Flexibility in Financial Accounting Income Strategies and Earnings Management in the Netherlands

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Chapter 5

Financial accounting flexibility in the Netherlands

5.1 Introduction

In a strongly regulated accounting environment the room to influence accounting income is restricted. Although the US are generally perceived to have a very regulated accounting environment for listed firms, there is ample evidence of earnings management in the US. Accrual accounting is essential to proper financial accounting, but it is apparent that the accrual process is ambiguous and not very well defined. Even in the US for virtually every major event that could affect the financial statements of a firm there exists a variety of alternative methods for matching costs and revenues (Beaver, 1989, p. 3). Although basically flexibility results from the accrual process itself, it can be subjectively restricted through special provisions in politically and culturally influenced accounting regulation.

Contrary to the US, the accounting environment is less restricted in the Netherlands. Nobes and Parker (2000, p. 173) for example state “the almost extreme permissiveness is an important feature of Dutch company financial reporting”. Vergoossen (1997, p. 589) states that “a special feature of Dutch accounting standards is their conceptual and interpretational nature. Accounting standards in the Netherlands are broadly formulated in contrast to the more descriptive and explicitly detailed formulation of accounting standards in some other countries, such as the US”. It is quite obvious that the subjective general accounting directions in the Civil Code and the lack of special provisions will lead to a very subjective financial statement (see for example Brink, 1992, p. 150 and Bindenga, 1994, p. 158). Although quantitative information on financial accounting discretion in the Netherlands is not available a former CEO stated that accounting income in financial statements can be biased forty percent in the Netherlands. So if there is a country where financial accounting flexibility,

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73 See quote from Fentener van Vlissingen in Chapter 1.
financial accounting discretion, income strategy and earnings management should be a primary object of study it is the Netherlands.

The first part of this study was concerned with a framework for managerial use of financial accounting discretion, a general discussion of incentives to use financial accounting discretion and a general discussion of constraints on the use of financial accounting discretion. This chapter addresses the first research question of this study, namely: what are the general possibilities to adapt financial accounting data within the opportunities offered by accounting standards in the Netherlands? This question will be addressed by way of an in-dept investigation of the number and characteristics of alternative accounting methods that the management of a firm can choose in general. The result is a detailed overview of general financial accounting flexibility in the Netherlands based on the Civil Code and the Guidelines issued by the CAR. The purpose of this overview is to be as complete as possible. On the basis of this detailed overview a new proxy to measure financial accounting discretion and to detect managerial influence over accounting income is developed in chapter 7. Before this detailed overview is provided paragraph 5.3 starts with a brief discussion of the financial accounting environment and more specific financial accounting regulation in the Netherlands. First however paragraph 5.2 provides a discussion of the possible methods to influence accounting income in general.

5.2 Methods to exert influence over accounting income

Managers who want to influence accounting income in order to implement their income strategy can choose from a large set of methods. In general, a distinction can be made between methods that require real decisions and methods that require the use of accounting methods and estimates (Hoogendoorn, 1985, p. 277, Bartov, 1993, p. 841 and Jiambalvo, 1996, p. 40).

Normally, real decisions are undertaken as part of the firm's business activities. The business activities are organized in order to create value and increase the value of the firm. However, real decisions may also be undertaken primarily to manage earnings instead of being aimed at
creating value. Real decisions undertaken to manage earnings may relate to operating, financing and investment decisions. Operating decisions for example may involve delaying or accelerating expenditures in relation to research and development, advertising and maintenance of equipment, but it may also involve the timing of closing sales agreements. Murphy and Zimmerman (1993) for example use research and development and advertising expenses surrounding CEO departures to analyze earnings management. They found that changes in research and development and advertising expenses are due mostly to poor firm performance. Financing decisions for example may relate to early extinguishment of debt when interest rates rise. Hand (1989) for example investigated whether firms undertook debt-equity swaps for an accounting paper profit or for a true financial gain. He found that firms undertook debt-equity swaps for both reasons, but that swapping to smooth accounting income was a much stronger motivation. Investment decisions may also be undertaken primarily to influence accounting income. The timing of asset sales for example in relation to earnings management was analyzed by Bartov (1993). His findings indicated that managers dispose assets in order to smooth accounting income and mitigate accounting based restrictions in debt covenants. The possibilities to influence accounting income through real decisions will depend for example on the use of historical costs principles by the firm, the firm’s business activities and the existence of long term obligations in relation to for example advertising and research and development. In respect to the ethical permissiveness of real transactions Bruns and Merchant (1990) concluded from empirical evidence that accounting interventions through real decisions in order to manage short-term earnings were experienced more acceptable from an ethical point of view than earnings management by accounting decisions.

The possibilities for accounting regulators to limit earnings management with real transactions are limited. However, valuation principles affect the possibilities to manage earnings with real transaction. Bartov (1993, p. 842) for example states that although historical cost accounting principles are more reliable than current cost principles, the former are more vulnerable to earnings management because accounting income is materially affected by the sale values of the assets involved. This aspect should be considered when evaluating the advantages and disadvantages of historical cost accounting relative to current-
cost accounting. It may be for this reason that CAR Guideline 226 on securities states that listed securities which can be sold immediately or almost immediately should be carried at market value if this is conducive to the view required by law. Further, the substance over form principle limits real transactions in the case these real transactions are reversed immediately after they had their earnings management effect on accounting income. Although law does not specify this principle, substance over form is an element of the reliability of financial statements. Reliability is one of the qualitative characteristics of financial statements (IAS Framework for the Preparation and Presentation of Financial Statements, § 35).

<table>
<thead>
<tr>
<th>BASIC DISTINCTION</th>
<th>SUB CATEGORY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real decisions to influence accounting income.</td>
<td>Operating decisions</td>
</tr>
<tr>
<td></td>
<td>Investing decisions</td>
</tr>
<tr>
<td></td>
<td>Financing decisions</td>
</tr>
<tr>
<td>Pure accounting decisions (i.e. accrual based accounting interventions)</td>
<td>(Changes in) Accounting methods</td>
</tr>
<tr>
<td></td>
<td>(Changes in) Accounting estimates</td>
</tr>
<tr>
<td>Combination of both</td>
<td>Combination of subcategories</td>
</tr>
</tbody>
</table>

Table 5.1 Alternative methods to influence accounting income.

Managers can also make pure accounting decisions to influence accounting income. Pure accounting decisions are accounting decisions with no direct, first order effect on cash flows (Jiambalvo, 1996, p. 40). It is for this reason that pure accounting decisions are often referred to as accrual based accounting interventions. Combinations of accounting decisions and real transactions are also possible. This may for example be the case when management first changes the procedures to account for a specific item and then uses real transactions to benefit from the accounting change. The possibility to influence accounting income with accounting decisions can be subdivided in two categories. The first category results from the flexibility in the principles used for valuation of assets and liabilities and the determination of results (i.e. accounting method choice). Examples are a change in accounting principles in relation to for

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74 According to Hoogendoorn (1996, p. 37) substance over form has its legal basis in the view the Civil Code requires in section 362 Title 9 BW2.
example goodwill accounting and the choice to use straight-line depreciation instead of
accelerated depreciation for a (new) category of assets. The second category results from
subjectivities, including all the estimates and interpretations management must make in the
process of preparing the financial statements (i.e. accounting estimates). Examples are the
estimation of the residual value of a new category of fixed assets and an adjustment in the
estimate of bad debt expense. Managerial influence over accounting income with accounting
decisions can be limited by financial accounting regulation. This holds especially for
accounting method choice. Accounting method choice can be limited by removing options
from the available set of accounting principles. As stated in the introduction the accounting
environment in the Netherlands leaves ample room for accounting choice and accounting
estimates. The next paragraph provides a detailed overview of the possibilities to influence
accounting income in the Netherlands through accounting decisions and its effect on current
and future accounting income. In this respect it is important to understand that accounting
decisions not only affect current accounting income but future accounting income as well.
The self-correcting nature of ("clean surplus") accrual accounting ultimately reverses all
influences of accounting decisions.

Reversal means that income increasing accounting interventions in the current period lead to a
decrease in income in future periods and vice versa. In general, a distinction can be made
between methods with no reversal effect and methods with reversal effect in the short or long
run. Usually the reversal of pure accounting decisions is quite obvious. A system where all
accounting expenses and revenues are reflected in accounting income is called "clean
surplus". Under "clean surplus" all accounting decisions have reversal effects in the short or
long run and involve only intertemporal shifts in accounting income. However since the
accounting system in the Netherlands has a number of possible violations against "clean
surplus" there are accounting interventions with no reversal effect. Examples of "dirty
surplus" gains and losses are for example goodwill accounting, revaluation adjustments,
cumulative effects of accounting changes and currency exchange differences.

