement 20

**Motivation:** In an analysis of results by Schroeder *et al.* (2005:264), they point out the "weakness of evaluating a company's liquidity by focusing solely on its working capital position". The success of a company may also be measured according to the liquidity of a company. If the liquidity of a company cannot be established based on the working capital position alone, it may not be a good indicator of the success of the company.

**Discussion:** Only 49% of the financial managers and 50% of the analysts agreed whereas only 46% of the academics agreed. Beaver (1968) conducted research on
which ratios are indicators of success. He found that the ratios based on the current classification are not the best indicators. Therefore, working capital classifications may not be good indicators of success; neither would the current ratio that is based on this classification serve as an indicator of success. Heath (1980) also seemed to suggest that working capital is of suspect utility when he asked the question: "Is working capital really working?" Kam (1990:71) appears to express the same sentiment through his claim that "the calculation of working capital suffers from many judgements that must be made in the valuation of its components". When judgements are involved in the valuation of an item, it may be based on the subjective opinion of the person expressing the judgement, therefore influencing the usefulness of the information.

The response indicates an uncertainty as to whether there is a problem with the classification of working capital or not – 23% of analysts and 23% of academics are uncertain. However, the disagreement ratio (financial managers – 37%, academics – 31% and analysts – 27%) indicate that a rather small percentage of respondents believe that the present working capital classification is correct. Lev (1974) warns that the ratios based on working capital used for decisions are not useful as they are based on a position at a specific point in time and need to be changed to incorporate the changes in working capital over time. Samuels, Wilkes and Brayshaw (1999:42) also state that it can be "dangerous to judge the liquidity and gearing position of a company" based on the information supplied in the balance sheet as the information relates to only one day in the year. Working capital positions vary among companies in industry and are, therefore, not good indicators of success. It is difficult to control all the components of working capital and in times of growth the working capital position can deviate quite substantially from the norm, resulting in upsets in the market (Samuels et al. 1999). When additional information is made available to users, these upsets may not realise in the market.
Motivation: Heath (1978) argues that the working capital concept was developed for the credit grantor and, since they are no longer the only primary users of financial statements, the needs of other users should be taken into account to provide information that may be used in making decisions. Because the working capital concept is based on earlier periods when there was a focus on the balance sheet and on the capability of a company to repay its debt, working capital did not develop fast enough to keep up with users' needs, i.e. decision-making (Schroeder et al. 2005). Schroeder et al. (2005) motivate the use of monetary items to suit user needs to enhance decision-making based on the working capital concept.

Discussion: A total of 28% of financial managers, 35% of analysts and 4% of academics agree with this statement. The responses to this statement agree with those of the previous Statement 20, namely, respondents tend to feel that the present classification of working capital is in order, despite the fact that numerous researchers indicate otherwise, as discussed below.
Chapter 6 – Results of the research

Ratios are used to make decisions and, if the ratios are based on a classification that is not a good indicator of success, the decisions to be taken may also be of doubtful nature. If the current working capital classification is not a good indicator of success, it follows that it may not be useful for decision-making purposes either. The negative response may be because of the fact that the working capital classification is almost part of the accounting tradition as it started in 1947 (Miller and Bahnson 2002). The respondents may have answered this question out of a habitual accountability viewpoint instead of a decision-making viewpoint. Working capital ratios were used to determine the credit worthiness of a company in the early days of accounting (Lev 1974). However, analysts have now shifted their attention to more economically meaningful indicators, for instance, the determination of technical solvency (Walter 1957). To overcome the problem of working capital being not useful for decision-making purposes, it is proposed that operating cycles are to be included in the supplements to the financial statements. This will provide additional information that may indicate why the ratios based on the working capital deviate considerably at certain stages in the life cycle of a company.

Statement 22: Working capital must be classified in terms of future cash flow realisation (Heath 1978:73)

![Response to Statement 22](image_url)

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Figure 6.25  Response to Statement 22
**Motivation:** According to Heath (1978) the analyst is concerned with how much cash the company will receive and when, rather than whether the receivable is part of the working capital. The Trueblood Committee (Trueblood 2004) also states that the supplying of information to predict, compare and evaluate future cash flows is as an objective of financial statements. As the working capital classification is part of the financial statements, it goes without saying that it ought to provide the same information.

