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Reflections on the Revision of the IASB Framework by EAA Academics

A key function of the European Accounting Association Financial Reporting Standards Committee (EAA FRSC) is to provide a mechanism for collating and bringing to the attention of the International Accounting Standards Board (IASB) research findings germane to discussion papers and proposed standards the IASB has developed and has exposed for public comment. The IASB is in the process of developing jointly with the U.S. Financial Accounting Standards Board (FASB) a common Conceptual Framework for Financial Reporting (CF). Providing informed comment on the CF has proved to be particularly difficult—in part because of the way the project has been broken down by the boards into manageable pieces.¹ An even greater difficulty for the EAA FRSC has been the very nature of a CF, involving as it does value judgments about the role of financial reporting in society, and as such arguably one which cannot readily be addressed by conventional accounting research methods. On the other hand, the fact that the membership of the EAA FRSC is drawn from a wide range and variety of European countries suggests that it might provide a suitable vehicle for bringing to bear diverse international research perspectives on these issues. But it required the EAA FRSC to employ different data-gathering methods, and with less regard than usual to meeting any comment deadlines specified by the IASB. All of this has taken place against the background of an unfolding international financial crisis that has raised major questions con-

¹ Work on the CF is being carried out by the two boards in five main phases dealing with (A) objectives and qualitative characteristics, (B) elements and recognition, (C) measurement, (D) reporting entity, and (E) presentation and disclosure. A discussion paper (DP) expressing preliminary views on phase A was issued in July 2006 (IASB, 2006), followed by an exposure draft (ED) in May 2008 (IASB, 2008), with the final chapter projected to be published in the first half of 2009. Round table meetings were held on phase C and a DP is planned for completion in the second half of 2009. A DP on phase D was issued in May 2008 and an ED is scheduled for the second half of 2009.

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The paper has been developed as part of the deliberations of the European Accounting Association Financial Reporting Standards Committee (EAA FRSC) on the IASB Conceptual Framework project. Members of the EAA FRSC are—in alphabetical order—Graeme Dean (The University of Sydney), Lisa Evans (University of Stirling), Günther Gebhardt (Chair, Goethe Universität Frankfurt am Main), Martin Hoogendoorn (RSM Erasmus-University), Jan Marton (Göteborg University), Ken Peasnell (Lancaster University), Roberto Di Pietra (Università degli Studi di Siena), Araceli Mora (Universidad de Valencia), Frank Thinggård (Aalborg University) and Alfred Wagenhofer (Karl-Franzens-Universität Graz).

cerning the role of financial reporting, questions that have undoubtedly altered the agendas and timescales of the two major standard-setting bodies.

Two special meetings were organized by the EAA FRSC. The first took the form of an open forum discussion held as part of the EIASM Fourth Workshop on Accounting Regulation held in Siena in September 2007. The forum occurred at a critical stage in the first phase of the development of the common CF by the IASB and FASB. A summary of the discussions held at the forum is provided in Gebhardt and Dean (2008). The second meeting took the form of a one-day workshop held in Frankfurt in November 2008 comprising members of the EAA FRSC and an invited group of non-members with special interests and expertise in the area.² This report provides a distillation of the discussions that took place at the Frankfurt Workshop.

The overlapping membership of the two events made it possible for the Frankfurt Workshop to build on the experience of the Siena Forum. The discussions at the workshop were grouped into four sessions. The approach was novel—rather than people presenting papers in a fixed format, a free-flow of ideas was promoted with only general introductory remarks from the chair.

FOUNDATIONS

The first session focused on broad questions regarding what the two boards were trying to achieve in developing a common CF. Concern was expressed in Siena and repeated in the Frankfurt workshop that the IASB/FASB efforts to date were being expressly devoted both to refining the language employed in the CF rather than taking the opportunity to carry out a fundamental review of what standard setters could (and could not) do to solve financial reporting problems in a world of imperfect and incomplete markets, and to the part that a CF might play in that process. Another theme common to both meetings was the importance of standard setters understanding what had happened in the past, perhaps best summed up by the oft-misquoted aphorism of the Spanish philosopher George Santayana that those who cannot remember the past are condemned to repeat it.³ A useful contribution that scholars can make to the CF project is to provide such historical lessons. In particular, an understanding of the criticisms of extant accounting presaging moves to develop a CF is critical.