The reversal of real decisions is usually quite obvious. When a firm delays or accelerates
necessary expenses the intervention will lead to a bias in the opposite direction in the short
run. The same holds for timing of sales agreements. If sales agreements are closed early in order to increase current accounting income, future accounting income will be lower because the profit on this agreement is already accounted for. However, since some real decisions to influence accounting income relate to unpredictable future events the reversal effect of real decisions cannot always be estimated. If the firm for example sells assets at year-end it is unsure whether this profit could also be realized in future years since prices may fluctuate.

The next paragraph provides a detailed overview of general financial accounting flexibility in the Netherlands, including the effect of accounting decisions on current and future accounting income. First however, a brief discussion of the financial accounting regulation is provided.

5.3 Financial accounting flexibility in the Netherlands

Flexibility is one of the basic concepts in this study. In chapter 2 flexibility was defined as the possibility to adapt financial information within the opportunities offered by the accounting standards. Flexibility has many aspects. A distinction can be made between flexibility in disclosure, flexibility in the principles used for valuation of assets and liabilities and the determination of results and other subjectivities, including all the estimates and interpretations top management must make in the process of preparing the financial statements. Disclosure flexibility is often related to items that bear no direct relationship to the firm’s accounting income. Disclosure influences the view financial statements should give by adding information not shown in the balance sheet or giving more detailed information in the notes. Since the focus in this study is on accounting income flexibility in disclosure is not discussed in this chapter. Financial accounting discretion was defined in chapter 2 as the firm specific possibilities to influence accounting income by real transactions and (pure) accounting decisions. It relates to flexibility because the firm specific latitude depends on the firm’s business activities, the prior financial accounting decisions and financial accounting flexibility. Financial accounting flexibility is the same for all firms that follow a countries’ GAAP. Financial accounting discretion is not since it also depends on prior accounting decisions and the firm’s business activities.
Financial statements need to be prepared in accordance with GAAP in the Netherlands. GAAP includes:

- Part 9, Book 2 of the Netherlands Civil Code and the relating law history;
- Case law from verdicts of the Enterprise Chamber of the Court of Justice in Amsterdam;
- CAR Guidelines for financial accounting;

As stated in paragraph 5.1 the provisions in BW2 are broadly formulated. The CAR interprets the provisions and issues Guidelines that are intended to influence financial accounting practice. A distinction should be made however between BW2 and the CAR Guidelines since it is not mandatory for firms to follow the Guidelines. Further, a distinction can be made between the authoritative statements in the CAR Guidelines and the recommendations in the CAR Guidelines. The authoritative statements are generally conductive to provide the view the law requires. They are not expected to be departed from without good reason. The recommendations and opinions only give support and direction, which implies that they can be departed from without good reason. Since the edition 2000 of NSA the authoritative statements included in the CAR Guidelines have the same status for auditors as BW2 and case law (NSA 120, section 3). Besides the fact that they are generally conductive to provide the view the law requires this makes it likely that audited firms will comply with the authoritative statements included in the CAR Guidelines.

It is for this reason that the authoritative statements in the CAR Guidelines are taken into account in the detailed overview of the possibilities to influence accounting income provided in this paragraph. Although the research period of the empirical part of this study is from 1988 – 1997, answering the first research question requires an up to date overview of financial accounting flexibility. Although the 2000 edition of the Guidelines for Annual Reporting in the Netherlands was already available, the 1999 edition is used to provide the detailed overview in this chapter. Due to the broader implementation of International Accounting Standards (IAS), the 2000 edition, although obviously more up to date, is characterized by a number of changes in accepted accounting practices that were characteristic for the research period of this study. Examples in this respect are the acceptance

75 From now on I shall refer to the part of the Civil Code that deals with financial accounting as BW2.
of IAS 36 regarding Impairment of Assets, IAS 22 regarding Business Combinations (ending the possibility to charge goodwill directly to shareholders’ equity) and the adoption of IAS 38 regarding Intangible Assets.

The option to depart from the special provisions in BW2 because of the true and fair view override, is not discussed here when looking at financial accounting flexibility in the Netherlands. The second sentence of section 362, subsection 4, BW2, is however potentially very important when looking at flexibility. It stipulates that the firm is *required* to depart from the special provisions if it is necessary to do so in order to give the view the law requires. Because the possibilities are potentially unlimited this provision is not discussed in this chapter except when the CAR Guidelines explicitly mention the use of this provision. Although the meta-rule that financial statements should provide a true and fair view ultimately determines whether interventions are beyond GAAP and auditors, and finally the Enterprise Chamber are the arbiters of this, accounting interventions are classified as earnings management in this study if they are within BW2, the authoritative statements of the CAR Guidelines and relevant case law.\(^\text{76}\).

In the detailed overview of financial accounting flexibility the focus is on two key elements in financial statements: current accounting income (C) and future accounting income (F). The interpretation of future accounting income is limited because it is restricted to the relationship with current accounting income. For every option current and future accounting income is taken into account and their effect is classified as either positive (+), negative (-), neutral (0) or indefinite (?)\(^\text{77}\) compared to alternative treatments. Since the possibilities to adapt financial information within the opportunities offered by the accounting standards, not only relate to flexibility items (i.e. specific accounting items in the financial statements where accounting decisions are applicable), but to the number of options as well, the accounting alternatives themselves are the key elements in the detailed overview of financial accounting flexibility.

\(^{76}\) The CAR Guidelines incorporate the rulings of the Enterprise Chamber where these are considered to have general relevance.

\(^{77}\) The effect is usually indefinite if the effect of estimates depend on the accounting method used for the estimated item.
Firm's with special provisions, such as insurance companies, banks and investment companies, are not included in the empirical part of this study because of their different financial accounting. The special provisions themselves are no subject either in the overview provided here. In the overview, only accounting issues for public limited liability companies are considered. Further, the primary focus is on consolidated financial statements because they are of primary importance to the stakeholders from an informational perspective. In the next part of this paragraph flexibility is discussed for all the items in the balance sheet and the income statement. The items are dealt with in the order as used in model A of the Annual Accounts Formats Decree.

5.3.1 Fixed assets

Fixed assets are assets held by a firm with the objective to use them on a continuing basis. There are three categories of fixed assets: intangible fixed assets, tangible fixed assets and financial fixed assets.

*Intangible fixed assets*

Intangible fixed assets are fixed assets which do not possess physical substance and cannot be classified as financial fixed assets. The aspects definition, recognition and measurement are especially relevant for intangible fixed assets. It can be said that the subjectivity when deciding on these aspects is one of the most important characteristics of intangible fixed assets.

An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise. An asset can be capitalized if the revenues exceed the future costs and leave enough room for amortization. Valuation of intangible fixed assets may, according to BW2, section 384, subsection 1, only take place at historical cost. Amortization is accrued to the future use of the asset. If the future economic benefits no longer provide sufficient scope for amortization a downward value adjustment

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78 All legal entities and companies are referred to as firms in this study.
should be applied. This downward adjustment depends on the interpretations management has about the economic future of the asset [1]. Section 365, BW2, states:

"1. The following shall be separately shown under intangible fixed assets:
   a. expenses in connection with the incorporation and the issue of shares;
   b. research and development costs;
   c. acquisition costs in respect of concessions, licenses and intellectual property rights;
   d. costs of goodwill purchased from third parties;
   e. prepayment on intangible fixed assets.

2. Insofar as the legal entity capitalizes the expenses and costs referred to in subsection 1.a and 1.b, it must state this in a note and maintain a reserve for the amount thereof."

In relation to flexibility, this section has two important implications. First, intangible fixed assets are not limited to the items mentioned in subsection 1. Other intangible fixed assets such as start-up expenses, rights to trade names, membership rights and software may also be included as long as they fit the criteria for recognition [2]. Secondly, following subsection 2, the firm is not obliged to capitalize intangible fixed assets. As an alternative the expenditures may be taken into the income statement or can sometimes be charged to the reserves. Guideline 210 paragraph 108 states that intangible fixed assets may only be capitalized if there are grounds for expecting future economic benefits or reductions in cost which flow from these assets to provide sufficient scope for amortization. But following subsection 2 of section 365 BW2, expenditures may be taken to the income statement even if there is sufficient scope for amortization.