**Discussion:** A total of 57% of the financial managers, 85% of the analysts and 52% of the academics agree. The analysts agree more with this statement than financial managers and academics. This may be as a result of different objectives and decision-making needs. Working capital classification is not based on future cash flow realisation since there are too many hybrids and valuation methods involved (Schroeder et al 2005; Wild et al. 2001). The uncertainty of cash flow is based on the future, and there are degrees of uncertainty which leads to prudence. The Trueblood Committee (objective nr 3.) recommended that useful information should be provided to users for the prediction, comparison and evaluation of potential cash flows, and should include information about the amount, timing and related uncertainty of the cash flows (Wolk et al. 2004). Most investment decisions are based on cash flow data, but accounting ratios are based on accrual accounting and not cash flow accounting (Samuels et al. 1999). It appears, therefore, that supplying information with regard to cash flows is much needed in order to assist users to make their own predictions with regards to future cash flows.
Chapter 6 – Results of the research

Statement 23: Because valuation and classification methods vary, owners’ equity at the start of a financial year may lead to different income and equity figures at the end of the financial year (Mattessich 1995:111)

![Response 23](image)

Figure 6.26 Response to Statement 23

**Motivation:** This statement attempts to determine what it means to maintain capital. When classification and valuation methods vary, it may not be clear what is meant by capital maintenance since the same owners’ equity at the beginning of a financial year may differ from the income and owners’ equity at the end of the financial year. Valuation and classification methods may, therefore, need to be used consistently to enable the understanding of the concept *maintenance of capital*.

**Discussion:** Respondents tend to agree that different valuation and classification methods may result in changes in equity figures from the beginning to the end of a financial year as 46% of financial managers, 60% of analysts and 56% of academics responded positively. Unfortunately this question may have been misinterpreted by the respondents since there are four concepts, namely, valuation, classification, income and equity involved in the statement, and it is possible that the respondents did not know which concepts to relate to. It may therefore not be sensible to include
these responses in a final analysis. The large number of uncertain responses, 19% of the financial managers, 24% of the analysts and 28% of the academics gives further motivation not to include these responses. Nevertheless, classification does influence the quality of the information contained in financial statements.

**Statement 24:** The operating cycle should influence the classification of working capital

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**Figure 6.27  Response to Statement 24**

**Motivation:** The operating cycles of companies differ: for instance, a retail company dealing with cash sales may very well have a different operating cycle to that of a manufacturing company (Schroeder et al. 2005). The question, however, is whether a different operating cycle ought to lead to a different classification of working capital.

**Discussion:** A total of 68% of the financial managers, 88% of the analysts and 70% of the academics agree with Statement 24. The operating cycle is the difference in time between the cash outflow and the cash inflow of a company. The operating cycles of companies do vary and should therefore influence the classification of working capital (Herrick 1954:627). Some companies have an operating cycle that is longer while others have a cycle that is shorter than a year. Samuels et al. (1999)
suggest that a company should reveal the operating cycle for the year and for the quarters as these may differ quite substantially, especially in companies with seasonal business. The working capital levels of retailing companies are relatively low because they have high levels of creditors, whereas for manufacturing companies it is fairly high because they need to invest in raw materials. In current accounting practices two components that influence the operating cycle have already been addressed, namely, provision for bad debts and slow moving inventory. In this regard one may refer again to objective nr. 3 of the Trueblood Committee (Trueblood 2004) which states that the necessary information on future cash flows should be provided to users. Hence, additional information about the operating cycles of a company ought to be provided together with the financial statements.