² Participants were Günther Gebhardt (Goethe Universität Frankfurt am Main) (chair), Wolfgang Ballwieser (Ludwig Maximilians University, München), Michael Bromwich (London School of Economics and Political Science), Graeme Dean (The University of Sydney), Joachim Gassen (Humboldt University Berlin), Jan Marton (School of Economics, Göteborg), Ken Peasnell (Lancaster University Management School), Frank Thinggård (Aalborg University), Petri Vehmanen (University of Tampere), Alfred Wagenhofer (Karl-Franzens-Universität Graz) and Geoffrey Whittington (Judge Business School, Cambridge).

³ A feature lacking in the current CFs and the documents is a brief overview of the historical antecedents in the accounting literature on these topics. It would be useful for the revised combined CF to have an overview of the different views on what the CF seeks to depict—and why the IASB/FASB have adopted their position on the issue. This may provide insights into the likelihood of such a CF preventing repeated criticisms of accounting in the future.

With that spirit in mind, the workshop did not see its function as being to seek a 'better' CF based on different axioms but rather to identify problems, deficiencies, inconsistencies and solecisms with the existing CFs and the latest FASB/IASB proposals. Participants recognized that the nature of the standard-setting process was 'political' in the sense that a CF had to be produced in a consensual manner, and as such would inevitably involve compromises. It would be piecemeal rather than revolutionary. The contribution that academics could make to the process was not to score easy points, but rather to draw on their knowledge of prior research and history to identify where such outcomes might simply defer problems for the standard-setting community.

A central problem faced by the two standard-setting bodies in creating a common CF is that enormous effort was expended in the late 1970s and 1980s by the FASB in developing its CF, a venture which gave it a head start and as such likely created a general resistance to ideas from other countries with different traditions. It is notable in this regard that the criticisms voiced about the IASB/FASB proposal to treat information relevant for assessing stewardship as subsumed within the decision-usefulness objective have been particularly pronounced outside the U.S.A., notably from within the European Union where stewardship has long been at the heart of financial reporting.⁴ The IASB/FASB DP acknowledges that stewardship may require more emphasis be placed on past transactions than would the decision-usefulness objective's focus on future cash flows, but suggests that the two needs do not necessarily conflict. There is a substantial body of academic research on agency theory that is related to stewardship, work that suggests the set of information useful for decision making by investors cannot safely be assumed to encompass the information needed for stewardship. A clear example is provided by Lennard (2007, p. 62): An event that has occurred in the period that is unique and will not recur is not relevant to the prediction of future cash flows and can therefore be omitted for investment decision-making purposes, but should be reported for stewardship.

Many of the criticisms raised in the Siena Forum concerning the subsuming of stewardship within the decision-making objective were echoed in the Frankfurt workshop and will not be repeated here.⁵ Since the Siena forum, Edwards *et al.* (2009) revealed through an historical review of early double-entry bookkeeping treatises that from the earliest times such texts recognized that accounting had multiple functions involving both decision making and accountability that had to be addressed simultaneously. However, another criticism does bear repeating because of a strongly expressed concern at Frankfurt regarding the general direction of the

⁴ The U.S.A. and the U.K. are often treated as having common so-called 'Anglo-Saxon' traditions in financial reporting. However, Bush (2005) provides an interesting comparison of how financial disclosure regimes developed differently in the two countries, with the former emphasizing information for investors but the latter placing considerable weight on stewardship. These traditions long predate the U.K.'s membership of the European Union. In the U.K., as in many other countries, financial reporting has always been grounded in company law. In the U.S.A., financial reporting since the 1930s has been largely determined by the Securities and Exchange Commission (SEC), a body charged with overseeing the capital markets.

⁵ See also Whittington (2008), which provides a carefully argued critique of the proposal.

proposed changes to the CF: Despite protestations to the contrary, a number of the proposed changes appear to be strongly influenced by a desire to make the standard-setting process more deductive, in the sense of creating clearer hierarchies of criteria, thereby reducing the need for trade-offs. Subsuming stewardship within decision-making provides the most striking example. Another is the proposal to substitute the qualitative characteristic of 'reliability' by 'faithful representation', thereby removing the possibility of a trade-off between 'relevance' and 'reliability'. It is now envisaged that to be a faithful representation of real-world economic phenomena, information must be 'verifiable', 'neutral' and 'complete'. 'Prudence' is to be dropped because of its inconsistency with neutrality. In doing this, the significance of subsuming stewardship within decision-usefulness becomes apparent: Prudence is deemed to have little to offer decision-makers (who can be expected to make their own allowances for risk), but can be highly relevant in a stewardship context. For the investor, accidental overstatements of net assets or earnings by some firms may well be offset by understatements by others and thus will tend to cancel out in a well-diversified portfolio. We cite studies later that demonstrate that this is an over-simplification, because of the possibility of outside decision-makers being misled by management. However, as the recent controversies regarding the payment of earnings-related bonuses by financial institutions have demonstrated all too clearly, overstatements of net assets and earnings can have particularly serious consequences in a stewardship context. Prudence is a long-established feature of financial reporting for good reasons grounded in the stewardship function of accounting. Workshop participants felt that neither function should be lightly discarded or downgraded.⁶