The expenses in connection with the incorporation and the issue of shares can be characterized as deferred costs. They do not fit the recognition criteria and can only be capitalized because they are explicitly mentioned in section 365, subsection 1, BW2.

[The identified aspects of flexibility are numbered. The numbers refer to the overview at the end of every subsection of this paragraph.]
Because the expenses in connection with the incorporation and the issue of shares are to third parties the amount involved can be determined fairly objective. Two treatments are allowed:

1. Capitalizing the expenses and amortization within five years (section 386, subsection 3, BW2) and maintaining a legal reserve for the capitalized amount.
2. Take the amount directly in the income statement under operating costs [3].

Research and development costs can also be characterized as deferred costs. Because the expenses in connection to research and development are to a large extent internal the amount involved cannot be determined objectively [4]. Guideline 210, paragraph 104 sums up the attributable costs. However, the firm is free to include costs to its own estimates and interpretations. This is especially the case for the allocation of indirect costs. Two treatments for research and development costs are allowed:

1. Capitalizing the expenses and amortization within five years (section 386, subsection 3, BW2) and maintaining a legal reserve for the capitalized amount.
2. Take the amount in the income statement under operating costs [5].

Guideline 210, paragraph 112 prohibits the capitalization of research and development expenditures of prior years if in a subsequent year the circumstances justify this treatment. Guideline 210, paragraph 111 specifies the grounds for expecting the existence of future economic benefits for research and development costs.

Initial and start-up expenses are not explicitly mentioned in BW2. Guideline 210, paragraph 105 defines initial and start-up expenses as expenses incurred between the moment the management takes the decision to undertake commercial exploitation and the moment that a normal level of activity is reached. The focus on initial and start-up expenses after research and development costs presumes that the CAR recommends following the same guidelines. The firm is however not obliged to do so. Especially the estimation of a normal level of activity is very subjective in this respect [6].

The items acquisition costs in respect of concessions, licenses and intellectual property rights are part of all purchased industrial and intellectual rights. In the event that the right is purchased individually the amount involved can be determined objectively. If the right,
however, forms part of a larger acquisition, the amount has to be separated from the other assets and liabilities, which is a more subjective process [7]. Industrial and intellectual rights developed by the firm itself cannot be capitalized due to the fact that section 365, subsection 1, BW2, mentions acquisition costs. Industrial and intellectual rights developed by the firm itself can however sometimes be capitalized under research and development costs.

For individually purchased rights two treatments are allowed:

1. Capitalizing the acquisition costs and amortization according to a method based on their estimated useful economic lives (section 386 BW2) [8]. In case there is no finite economic life this treatment may result in capitalization without amortization. In both cases, finite and infinite economic life, Guideline 210, paragraph 108 should be taken into account, which states that downward value adjustments should be applied if necessary. Estimating the useful economic life or deciding that individually purchased rights have no finite economic life is very subjective.

2. Expense the acquisition costs as operating costs [9].

For rights that are part of a larger acquisition, three treatments are allowed:

1. Treatment as part of acquisition goodwill.

2. Separating and capitalizing the acquisition costs and amortize according to individually purchased rights.

3. Expense the acquisition costs, directly and for the whole amount, as operating costs.

A business combination may give rise to goodwill when a firm purchases the shares of another firm or when a firm purchases the assets and liabilities of a firm. If the firm purchases the shares of another firm, the amount of goodwill depends on the valuation of the participating interest (section 389, subsection 7, BW2) [10]. In general, it can be said that different forms of the equity method give rise to different amounts of goodwill. But even when one uses a certain method, different amounts of goodwill may arise because of the subjectivity when one determines the fair value of the assets and liabilities of the participation (see also under financial fixed assets). Fair value accounting has presented an opportunity to acquisitive firms to write-down the value of assets on a pre-acquisition basis. To the extent that firms write down the value of current assets, the profit realized from the disposal of these current assets is increased. If fixed assets are written down, then the future depreciation
charge is reduced and future accounting income is increased. The choice for a certain method and the determination of the fair value therefore may affect the firm's accounting income in the future. Another item open to flexibility with respect to acquisitions of participating interests is the reorganization provision at the outset of the acquisition. These provisions can be taken into account in the books of the participation, lowering the net asset value or current value and thus increasing the goodwill amount. The provisions can also be taken into account by the acquisitive firm itself, corrected on the historical cost of the participating interest [11]. Thus both pre-acquisition write-downs and reorganization provisions at the outset of the acquisition may increase the amount of goodwill.

If the purchase price is higher than the first valuation positive goodwill arises which:

1. Can be charged separately to the income statement [12];
2. Can be charged separately to the shareholders' equity [13];
3. Can be capitalized as goodwill and amortized over the expected useful life [14]. Only if the goodwill can be reasonably attributed to a period considerably longer than five years, it is allowed to amortize over this longer period (section 386, subsection 3, BW2) [15].

If the firm purchases the assets and liabilities of a firm and goodwill arises, this goodwill may:

1. Be capitalized as goodwill and amortized over the expected useful life. Only if the goodwill can be reasonably attributed to a period considerably longer than five years, it is permissible to amortize over this longer period [14];
2. Be assigned to the individual assets and liabilities and amortized accordingly [16].

If the first valuation is higher than the purchase price negative goodwill arises. Negative goodwill should be included in a revaluation reserve unless it is a reflection of the disadvantage attached to the participating interest [17]. In the latter the firm treats negative goodwill according to the accounting method used for positive goodwill. When positive goodwill is charged to shareholders' equity, negative goodwill is added to equity. When positive goodwill is expensed in the income statement, negative goodwill is accrued to the income statement in order to reflect the disadvantages over time [18].
Ite m m

Accounting flexibility for intangible fixed assets

<table>
<thead>
<tr>
<th>Item</th>
<th>Accounting flexibility for intangible fixed assets</th>
<th>C</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Downward value adjustments of intangible fixed assets (the more)</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>2</td>
<td>Capitalize other intangible fixed assets</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>3</td>
<td>Capitalize the cost of incorporation and issue of shares</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>4</td>
<td>Amount research and development costs</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>5</td>
<td>Capitalize research and development costs</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>6</td>
<td>Decide on normal level of activity with start up expenses</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>7</td>
<td>Amount intellectual rights</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>8</td>
<td>Estimate useful economic life of intellectual rights (the longer)</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>9</td>
<td>Expense the acquisition cost of intellectual rights</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>10</td>
<td>Amount of goodwill is subjective</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>11</td>
<td>Amount of reorganization reserve and its classification</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>12</td>
<td>Charge goodwill separately to income statement</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>13</td>
<td>Charge goodwill separately to shareholders’ equity</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>14</td>
<td>Capitalize goodwill and amortize over useful economic life</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>15</td>
<td>Estimate useful economic life of goodwill if capitalized (the longer)</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>16</td>
<td>Assign goodwill to individual assets and liabilities</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>17</td>
<td>Relation between negative goodwill and disadvantages</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>18</td>
<td>Accrual of negative goodwill to disadvantages over time (the shorter)</td>
<td>+</td>
<td>-</td>
</tr>
</tbody>
</table>

Table 5.2 Overview of financial accounting flexibility for intangible fixed assets.

Determining whether there is a disadvantage attached is subjective just as the deductions that should be made for possible related losses. If the related losses become apparent at a later stage, it is possible to deduct the losses from the revaluation reserve (Guideline 214, paragraph 230).

**Tangible fixed assets**

Tangible fixed assets are all fixed assets with physical substance held by the firm. Section 366, BW2 states:

"1. The following shall be shown separately under tangible fixed assets:
   a. buildings and land used for business purposes;
   b. machinery and plant;
   c. other fixed operating assets such as technical and office equipment;
   d. tangible fixed operating assets under construction and prepayments on tangible fixed assets;
   e. tangible fixed assets not used in the production process.

2. If the legal entity has only a limited right in rem or in personam to enjoy
tangible fixed assets on a permanent basis, this shall be stated."

Classification as a tangible fixed asset depends on beneficial ownership, not on legal ownership. The first subjective element occurs here. The question whether the firm has the beneficial ownership or not is answered by interpreting the definitions of disposition and risk. Although there are criteria for capitalizing assets legally owned by another firm, the use of these criteria is open to interpretation by the firm's management. The off-balance financing of tangible fixed assets has its influence on the solvency and profitability of the firm. Even when using the beneficial ownership rule strictly, the firm has ample possibilities for off-balance financing and thus influencing the view the financial statements should give. Because the focus in this research is on managerial influence over accounting income the flexibility related to off-balance financing is not discussed in detail.