**Statement 25: A part of deferred taxation may also be classified as a part of equity**

![Response 25](image)

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**Figure 6.28  Response to Statement 25**

**Motivation:** According to Wild *et al.* (2001), deferred tax liabilities will only become payable when a company starts to report losses. Since this future reversal is only a remote possibility, for instance, with timing differences due to accelerated depreciation, the deferred credit that exists may be viewed as a source of funds and therefore be classified as equity. Graul and Lemke (1976) advocate that a deferred
taxation credit may be viewed as an investment by government in a company, the reason being that government wants to stimulate growth in the business. This kind of argument will result in a deferred taxation credit classified as part of owners' equity because it is viewed as a capital investment. A further motivation to classify a part of deferred taxation as equity may be because the company will never pay back this "liability" unless the company starts to make losses and doesn't recover and become a going concern again. CFA (2006:235) states that "if deferred tax liabilities are expected to reverse in the future, then they are best classified as liabilities. If, however, they are not expected to reverse in the future, they are best classified as equity". It may be argued that in most cases it is unlikely for companies to start reporting losses continually because of the going concern assumption and, therefore, this part of deferred taxation should be classified as equity.

**Discussion:** The general negative outcome of only 54% of the financial managers, 41% of the analysts and 36% of the academics agreeing with Statement 25 may be because the respondents did not take all attributes of deferred taxation into account. Deferred taxation is called a hybrid by Wild et al. (2001) because it has properties of more than one class. A deferred taxation credit on a balance sheet is a known hybrid. Griffiths (1995), Coffman, Tondkar and Previts (1993), and Milburn (1985) all argue that deferred tax liabilities may be viewed as a source of funds because it will only become payable when a company starts to report losses and could, therefore, be classified as part of equity. The following is a response from two financial managers who together filled in one questionnaire: "We do not believe that a portion of deferred tax liability can be reclassified as an equity instrument but we do agree with the current requirement to recognise deferred tax revaluation of PPE in equity". It follows that if a portion of deferred taxation is viewed as part of equity, it may have a significant influence on the Return of Equity (ROE) and the leverage of a company.
Chapter 6 – Results of the research

Statement 26: Uncertainties attached to contingencies should be classified according to probabilities

<table>
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Figure 6.29  Response to Statement 26

Motivation: If there is some degree of uncertainty which surrounds contingencies, it may be necessary to attach a schedule that supplies more information to the user. This information may need to include the percentage of probability that the unforeseen event will take place and, in the event of taking place what in flow or out flow of cash may be expected. This may guide/assist users in the prediction of future cash flows.

Discussion: This statement rendered a very positive response, with 65% of the financial managers, 85% of the analysts and 66% of the academics agreeing. Respondents do agree that this classification may lead to more useful information. This may be because they experience the need for more information to be revealed with regards to contingencies. When the measurement of assets and liabilities are largely based on assumptions about a future event, the precision of the measurement is influenced (AICPA 1994). AICPA (1994) recommends that where there are significant uncertainties, the following should be disclosed: 1) how the amount was derived, 2) how estimates were arrived at, and 3) assumptions and
judgements. This statement is linked with the future and therefore uncertainty will necessarily be part of the classification. As ASOBAT (Chambers 1998) stated, users need to make predictions about the future. An accountant cannot make specific predictions on behalf of the users, but the accountant can provide a user with the necessary information to enable the user to make more accurate predictions (Wolk et al. 2004). The Trueblood Committee reported that users need useful accounting information to aid them in the prediction of future variables (Trueblood 2004). The prediction of the future is mainly concerned with future cash flows; therefore, the classification of uncertainties attached to contingencies according to probabilities may aid future cash flow predictions.

Statement 27: Advertising may also be classified as an investment rather than an expense

![Response 27 Diagram](image)

**Figure 6.30  Response to Statement 27**

**Motivation:** Like R&D, advertising expenses promise benefits for a number of years to come, therefore it is logical according to Higgins (2004) to record the expenses as assets and then distribute the costs over the useful life of the asset. Instead, "because the magnitude and duration of the prospective payoffs from research and development (R&D) and marketing expenditures are difficult to estimate, accountants
duck the problem by forcing companies to record the entire expenditure as an operating cost in the year incurred" (Higgins 2004:13). Lev and Zarowin (2003) state that advertising costs are expensed immediately although it may deliver significant future benefits for the company and may be viewed as an asset as soon as uncertainty with regards to the benefits has largely been removed. In turn Nakamura (2003) also argues that advertising and marketing expenditure are crucial to a company’s success as customers learn about new products of a company through advertisements and marketing campaigns.