There are different principles for the valuation of tangible fixed assets. Principles which may be considered are the acquisition price or manufacturing cost and the current value (section 384, subsection 1, BW2) [19]. It is possible to use different principles for the valuation of the items in the balance sheet and for the determination of accounting income, if the balance sheet items are valued at historical cost [20]. Further different categories of tangible fixed assets can be valued at different principles.

Unlike intangible fixed assets there are less special provisions for the valuation of different categories of tangible fixed assets. Only the last category mentioned in section 366, BW2, tangible fixed assets not used in the production process, has the specific limitation that the current value is limited to the net realizable value for this category. Historical cost is the cost of acquisition or the manufactured cost. The cost of acquisition of an asset is the total cost of acquiring the asset (i.e. the purchase price and the additional costs). The manufactured cost is used when the asset is produced by the firm. The manufactured cost may comprise the acquisition cost of the raw materials and consumables used and the other expenses directly attributable to the production. The manufacturing cost may also include a reasonable part of the indirect costs and the interest on debts over the period attributable to the production of the asset (Section 388, subsection 2, BW2). The assignment of other expenses directly
attributable to the production, a reasonable part of the indirect costs and the interest on debts allows for choices and subjectivity in the capitalization of tangible fixed assets at historical cost [21]. By capitalizing a higher amount the firm influences accounting income upwards. When capitalizing renewal expenses the same subjectivity may occur.

The current value of tangible fixed assets can be based on replacement cost, recoverable amount or net realizable value [22]. Replacement cost may be used when the firm is likely to replace the asset in the future by a comparable asset. The recoverable amount may be used when it is unlikely that the asset will be replaced and the asset is still used in the production process. If the firm no longer uses the asset in the production process, the net realizable value is used. Valuation of tangible fixed assets at current value generally implies revaluation of the assets over time. Changes in the current value should in principle be reflected in the revaluation reserve. Revaluation increases the firm’s equity and thus has a positive effect on solvency. It has however a negative effect on accounting income because revaluation generally increases the amortization base of the asset. From Guideline 212, paragraph 220 to 229, it follows that the realized part of the revaluation reserve can be either taken to the income statement or credited to the freely disposable reserves [23]. In determining the result it is possible to take into account the firm’s outside finance (i.e. financial leverage) [24]. The determination of the current value generally is subjective due to the "soft" criteria for the choice of the valuation base, the various ways to determine the replacement cost and problems in assigning and predicting the determination of the recoverable amount. In general, it can be said that the valuation of items at current value is more subjective than the valuation of items at historical cost. Although both principles have assignment problems, valuation at current value is more open to managerial estimations and interpretations (especially for non-fungible goods).

Where tangible assets are subject to obsolescence or wear and tear, amortization should be taken into account. Land generally is not subject to obsolescence and therefore does not qualify the conditions for amortization. Amortization should match the diminution in value of the performance potential of tangible fixed assets. Management may affect accounting income by estimating the useful economic life [25], the residual value [26] and the depreciation
Method chosen [27]. Estimating the useful economic life and the residual value is a subjectivity whereas the depreciation method is an accounting method choice. Generally the following applies: the shorter economic life and the lower the residual value is estimated the lower accounting income in the current period. Further, the more progressive the depreciation method the lower accounting income in the current period. If the estimated useful life is revised, the depreciation charges should be recalculated. If the useful life of the asset is lengthened, the amount by which the depreciation already charged can be reduced should either be credited to the income statement in the period of the extension or be reflected in a reduction in future depreciation charges (Guideline 212, paragraph 220) [28].

<table>
<thead>
<tr>
<th>Item</th>
<th>Accounting flexibility for tangible fixed assets</th>
<th>C</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>19</td>
<td>Current value as valuation principle</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>20</td>
<td>Balance sheet historical cost, income statement current value</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>21</td>
<td>Determination and allocation of manufacturing cost (the higher)</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>22</td>
<td>Determination of the current value (the higher)</td>
<td>0</td>
<td>-</td>
</tr>
<tr>
<td>23</td>
<td>Realized part of revaluation reserve in results</td>
<td>+</td>
<td>0</td>
</tr>
<tr>
<td>24</td>
<td>Take into account outside finance under item 21</td>
<td>+</td>
<td>0</td>
</tr>
<tr>
<td>25</td>
<td>Determination of useful economic life (the longer)</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>26</td>
<td>Determination of residual value (the higher)</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>27</td>
<td>Determination of progressiveness of depreciation method (the more)</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>28</td>
<td>Credit past depreciation to income statement</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>29</td>
<td>Impairment of tangible fixed assets</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>30</td>
<td>Revalue impaired tangible fixed assets</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>31</td>
<td>Classification of sale-and-leaseback transaction</td>
<td>?</td>
<td>?</td>
</tr>
</tbody>
</table>

Table 5.3 Overview of financial accounting flexibility related to tangible fixed assets.

If tangible fixed assets are valued at historical cost, it is possible that, apart from the systematic reduction in book value reflected in the amortization charge, a permanent diminution in value arises. This diminution is accounted for by impairment of the asset to the net realizable value or recoverable amount [29]. The first is applied when the asset is no longer used in the business, the latter when the asset continues to be used in the business. When the recoverable amount however is lower it should be used instead of the net realizable value (Guideline 212, section 224). In exceptional circumstances a diminution may have ceased to apply. In these cases, the asset should be revalued upwards [30], up to a maximum of the book value at which the asset would have been carried if no allowance had been made
in the first place. Assessing the permanent diminution and its' reversal is a continuous process which is not free from managerial subjectivity.

A sale-and-leaseback arrangement is an arrangement between a user/legal owner of an asset and another party, where the user sells the asset to the other party and leases the asset afterwards from the other party. Although sale-and-leaseback transactions are real transactions, they are discussed here because the incorporation of the transaction in the financial statements is open to flexibility [31]. If the sale-and-leaseback fits the criteria for financial leases any difference between the book value and the proceeds from the sale should be spread over the period of the lease contract. If the sale-and-leaseback fits the criteria for operational lease any difference should be recognized immediately in the income statement. If however the price is not based on the fair value of the asset the positive difference should be accrued to the remaining accounting period. The negative difference should be recognized in the income statement unless it is offset by future payments and this part of the difference should be accrued to the remaining accounting period.

**Financial fixed assets**

A firm has a participating interest in another firm if it contributes capital with the objective of a long-term relationship for the furtherance of its own activities. If a capital contribution in an enterprise does not satisfy the criteria for a long-term relationship that furthers existing activities, the interest is classified under other securities. Other securities under financial fixed assets are distinguished from securities, as in current assets, by the criterion of durability. The classification of interests as group companies, participating interests or other securities, is sometimes at the management’s discretion. In these cases where the function of the interest is not clear, the classification will depend on managerial estimates and objectives.

Section 367, BW2, states:

"The following shall be shown separately under financial fixed assets:

a. shares, depository receipts issued for shares and other forms of Participation in group companies;
b. other participating interests;"
c. receivables from group companies;
d. receivables from other legal entities and partnerships which have a participating interest in the legal entity or in which the legal entity has a participating interest;
e. other securities;
f. other receivables, with specific mention of receivables arising from loans and advances to members or holders of registered shares”.

As stated in the introduction, the primary focus is on consolidated accounts. In the consolidated accounts only unconsolidated participating interests are shown. In paragraph 5.3.7 the flexibility in the scope of consolidation and consolidation methods, is discussed. The valuation of unconsolidated participating interests depends on the question whether the firm exercises significant influence on the commercial and financial policy of the participating interest. Significant influence is presumed to exist if the participating firm is able to exercise at least 20% of the voting rights attached to the shares at its own discretion (section 389, subsection 1, BW2). If the firm exercises a significant influence, valuation of the participating interest should take place at the equity method. The answer to the question whether significant influence is exercised is, in spite of the legal presumption, subjective [32]. If there is enough information to determine the net asset value of the participating interest it should be valued accordingly. Where insufficient information is available for the determination of the net asset value another form of the equity method must be used [33]. Other forms of the equity method are:

1. Valuation on the basis of disclosed shareholders' equity of the participating interest;
2. Valuation on the basis of the acquisition cost of the participating interest;
3. Valuation on the basis of new principles for the participating interest.

The amount by which the book value of the participating interest has changed since the previous financial statements is shown in the income statement as the income share in the participating interest.

If no significant influence is exerted in the participating interest, valuation should be in accordance with the provisions of section 384, subsection 1, BW2. The appropriate valuation principle is then either acquisition cost or current value (Guideline 214, paragraph 217) [34].
The dividend declared is shown as the income from the participating interest. Dividend received by the firm from profits in the pre-acquisition period should be corrected on the acquisition cost of the participating interest (Guideline 214, paragraph 505). When the firm uses other valuation methods than the net asset value or current value any expected permanent diminution in value should be reflected. When the firm intends to dispose of a participating interest and the expected realizable value is lower than the book value it should be shown at the lower value.

<table>
<thead>
<tr>
<th>Item</th>
<th>Accounting flexibility for financial fixed assets</th>
<th>C</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>32</td>
<td>Classification of interest (significant influence and durability)</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>33</td>
<td>Different forms of the equity method can be used</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>34</td>
<td>Valuation at current value when no significant influence is exerted</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Table 5.4 Overview of financial accounting flexibility related to financial fixed assets.

5.3.2 Current Assets

Stocks

Stocks are goods intended to be sold or to be used in the manufacturing process of goods or for the provision of services. Which goods are to be included in stocks will depend on the function of the goods in the firm's business. The aspects of definition and recognition are important for stocks. The most important question is whether the firm's management capitalizes the physical stock or the economic stock position [35]. The physical stock is the stock actually present and the economic stock position is the stock on which there is exposure to a price risk. In both cases it is possible to account for unrealized losses on existing purchase and sales orders on an individual contract basis or per group of commodities. In case the economic stock position is capitalized the same holds for unrealized gains (Guideline 220, paragraph 215).

A distinction is made between work in progress on long-term construction contracts and other stocks. Although the same prescriptions for valuation in BW2 are valid, the recognition of revenues may be different. Applicable valuation principles for stocks are the cost of acquisition or manufactured cost and current value [36]. If the firm uses cost of acquisition as
a valuation principle, the additional direct expenses to the acquisition should be capitalized. If the firm uses manufactured cost this shall comprise the acquisition cost of the raw materials and consumables used as well as the other expenses directly attributable to the production. It may also include a reasonable part of the indirect costs and the interest on debts over the period attributable to the production of the asset. The attribution of incidental expenses, other expenses directly attributable to the production, a reasonable part of the indirect costs and the interest on debts makes the capitalized amounts subjective [37]. By capitalizing a higher amount, the firm improves its current accounting income.

Section 385, subsection 1, BW2 states that assets shall in principle be valued separately. Subsection 2 allows for similar components of stocks to be valued collectively, either on the basis of weighted average prices, by the "first in first out" method, by the "last in first out" method, or by some similar method [38]. Subsection 3 allows stocks of raw and ancillary materials regularly replaced, to be shown at a fixed quantity and value [39]. Thus section 385, BW2 brings some flexibility into the valuation of stocks. The effect of this flexibility on current and future accounting income depends on the method chosen and the movement of the relevant prices. When a firm values current assets at acquisition cost or production cost, section 387, subsection 2, BW2 states that they shall be valued at market value if this value is lower [40]. Further, the firm shall take into account provisions for non-saleable stock [41]. If an extraordinary reduction in the value of current assets is reasonably foreseeable in the near future, it may be taken into account in the valuation thereof (section 387, subsection 3, BW2) [42].

A distinction should be made between work in progress in relation to semi-manufactures and work in progress on construction contracts. For semi-manufactures the foregoing about stocks is applicable. Work in progress on construction contracts can be classified according to the contract terms in two categories: fixed-price contracts and cost-plus contracts. Work in progress on construction contracts are capitalized and valued according to stocks. The capitalized amount depends on the attribution of other expenses directly attributable to the production and on the attribution of a reasonable part of the indirect costs and the interest on debts. Again this is subjective because it depends on managerial estimates [37].
There are two methods for recognizing revenues on construction contracts: in proportion to the stage of completion of the work or upon completion of the contract [43]. The firm must decide which of these two methods is applicable. The decision depends on the question whether or not the profit on the work done can be reliably measured. If the profit can be measured reliably, the profit should be allocated in proportion to the stage of completion. The stage of completion can be measured in a variety of ways [44], but the same revenue recognition method should be applied to similar contracts (Guideline 220, paragraph 405).

<table>
<thead>
<tr>
<th>Item</th>
<th>Accounting flexibility for stocks</th>
<th>C</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>35</td>
<td>Capitalize the physical stock or the stock position</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>36</td>
<td>Value stock at current value</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>37</td>
<td>Determination, allocation of manufactured cost (the larger the amount)</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>38</td>
<td>Value similar components collectively</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>39</td>
<td>Regularly replaced stocks at fixed quantity and value</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>40</td>
<td>Value at lower market value</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>41</td>
<td>Provision for non-saleable stock (the larger the amount)</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>42</td>
<td>Foreseeable extraordinary reduction in the future</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>43</td>
<td>Recognizing profits in proportion to the stage of completion</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>44</td>
<td>Different ways to measure the completion of the contracts</td>
<td>?</td>
<td>?</td>
</tr>
</tbody>
</table>

Table 5.5 Overview of financial accounting flexibility related to Stocks.

**Debtors**

A receivable is usually considered as a current asset if it falls due within one year. The aspects of definition and recognition are also important for receivables because it is possible to transfer receivables to other non-related parties in several ways, for example factoring. Even if the firm transfers the receivable to another party, the party carrying the risk capitalizes the receivable as an asset. Receivables are in principle stated at face value. The firm must take into account provisions for bad debts when relevant [45]. The firm may determine these provisions for bad debts either on a general or specific basis or by a combination of the two [46].

<table>
<thead>
<tr>
<th>Item</th>
<th>Accounting flexibility for debtors</th>
<th>C</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>45</td>
<td>Provision for bad debt (the larger the provision)</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>46</td>
<td>Provision on a general or specific basis</td>
<td>?</td>
<td>?</td>
</tr>
</tbody>
</table>

Table 5.6. Overview financial accounting flexibility related to debtors.
Securities

Securities not intended for use on a lasting basis in the conduct of the firm’s business are included in current assets. Securities under current assets may only be valued at historical cost (section 384, subsection 1, BW2). Section 387, subsection 2, BW2 states that current assets shall be valued at market value if, on the balance sheet date, the same is lower than the acquisition price or production cost. Further, subsection 3 states that an extraordinary reduction in the value of the current asset reasonably foreseeable in the short-term, may be taken into account in the valuation of the asset [47]. There are two methods of making a downward adjustment to a lower market value: individually or collectively [48]. Contrary to section 384, subsection 1, BW2 Guideline 226, paragraph 107, states, as a consequence of Guideline 120, paragraph 503, that listed securities which can be sold immediately or almost immediately should be carried at market value if this is conducive to the view required by law [49]. The latter however is open for managerial interpretation.

<table>
<thead>
<tr>
<th>Item</th>
<th>Accounting flexibility for securities</th>
<th>C</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>47</td>
<td>Foreseeable extraordinary reduction in the future</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>48</td>
<td>Adjustment to lower market value individually or collectively</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>49</td>
<td>The higher market value is conducive to provide the view required</td>
<td>+</td>
<td>?</td>
</tr>
</tbody>
</table>

Table 5.7 Overview financial accounting flexibility related to securities.

Cash

Cash should generally be stated at face value. If funds are not freely disposable this could be taken into account in the valuation.

5.3.3 Liabilities

Liabilities in general can be divided in long-term and current liabilities and are generally stated at face value. A liability is usually considered a current liability if it falls due within one year. The part of a long-term liability that falls due within one year may be classified under current liabilities. The distinction between long-term and current liabilities is important for the firm’s liquidity position. For the purpose of this chapter another classification is more important: the distinction between liabilities and shareholder’s equity. This distinction is not
only important for the firm's solvency position, but also for the classification of interest and dividends. Paragraph 5.3.5 of this chapter deals with the flexibility associated with this classification.

5.3.4 Provisions

Provisions relate to:
1. Liabilities and losses the extent of which is uncertain but can reasonably be estimated;
2. Risks related to certain liabilities and losses;
3. Expenses to be incurred in a subsequent year, originating from the year under review or prior years.

BW2 distinguishes between provisions for pension liabilities, provisions for tax liabilities and other provisions.

Provisions for pension liabilities

Pension rights are rights of employees or former employees to benefits which are dependent on life and become payable on attaining the pension age or prior death. BW2 has no provisions for the complex valuations of pensions. The general principles used for the valuation of assets and liabilities and the determination of results are therefore applicable.