Discussion: The general negative outcome of only 31% of the financial managers, 36% of the analysts and 24% of the academics agreeing with Statement 27 may be as a result of not taking all the attributes and future benefits of advertising into account. With the matching concept in mind, the costs of advertising may be matched with the future benefit for the company, as is done in the case of research and development. When companies advertise themselves or their product, it is an investment in their future. Responses from two different financial managers are:

1. “We believe that sometimes there is a future benefit from advertising, but the measurement, amortisation and impairment issues associated with this benefit are too subjective to justify recognition”. If a future benefit may be derived from a certain action, for example advertising, it may need to be classified as an investment when all relevant attributes are taken into account, even if the measurement, amortisation and impairment issues are subjective.

2. “I don’t believe that there is a tangible measure for advertising, and therefore the classification as an investment would make me nervous”. When all the relevant attributes of advertising are taken into account, it may be viewed as an investment in the future of a company and it may be classified accordingly.
Statement 28: Cash should be earmarked in anticipation of the purchase/replacement of a fixed asset

<table>
<thead>
<tr>
<th></th>
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<tr>
<td>Analysts</td>
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<tr>
<td>Academics</td>
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Figure 6.31 Response to Statement 28

Motivation: The provision for depreciation “has no place” in the income statement, because it cannot be matched with income according to Fitzgerald and Fitzgerald (1947:217). If an amount equal to the depreciation is withdrawn from income and placed in a fund to provide for the replacement of fixed assets, it may be placed in the income statement. Miller and Bahnson (2002:74) argue that “the usefulness of information produced by allocating a historical cost (measured in historical dollars) over a predicted but unobserved future period” should be questioned. Hence, a more useful suggestion may be the earmarking of cash (internal fund) for the future replacement of an asset instead of allocating a historical cost.

Discussion: The outcome of this question is slightly negative with 43% of the financial managers, 50% of the analysts and 48% of the academics agreeing with Statement 28. The current practice is to write-down an asset by depreciating the asset. Instead of using the depreciation provision to match the expense of the asset with the revenue earned, a provision for the replacement of the asset should be created (van der Poll 2003). If the provision does not earmark the cash for the future
replacement of the asset, the cash may have been used for operating expenses when replacement takes place, and the company may then need to borrow cash to replace the asset instead of making use of an internal fund. The respondents seem to be more inclined to follow the traditional depreciation provision approach and do not seem to realise the benefits of this earmarking or creation of an internal fund.

| Statement 29: The behaviour of bank overdrafts may lead to a different classification |

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<tr>
<td>Total</td>
<td>27.78%</td>
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**Figure 6.32  Response to Statement 29**

**Motivation:** This statement attempts to determine whether the classification of a bank overdraft may be based on the behaviour of the bank overdraft, i.e. short or long term behaviour. If a company has a bank overdraft which carries on over the years, it may be viewed as a long term liability based on the intention to fund the company from an overdraft. If a bank overdraft cannot be repaid by a company without “destroying” the company financially, then it may be viewed as a long term liability rather than a current asset based on the attributes involved.

**Discussion:** A total of 59% of the financial managers and 62% of the analysts agree with Statement 29 and this may be because of their experience in practice. Only 46%
of the academics agreed whereas 29% of the academics were uncertain. If a
comppany operates on a bank overdraft over an extensive period, it may be regarded
that the intention of the company is to make use of a bank overdraft facility as a long-
term borrowing mechanism. This classification would differ between the two
viewpoints, namely, decision-making and accountability. Some bank overdrafts
cannot be repaid without destroying the company (Most 1982). This may lead to the
classification of a bank overdraft as long term rather than as a current asset based
on the behaviour/attributes of the overdraft.

Statement 30: Classification can be used for window dressing

<table>
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Figure 6.33  Response to Statement 30

Motivation: Classification may be used to smooth out the volatility of results (Miller
and Bahnson 2002, Wolk et al. 2004). This may be done through timing transactions
or, put differently, classifying transactions through the use of time. Classificatory
smoothing may be done by moving items between operating and non-operating
income (Wolk et al. 2004). The practice of classification for window dressing needs to
be addressed in a classification framework for accounting information.
Discussion: A total of 74% of the financial managers, 55% of the analysts agree and 67% of the academics agree with Statement 30. The response from financial managers may be as a result of their direct involvement with the classification of financial information and their experience in the field. Financial analysts feel that reclassification is their prerogative, and that companies do not need to hide the truth through window dressing. Analysts believe it is much better to report and explain the volatility than to smooth it out (AIMR 1993; AICPA 1994) since analysts may need to do their own predictions based on the information supplied to them. Hence companies should report transactions as and when they occur. This view is shared by Knutson (1993).

Responses from two different financial managers are:

1. “Interpretations offer any entity scope to apply the standard to their advantage without having to have any substance. Window dressing, intended misstatement, etc. is much more likely under IFRS than under previous accounting standards as the fair value model are more closely followed. Using a ‘fair value’ model to recognise and classify transactions in the absence of specific guidelines open the door to any possible method of misstatement”. Hence, this response blames IFRS for the possibility of window dressing classification.

2. “Fair value accounting legitimises manipulation. I believe in matching and prudence. Academics/auditors are to busy forcing everyone into boxes!” Quality financial reporting may stem from the development of a classification framework for accounting information which may in turn supply more useful information to the users of financial statements.

Enron is one of the companies who paid the price because they attempted to “make them [selves] look better than they really [were]” (Miller and Bahnsen 2002:11). Griffiths (1995) claims that creative accountants classify numbers in such a way that they influence important figures in a company. Therefore, a company may need to classify transactions as and when they occur, and leave the smoothing and prediction to the users.
Motivation: As suggested by Mulford and Comiskey (2002), companies may classify items as non-recurring to adjust their earnings. The variability of earnings per share before extraordinary items may be increased and while the predictive ability of earnings may be decreased by the classification of nonrecurring items (Cameron and Stephens 1991). This may result in adjusted earnings through classification of accounting information.

Discussion: A total of 74% of the financial managers, 69% of the analysts and 70% of the academics agreed with Statement 31. This calls for the separation of activities that occur in the normal business of a company and those that do not occur regularly. It is easier to manage normal transactions and activities than abnormal. The outcome of this question agrees with the outcome of the previous statement (30) which is based on window dressing. This is to be expected since the classification of non-recurring items to adjust earnings (the subject of Statement 31) is viewed as a form of classification for window dressing, which is the subject of Statement 30.
Statement 32: Classification can be done according to authoritative principles laid down by governing bodies

<table>
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<td>Analysts</td>
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<td>Total</td>
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</tbody>
</table>

Figure 6.35  Response to Statement 32

Motivation: This statement attempts to establish whether authoritative principles laid down by governing bodies such as SAICA and the FASB may be used for the classification of accounting information.

Discussion: A total of 65% of the financial managers, 53% of the analysts and 58% of the academics agree with Statement 32. External users had a significant influence on the development of the current/non-current classification system, especially the credit grantor (Heath 1978). The relevant requirements of external users may need to be taken into account when authoritative principles are laid down by governing bodies. Griffiths (1995:viii) argues that companies have flexibility to their advantage when they apply accounting rules and regulations, not because standard setters are “lax”, but because flexibility is built into the regulations for relevance. The outcome of this statement seems to suggest that rules and regulations laid down by governing bodies may need to be incorporated into a classification framework for accounting information.
6.3.2.2 General comments from respondents
In this section a number of general comments received from the respondents are listed and discussed.