The usual schemes for building up pension rights are average-pay schemes, final-pay schemes or a combination of both. Pensions are sometimes subject to revision once the pension is in payment, depending on developments in the cost of living or wage levels. Only in a limited number of cases it is permitted that the firm itself administers the fund to meet the pension rights. In general, the pension liabilities will be insured with a life insurance company, a company pension fund or an industry pension fund.

It is important to know where the pension liabilities are insured. Generally speaking the closer the relationship between the pension fund to the firm, the more flexible the firm is in determining the pension cost. For this reason Guideline 252, paragraph 318, states that provisions should be made in the balance sheet of a firm for any deficits in a company pension fund for which the firm is legally liable. If the firm is affiliated to an industry pension
fund it is only recommended to make provisions in its balance for its share of the deficit [50]. Surplus funds held by the company pension fund may be taken into account if and to the extent that they may reasonably be expected to result in lower charges for the firm [51]. Given the close relationship there often is between the firm and the company pension fund the former gives opportunities for management to exert influence over accounting income.

There are two methods for providing the funds to meet pension rights: the funded system and the pay-as-you-go system. In the Netherlands, the funded system is compulsory. The interest rate used as the discount factor can, within boundaries, be influenced by the firm's management [52]. There are several possible variants of funded systems. The differences between the variants mainly concern with the way past-service charges are dealt with. Pension charges can basically be treated in the balance sheet and income statement in two different ways: calculated on a specific or general basis [53]. Under both methods it is possible to take into account pay rises to be awarded in the future if these will have retroactive effect on the accrued pension rights at balance sheet date [54].

<table>
<thead>
<tr>
<th>Item</th>
<th>Accounting flexibility for pension provisions</th>
<th>C</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>50</td>
<td>Provisions for share in deficit industry pension fund</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>51</td>
<td>Take into account surplus of company pension funds</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>52</td>
<td>Interest rate used as discount factor (the higher)</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>53</td>
<td>Pension charges calculated on a general or specific basis</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>54</td>
<td>Take into account future general pay rises</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>55</td>
<td>Provisions for early retirement if the scheme were extended</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>56</td>
<td>Ignore mortality and interest calculations in early retirement schemes</td>
<td>-</td>
<td>+</td>
</tr>
</tbody>
</table>

Table 5.8 Overview of financial accounting flexibility related to pension provisions.

Early retirement schemes differ from pension rights in several ways. The nature of the early retirement schemes leaves the firm's management the following two options. Guideline 252, paragraph 405, states that it is deemed admissible not to make a provision for early retirement of employees who would only be in a position to opt for the scheme if it were extended [55]. Further, paragraph 406 of the same Guideline states that it is permissible to ignore mortality rates and interest calculations insofar as the provision relates to benefits to be paid out over a limited number of years [56].
Provision for deferred taxation

Income before tax may differ from what is known as the taxable amount. Temporary differences may arise due to the difference in legislation or accounting decisions of the firm's management. Temporary differences are differences between the book value of an asset or liability in the balance sheet and the book value for tax purposes, including:

1. Temporary differences leading to tax liabilities and tax credits in future years on realization of an asset, release of a provision or settlement of a liability or accrual;
2. Temporary differences that will not lead to tax liabilities and tax credits in future years on realization of an asset, release of a provision or settlement of a liability or accrual.

<table>
<thead>
<tr>
<th>Item</th>
<th>Accounting flexibility for deferred taxation provisions</th>
<th>C</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>57</td>
<td>Deferred tax items at discounted value</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>58</td>
<td>Capitalize deferred claims if reasonable to suppose realization</td>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>59</td>
<td>Revaluation of assets without deferred tax items</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>60</td>
<td>Settlement of taxation of revalued assets against equity</td>
<td>+</td>
<td>+</td>
</tr>
</tbody>
</table>

Table 5.9 Overview of the flexibility related to provisions for deferred taxation

Deferred tax items should be carried in the balance sheet either at face value or discounted value [57]. A tax credit should be included in the balance sheet if it is reasonable to suppose that it will be possible to realize the claim in due course (guideline 272, paragraph 306). This "reasonable to suppose" makes the capitalized amount subjective [58]. If the valuation of assets takes partly place at current value, the law leaves open the possibility of not including deferred tax items in the balance sheet in the event of revaluation of the assets (section 390, subsection 5, BW2) [59]. The settlement of the taxation on the increase in the equity reflected in the balance sheet takes place in the form of a charge against shareholders equity, or a gradual charge to the income statement [60].

Other categories of provisions

Not every uncertainty warrants the recording of a provision. Guideline 252, paragraph 105, states that the following two conditions must be met: they are identifiable, specific risks and the risks must have existed on balance sheet date and stem from events which took place prior to balance sheet date, transactions effected prior to balance sheet date or commitments entered
into prior to balance sheet date. The firm’s management has to identify the risks, which can be a subjective process [61]. The decisions as to which risks warrant the recording of a provision and which do not should follow a consistent policy. Once the firm’s management decides to form a provision for a certain risk it has to decide on the amount of the liability. Although the possibility of making a reasonable estimate is a requirement for the formation of a provision, the estimate itself can be highly subjective [62]. If for example a best estimate is not possible, it is an option to provide for the lowest amount from the range of possible estimates as well as the average amount.

There are two possible methods for calculating the charge of the provisions to the financial statements: the general method and the specific method [63]. Combinations of both methods are also possible. When using the specific method the two basic approaches for estimating the movements in the provision are: collective valuation and item-by-item valuation [64]. Generally, movements in provisions are accounted for in the income statement, except if Guideline 240 permits them to be charged directly in shareholders’ equity [65]. In paragraph 5.3.5 the direct charges to shareholders’ equity are discussed.

Although it is impossible to sum up all categories of provisions the following aims to deal with the most important in respect to flexibility. Section 374, subsection 2, BW2 states that the diminution in value of an asset shall not be presented in the form of a provision. Provisions may, however, be made for existing risks of future diminution in value (Guideline 252, paragraph 103) [66]. Provisions for major maintenance of certain classes of fixed assets may be taken into account in the valuation of these assets or if this is not the case, a provision should be formed for major maintenance.

If the firm is not insured for certain risks which are normally insured, it is possible to record a provision. The additions to this provision are calculated on a general basis and should correspond with the premiums that would be paid if the risk was normally insured. The amount of the provision should not be greater than is reasonable for the nature and size of the risk. Provisions for risks arising out of claims, disputes and legal proceed are recorded if a
reasonable estimate is possible. The same holds for provisions for existing environmental pollution.

The provisions connected to reorganization and redundancy schemes depend very much on the view the firm's management has. Guideline 252, paragraph 921, states that when the going concern assumption no longer applies to all or part of the business, adequate provisions should be made. But even when the going concern assumption is valid provisions may be recorded for other kinds of reorganizations. It is for example possible that the firm's management decides that production is automated, production is transferred to another country or that by organizing processes differently, employees will be transferred or dismissed. The financial consequences of these decisions can be estimated, but are highly subjective. Another subjectivity is the moment of forming a provision because the firm's management is more or less free in the timing of the reorganization [67].

<table>
<thead>
<tr>
<th>Item</th>
<th>Accounting flexibility for other provisions</th>
<th>C</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>61</td>
<td>Decide on the relevant risks for forming provisions (the more)</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>62</td>
<td>Estimating the amount of the provision (the higher)</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>63</td>
<td>Provisions calculated on a general basis</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>64</td>
<td>Item-by-item valuation for movements</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>65</td>
<td>Movements in the provisions charged to the shareholders' equity</td>
<td>+</td>
<td>0</td>
</tr>
<tr>
<td>66</td>
<td>Provisions for future diminution in value of assets</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>67</td>
<td>Timing of reorganization provisions</td>
<td>?</td>
<td>?</td>
</tr>
</tbody>
</table>

Table 5.10 Overview of financial accounting flexibility related to other provisions

5.3.5 Shareholders' equity

As stated in the previous paragraph there is gray area between shareholders' equity and liabilities. The classification between shareholders' equity and liabilities may be ruled by the formal legal principle or the substance over form principle. Using the formal legal principle items are classified according to their legal status. The substance over form principle classifies items according to their economic impact on the firm. When the substance over form principle is used it is possible that items legally classified as liabilities may be classified as shareholders' equity due to their economic reality. This economic reality results from

112
special provisions in the contract. The opposite is also possible, items legally classified as shareholders' equity may be shown as a liability in the financial statements due to special contract provisions. The classifications are not only important for the firm's solvency position but also for the classification of interest and dividends [68].