6.3.2.2.1 Comments from financial managers
"The increased complexity of Accounting Statements [is] making the understanding of financial statements extremely difficult to the point where no matter how items are classified, the financial statements are becoming less meaningful to the investor as a whole". The important objective of financial statements is to supply useful information to users and, therefore, the complexity of the said statements may be decreased after a classification framework for accounting information has been developed.

"Typically rules governing classification are issued by accounting bodies, not analyst representatives, so they tend to ignore the requirements of analysts". The new tendency as displayed by AICPA (1994) is to take the needs of users into account in developing financial statements, hence, user requirements may need to be taken into account when a classification framework for accounting information is developed. This objective has been stated a number of times in this work.

Below is a lengthy response from a financial manager, divided into four parts:

1. "Your questionnaire does not take into account IFRS. IFRS dictates classification to [a] large extent. Also IFRS has moved away from historical accounting to fair value accounting. The classification of fair value accounting is stipulated in the IFRS standards". IFRS was taken into consideration in quite a number of statements in the questionnaire. Even though IFRS is rather prescriptive, a classification framework guiding the compilers of financial statements is still needed. Naturally, an initial measurement to determine relevant attributes may have to precede the classification.

2. "Accounting should be recording actual results and not future or forecasted results. You can use the actual results for future or forecast models, but the classification must be the same. You should not account for the future or forecast, as the future is never known or certain and invariably cannot be accurately predicted. It is for this reason that USA stock exchange filers..."
include a forward looking statement in all publications of results or financial information, which effectively give a disclaimer on the future or forecasted information ever being achieved”. Of course the respondent is correct in observing that the future is never known and is uncertain. The author therefore suggests that additional information ought to be provided to users of financial statements to enable them to make their own predictions. Recall that Miller and Bahnson (2002) suggest the use of an information intersection (refer to Section 3.10). In this thesis an even larger adherence to the needs of users is proposed in the form of a distributed union minus conflicting requirements.

3. “You should also have only one version of the truth. You cannot have different classifications of actual results and forecast or budget results, because then there is no accountability and responsibility in the business. When you have different versions of the ‘truth’ then chaos reigns in the business and everyone talks at cross purposes to each other, or you waste time explaining matters over and over again”. Only one generic classification framework will be the outcome of this thesis, namely, a distributed union of the requirements of all stakeholders, minus the requirements that are in conflict with any other. This process is illustrated in Example 1.1 and taken further in Chapter 7.

4. “Your internal accounting classifications should be the same as your external accounting classifications as this focuses all staff and stakeholders on the same matters requiring attention or explanation or action”. As in point 3 above, a single generic classification framework providing information that satisfies some subset of the needs of all users, together with supplementary information is proposed in this thesis.

6.3.2.2.2 Comments from an analyst

Statements 11-14 and 16: “In my experience accountants give financial statements to mislead and for tax purposes”. The tax regulator may have a significant influence on accounting principles, and it is plausible that in some instances companies do classify for window dressing. Hence users may be misled in a subtle way. However,
with the proposed classification framework the needs of users may be taken into account more than has been the case previously which should result in more useful information.

Statements 20-24 and 30: "We cannot even get comparable heps [Headline earnings per share], Tangible NAV/share or free cash flow from companies – why bother with working capital? The auditors do not help either – the same auditor approved (company = CCN) tangible NAV and then issued a fair and reasonable statement to take out minorities at a fraction of TNAV/share". Again, the generic classification framework takes users’ needs into consideration and so should provide users with the information they require to make decisions.

6.4 Summary
In this chapter the research results from the literature survey were linked up through figures 6.2 and 6.3 with the questionnaire and the analysis of financial statements. The 32 statements in the questionnaire were presented and discussed. The results strongly support the need for the development of a classification framework for accounting information to enable the provision of useful information for decision-making.

From the analysis of the financial statements the following was observed:

- Little conformity is displayed in the balance sheets as well as the income statements when categories are named. In general, however, companies tend to adhere strictly to the rules and regulations prescribed to them by GAAP and IFRS.