Another important item of flexibility is the possibility for direct movements in shareholders' equity. The direct movements in shareholders' equity differ in effects and frequency. The first category of movements results from the relation between the firm and its shareholders. Movements of this kind also include the expenses and capital tax related to the issuing of shares [69]. Further, when current value is the principle applied, revaluations should be reflected in shareholders' equity. The cumulative effects of accounting method changes should be reflected directly in shareholders' equity at the beginning of the year in which the method change was implemented if the method change involves a change from valuation on the basis of historical cost to a basis of current value and vice versa. The cumulative effect of other method changes and effects of fundamental errors may be reflected directly in shareholders' equity at the beginning of the year in which the method change was implemented or may be reflected in the income statement (see also paragraph 5.3.8) [70].

As stated in paragraph 5.3.1 a business combination may give rise to goodwill when a firm purchases the shares of another firm or when a firm purchases the assets and liabilities of a firm. If the firm purchases the shares of another firm goodwill can be charged separately to the shareholders' equity (see also paragraph 5.3.1). Exchange differences resulting from foreign entities should be credited or debited directly to the shareholders' equity. The classification of a participating interest can however be subjective. Foreign currency translations are dealt with in paragraph 5.3.7 of this chapter.

Material items of a non-recurring or exceptional nature such as adjustments to the provision for deferred tax liabilities due to the revaluations of assets, effects of a financial reorganization, losses due to non-insurable destructions of capital and the adverse effects of nationalizations may be shown directly as movements in shareholders' equity. The distinction between non-recurring and recurring (future) and the distinction between extraordinary and
exceptional nature is not straightforward. The decision to charge these items to the shareholders' equity can be highly subjective [71].

<table>
<thead>
<tr>
<th>Item</th>
<th>Accounting flexibility for shareholders' equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>68</td>
<td>Classification as interest or dividend in case of hybrid financing</td>
</tr>
<tr>
<td>69</td>
<td>Charge expenses and capital tax to the share premium</td>
</tr>
<tr>
<td>70</td>
<td>Cumulative effect of accounting changes charged to equity</td>
</tr>
<tr>
<td>71</td>
<td>Direct equity movements of non-recurring or exceptional items</td>
</tr>
</tbody>
</table>

Table 5.11 Overview of financial accounting flexibility related to shareholders' equity

5.3.6 Consolidated accounts

Consolidated financial statements are very important in analyzing listed firms in the Netherlands. A consolidated statement emphasizes the economic unity of all enterprises in the group. Section 405, subsection 1, BW2 defines consolidated financial statements as "financial statements in which the assets, liabilities, income and expenditure of legal persons and partnerships constituting one group or part of a group are shown on a unified basis". The legal requirement for consolidation is laid down in section 406, subsection 1, BW2: "The legal person which, solely or jointly with another group company, heads its group shall, in the notes to its financial statements, include consolidated financial statements showing its own financial information with that of its subsidiaries in the group and other group companies". In practice the consolidated financial statements are disclosed before the financial statements of the firm in the annual accounts.

Section 405, subsection 2, BW2 states that the consolidated financial statements must give a view of the group in accordance with section 362, subsection 1, BW2. The provisions for the financial statements, apart from some exceptions, apply also to consolidated financial statements. The items in the consolidated financial statements should, in principle, be presented according to uniform accounting methods.

As stated before shares and receivables in group companies are normally not an item in the consolidated accounts since the group is accounted for on a unified basis. Group companies
can however be excluded from consolidation on the grounds of immateriality, disproportionate costs and long delay, or because they are held only for resale (section 407, subsection 1, BW2). Further, group companies must be excluded on the grounds of different activities (section 406, subsection 3, BW2) and can be excluded if the firm administers group companies pursuant to a co-operation arrangement with another firm and it has no activities other than the administration and financing of group companies and participating interest (section 407, subsection 3, BW2). Although the sections mentioned above bring some flexibility in the consolidation requirements, this will not have any influence on accounting income. Group companies excluded from consolidation should be valued consistent with the other participating interests.

The manner in which the group company is acquired is important for the consolidated accounts afterwards. A distinction can be made between the "purchase method" and the "pooling" method. In case of the purchase method the firm purchases the shares of another firm by means of cash or securities. In case of the pooling method the firm gains control over another firm by means of exchanging their own shares with the shareholders of the newly controlled firm. In the latter case the consolidation takes place at book-value and no revaluation takes place and no goodwill arises. In general, future accounting income is lower and owner's equity is higher when using the "purchase method", except when the goodwill is charged to the shareholders' equity. The manner in which the group company is acquired thus gives opportunities for management to influence accounting income [72].

<table>
<thead>
<tr>
<th>Item</th>
<th>Accounting flexibility for consolidated accountings</th>
</tr>
</thead>
<tbody>
<tr>
<td>72</td>
<td>Acquire group companies through pooling of interests</td>
</tr>
<tr>
<td></td>
<td>C  F</td>
</tr>
<tr>
<td></td>
<td>+  +</td>
</tr>
</tbody>
</table>

Table 5.12 Overview of financial accounting flexibility related to consolidated accounts

5.3.7 Foreign currency translations

Foreign currency translations are important when discussing flexibility because volatile exchange rates can affect the valuation of assets and liabilities in foreign currencies and thus will affect accounting income.
The first item of flexibility is the possibility for the firm’s management to decide on their reporting currency [73]. Section 362, subsection 7, BW2, first sentence states: "If justified by the activity of the legal entity or the international structure of its group, the financial statements as a whole, or only the consolidated accounts, may be prepared in a foreign currency".

Regarding exchange differences a distinction is made between transactions and foreign activities. Transactions in foreign currencies settled during the accounting period should be included in the financial statements at the settlement rate of exchange. Unsettled foreign currency transactions should be included in the balance sheet at the rate of exchange prevailing on balance sheet date. Where the exchange risk has been hedged, this shall be taken into account in determining the results (Guideline 120, paragraph 907). Deciding whether exchange risks are hedged can be subjective [74]. Exchange differences on the translation of monetary items should be included in the income statement in the period in which they arise (Guideline 120, paragraph 906). Exchange differences on the translation of non-monetary items carried at current value should be accounted for directly in shareholders’ equity as part of the revaluation reserve (Guideline 120, paragraph 906). Since items that are carried at historical costs are translated at the historical exchange rates, no exchange differences occur here (Guideline 120, paragraph 905, b)

With respect to foreign currency translations associated with participating interests Guideline 120, paragraph 912 states that the foreign group companies consolidated in the firm’s financial statements must be separated in two groups: activities conducted through foreign entities and direct foreign activities [75]. Exchange differences from direct foreign activities are recorded similar to foreign transactions (Guideline 120, paragraph 118). The assets and liabilities of foreign entities are translated at exchange rates prevailing on balance sheet date. The items in the income statements of these entities are translated at the prevailing rates of the transactions, or the average exchange rates over the accounting period [76]. The translation differences are accounted for directly in shareholders’ equity (Guideline 120, paragraph 119). When a participating interest is disposed, the cumulative amount of exchange differences
related to that interest may be recognized in the income statement in the same period in which
the gain or loss of disposal is recognized (Guideline 120, paragraph 928) [77].

<table>
<thead>
<tr>
<th>Item</th>
<th>Accounting flexibility for foreign currencies</th>
<th>C</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>73</td>
<td>Decide on the reporting currency</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>74</td>
<td>Take into account the hedge regarding foreign currency</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>75</td>
<td>Separation of group companies in two groups</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>76</td>
<td>Use average exchange rates for foreign entities</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>77</td>
<td>Recognize cumulative exchange difference in income statement</td>
<td>?</td>
<td>?</td>
</tr>
</tbody>
</table>

Table 5.13 Overview of financial accounting flexibility related to foreign currencies

5.3.8 Other items of flexibility

In paragraph 5.3.1 to 5.3.7 the items of flexibility in the principles used for valuation and the
subjectivities when applying them were discussed. In this paragraph four aspects of flexibility
related to the principles used for valuation are discussed. The four aspects of flexibility are
changes in accounting methods, changes in estimations, corrections of fundamental errors and
extraordinary items.