Results from the questionnaire indicated the following:

1. Accountability versus decision usefulness
   - The respondents generally agree on the historical reason for classifying, namely, accountability.
   - From the responses it is apparent that accountability and useful in terms of decision-making are viewed by the respondents as the same idea.
• If analysts and other users reclassify financial statements for useful decisions and accountants classify for accountability, it follows that there may have to be a difference in the classification system used.

2. New developments

• New kinds of transactions may introduce new attributes and relationships and may not fit into the present classification structure; therefore, the need may arise to develop a classification framework that takes attributes into consideration.

3. Classifying like with like: relationships and common attributes

• A proposed classification framework for accounting information should take into account that elements of different kinds (types) ought not to be grouped together.

• Relationships among the various items of the financial statements are very important when classification takes place and respondents seem to acknowledge the importance of relationships in classification. New relationships may be revealed when reclassification takes place. Economic reality is often the personal perceptions of the user. The objective of classification is to reveal relevant relationships; these should in turn reveal more ‘truth’ about the system, thereby changing data into information (refer to Corollary 3.1).

• Items are classified according to their common attributes and, looking at the issue of measurement at a more detailed level, one may argue that, before being classified, attributes have to be identified. This may be viewed as “measuring” or evaluating the item to determine relevant attributes (refer to Corollary 3.2).

4. Skill

• The respondents indicated that skill is necessary for the classification of accounting information.

5. Time

• A proposed classification framework for accounting information may need to take time (i.e. past, present and future) into account.

• Analysts are concerned with a company’s future earnings and cash flows. Hence it would be to the benefit of analysts if accounting information could
be classified in such a manner that it facilitates this forecasting. It appears, therefore, that supplying information with regard to cash flows is much needed for users to make their own predictions with regards to future cash flows. The prediction of the future is mainly concerned with future cash flows and the classification of uncertainties attached to contingencies according to probabilities may, therefore, aid future cash flow predictions.

6. **Uncertainty**
   - People’s views of uncertainty will necessarily be different since it is based on human judgement. Therefore, the degree to which the prudence principle will be practised varies from one person to the next resulting in degrees of uncertainty and ultimately a different classification.

7. **Classification that may mislead users**
   - The objective of financial reports is to provide useful information but if it is classified in a manner that hides the nature of the data or even omits data, then the objective may not be reached.

8. **Miscellaneous**
   - If a user knows what classification principle was used, more meaningful decisions may be inferred from the information given.
   - When a decision to classify an item is based on an intention the result may differ from the classification of an item based on normal business practices.
   - Valuation and classification methods may need to be used consistently to enable the understanding of the concept maintenance of capital.
   - The relevant requirements of external users may need to be taken into account when authoritative principles are laid down by governing bodies.

9. **Working capital**
   - To overcome the problem of working capital not being useful for decision-making purposes, it is proposed that operating cycles are to be included in the supplements to the financial statements.
   - Samuels et al. (1999) suggest that a company should reveal the operating cycle for the year and for the quarters as these may differ quite substantially, especially in companies with seasonal businesses.
10. **Proposed reclassifications**

- Deferred tax liabilities may be viewed as a source of funds because these will only become payable once a company starts to report losses and could, therefore, be classified as part of equity.

- With the matching concept in mind, the costs of advertising may be matched with the future benefit for the company, as is done in the case of research and development (R&D).

- The respondents seem to be more inclined to follow the traditional depreciation provision approach and do not seem to appreciate the benefits of the earmarking of cash for the replacement of a fixed asset or the creation of an internal fund.

- Some bank overdrafts cannot be repaid without destroying the company (Most 1982). This may lead to the classification of a bank overdraft as long term rather than as a current asset based on the behaviour/attributes of the overdraft.

11. **Window-dressing**

- Analysts believe it is much better to report and explain the volatility than to smooth it out (AIMR 1993; AICPA 1994) since analysts may need to do their own predictions based on the information supplied to them.

In the next chapter previous and present accounting frameworks are presented and discussed, following which a comprehensive classification framework for accounting information is developed for the balance sheet as well as for the income statement.