Changes in accounting methods

Section 384, subsection 6, BW2, first sentence states: "The principles on which the valuation
of assets and liabilities and the determination of the results are based may only be changed
from those applied in the preceding financial year for sound reasons". A change in an
accounting method is deemed to occur if one or more of the following principles and or rules
differ from those used in the preparation of financial statements for the preceding year
(Guideline 140, paragraph 103 and 104):

a1. Valuation principles applied to assets and liabilities, including estimating methods
    used;

a2. Methods of allocating to periods;

a3. Criteria employed in judging the need for or admissibility of reflecting
    movements directly in shareholders' equity;

b. Consolidation criteria;

c. Layout and other aspects of presentation.
Guideline 140, paragraph 111, states that the accounting methods should be changed if required by BW2 or by the guidelines or if the change would be of significant benefit to the view imparted by the financial statements. A change is however also permissible if it can be deemed to be based on sound reasons as mentioned in BW2. Guideline 140, paragraph 112, states that "in any decision on a change in accounting methods, the view which the financial statements are required to provide, as referred to in paragraph 110, will continue to be of overriding consideration" [78].

There are two procedures in reflecting the effects of changes in accounting methods in the financial statements. In both procedures the shareholders' equity as at the end of the preceding financial year is restated on the basis of the revised policies. The difference in the two procedures lies in reflecting the difference between the shareholders' equity as at the end of the preceding financial year before and after restatement. The first procedure is to reflect the difference directly in shareholders' equity at the beginning of the year in which the method change was implemented, taking into account taxation on accounting income (Guideline 140, paragraph 116). The alternative is to reflect the difference as an extraordinary item in the income statement in the year in which the accounting method change was implemented, taking into account taxation on profits [79]. The first procedure is preferred by the CAR and is prescribed in the CAR Guidelines if the accounting method change involves a change from valuation on the basis of historical cost to a basis of current value and vice versa. The procedure should also be adopted in the case of changes in the criteria governing the need for or admissibility of reflecting movements directly in shareholders' equity.

In the exceptional case that the cumulative effect of the accounting method change cannot reasonably be determined, the book values at the beginning of the year in question under the previous accounting methods should be used as the basis for the application of the new policies. The decision whether or not the cumulative effect can be determined may be subjective [80].
Accounting flexibility for accounting method changes

<table>
<thead>
<tr>
<th>Item</th>
<th>Accounting flexibility for accounting method changes</th>
<th>C</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>78</td>
<td>Permissibility of change in accounting method</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>79</td>
<td>Reflect cumulative effect in income statement</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>80</td>
<td>Reasonably impossible to determine cumulative effect</td>
<td>?</td>
<td>?</td>
</tr>
</tbody>
</table>

Table 5.14 Overview of the flexibility related to accounting method changes

Changes in accounting estimates

A change in accounting estimates is said to occur if an estimate is revised due to changes in the circumstances on which it was based. A distinction is made between a change in estimate and a change in the estimating method. A change in estimating method is seen as an accounting method change. Both changes however can have the same effects. A change in accounting methods should always be disclosed in the notes, a change in estimate should only be disclosed if the change is material to the accounting period or potentially material to one or more ensuing periods. A change in estimate can be subjective [81].

Guideline 212, paragraph 220, states that the revision of the expected useful life of tangible fixed assets is a change in estimate. The way this revision is accounted for depends on whether the useful life is lengthened or shortened. If the useful life is lengthened, the amount by which the already charged depreciation can be reduced should be either credited to the income statement or be reflected in a reduction in the depreciation charged in the remaining useful life [82]. If the useful life is shortened, the amount by which depreciation has been undercharged should be expensed directly in the income statement.

<table>
<thead>
<tr>
<th>Item</th>
<th>Accounting flexibility for changes in accounting estimates</th>
<th>C</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>81</td>
<td>Accounting estimates and changes in estimates can be subjective</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>82</td>
<td>Previous depreciation partly credited to the income statement</td>
<td>+</td>
<td>-</td>
</tr>
</tbody>
</table>

Table 5.15 Overview of financial accounting flexibility related to changes in accounting estimates

Corrections of errors

The CAR makes a distinction between fundamental en non-fundamental errors. A fundamental error is such an inaccuracy in financial statements that the financial statements
are seriously defective in imparting the view the statements should give. A fundamental error
should be disclosed in the financial year for which the financial statements have not yet been
adopted or approved following as closely as possible upon the financial year in which the error was made [83].

There are two procedures in reflecting the effects of the correction of fundamental errors in
financial statements. In both procedures the shareholders' equity as at the end of the preceding
financial year are restated on the basis of the correction. The difference in the two procedures
lies in reflecting the difference between the shareholders' equity as at the end of the preceding
financial year before and after restatement. The first procedure is to reflect the difference
directly in shareholders' equity at the beginning of the year in which the errors are corrected.
The alternative is to reflect the difference as an extraordinary item in the financial statements
in the year in which the errors are corrected [84].

Non-fundamental errors are corrected in the year for which the financial statements have not
yet been adopted or approved following as closely as possible upon the financial year in
which the error was made. The effect of the correction is reflected as an ordinary revenue or
expense item in the income statement in the year of the correction.

<table>
<thead>
<tr>
<th>Item</th>
<th>Accounting flexibility for correcting errors</th>
<th>C</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>83</td>
<td>Distinction between fundamental and non-fundamental errors</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>84</td>
<td>Reflect cumulative effect of fundamental errors in income statement</td>
<td>?</td>
<td>?</td>
</tr>
</tbody>
</table>

Table 5.16 Overview of financial accounting flexibility related to correction of errors

*Extraordinary items*

Extraordinary revenue and expenses are income statement items not arising in the ordinary
course of the business of the firm. Section 377, subsection 1, BW2, states that extraordinary
items are to be shown separately in the income statement. The basis on which a firm
distinguishes between revenues and expenses from ordinary activities and extraordinary items
is part of the firm's accounting principles (Guideline 270, paragraph 207). Extraordinary
items do not directly related to valuation principles or accounting estimates and the
classification does not influence accounting income. However, extraordinary items are
important when handling flexibility because many users are focused on accounting income from ordinary business activities. The distinction may be essential when comparing the income statements of the same firm in different years.

The distinction between revenue and expenses arising from ordinary activities and extraordinary items is sometimes subjective [85]. The distinction depends on the frequency of occurrence in relation to the duration of the typical production cycle and the scale of the firm's business. The classification of items in the income statement is in some cases straightforward because of its nature or because of BW2 provisions and authoritative statements in the Guidelines. In other cases however the firm's management can influence the view the financial statements should give by classifying items as ordinary or extraordinary because there are no strict rules for this classification.

<table>
<thead>
<tr>
<th>Item</th>
<th>Accounting flexibility for extraordinary items</th>
<th>C</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>85</td>
<td>Distinction between ordinary and extraordinary items</td>
<td>?</td>
<td>?</td>
</tr>
</tbody>
</table>

Table 5.17 Overview of financial accounting flexibility related to extraordinary items

5.4 Summary and implications for this study

Financial accounting flexibility is an important phenomenon in countries with a less regulated accounting environment. As stated in the introduction of this chapter the accounting environment in the Netherlands is perceived to be rather flexible. The aim of this chapter is to answer the first research question:

RQ1 : What are the general possibilities to adapt financial accounting data within the opportunities offered by accounting standards in the Netherlands?

Even when taking into account the authoritative statements in the 1999 edition of the CAR Guidelines, there are at least 85 discretionary accounting items relating to accounting methods and accounting estimates. The 85 items are general possibilities to adapt financial accounting data within the opportunities offered by accounting standards in the Netherlands. From the overview it is impossible to conclude whether there are more opportunities to influence
accounting income in the Netherlands than in other countries. However, an indication in this respect are the number of differences between the CAR Guidelines and the IAS provided in the 1999 edition of the CAR Guidelines.

Although it is quite obvious that there is ample room to influence accounting income in the Netherlands by accounting decisions, there is a tendency towards a more regulated accounting environment. Since the introduction of statutory regulations for financial statements in 1970 the following developments are important in this respect. First, the development in IAS in general and the reduction of IAS flexibility through the comparability project more specific. Second the foundation of the CAR in 1981 in general and the policy of the CAR to adopt IAS, except where these are not appropriate to the financial accounting situation in the Netherlands, more specific. Finally, the explicit recording of the authoritative statements from the CAR Guidelines in NSA 120 since NSA edition 2000.

International differences in the accounting environment, including the flexibility of the accounting system, the enforcement of accounting regulation and other aspects of the institutional setting, limit the possibility to generalize the research findings on earnings management in other countries. Further, it may limit the possibility to transpose the research methods used in other countries. This may especially hold for the measurement variables used. This aspect is discussed in the next chapter.