Discussion of these fundamental questions led participants to question the role a new CF was expected to fulfil. For the FASB, its CF is purely an instrument used to inform the process by which new standards are created and old ones amended. On the other hand, the IASB's CF is expected to play a 'gap filling' role when accountants and auditors face accounting policy choices not covered by a standard. This is a fundamental difference which warrants greater consideration than it has hitherto received. Countries which adopt IFRS are at liberty to introduce their own standards on topics where there is no standard. In the U.S.A., the 'authoritative literature' has always included SEC Staff Bulletins, and guidance can be sought in a variety of other ways. In Europe, the 'true and fair override' has even allowed for the possibility of departing from accounting standards⁷—though how this has been interpreted has varied across member states.⁸ How IFRS is implemented in different countries around the world and what, if any, role the CF might play are areas of major contemporary research interest.

⁶ For other examples of how the downgrading of stewardship seems to be permeating other parts of the CF (e.g., the definition of an asset), see Whittington (2008).

⁷ See Livne and McNichols (2009).

⁸ For a discussion of this in the context of the principles-versus-rules debate, see Benston *et al.* (2006).

Another fundamental issue raised in the workshop is the sloppy use of technical language generally. Consider specifically the casual way the CFs use the word ‘measurements’ to refer to accounting numbers. This is not restricted to the boards’ documents, of course; it is a casual linguistic convention commonplace right across accounting. However, it is at odds with the efforts the boards have made through their CFs to impose discipline on the accounting process, by restricting what might qualify for recognition as assets and liabilities. The proposed removal of the previous reference in the definition of an asset (liability) to expected future benefits (outflow) and replacement with ‘present economic resource’ (‘present economic burden’) limits what can be recognized to things that exist in some sense, as opposed to being future possibilities. However, the proposals continue the standard setters’ tradition of leaving open the question of how numerical values are to be assigned to the assets and liabilities. Workshop participants observed that the continued use of the term ‘measurement’—in conjunction with ‘faithful’ representation—gives a quasi-scientific aura to the accounting process, in the sense of implying it would be the result of the discovery of ‘facts’, whereas what we have in practice is better described as codified conventions. This begs the question of whether a CF should be a rationalization (*ex post*) of practice, as in this sense it seems to be, or whether it should aspire to do better.

ENTITY VERSUS PROPRIETARY PERSPECTIVE

The issue of whether financial reporting should be based on an entity perspective or a proprietary perspective was discussed at some length in the second session. The distinction between these two perspectives has a long history in accounting thought. The boards have expressed a preference for the entity perspective, primarily because they regard it as being consistent with serving a wide range of users. Workshop participants largely agreed with the boards that financial statements should address the needs of a wide range of users, but took the view that more attention needed to be given to the full implications of adopting an entity perspective. If financial standard setting decisions simply involved portraying different kinds of financial information useful to a wide range of users then there would be no major implications. As the boards state: ‘adopting the entity perspective does not preclude also deciding in future standards projects to include in financial statements more information that might be viewed as consistent with a proprietary perspective’ (IASB, 2006, BC1.12). However, accounting is not simply a matter of portraying financial information. Choices have to be made about the definitions of key elements, notably of equity, liability and the ‘bottom line’.

The difficulties in developing a generally acceptable accounting standard for employee stock options provides a useful example of how these definitions can have important consequences. It could reasonably be argued that the requirement in SFAS 123 (FASB, 1995) that U.S. companies must disclose in footnotes the *pro forma* effects on earnings of employee compensation expense attributable to amortizing the fair value of employee stock options at grant date was a good example of the FASB (a) adopting an entity perspective (i.e., by not including the expense in the

income statement itself) and (b) exercising its prerogative to mandate the provision of additional information consistent with a proprietary perspective. This would be more persuasive were it not for the fact that the FASB really wanted to require firms to recognize employee stock options as an expense, which it (and the IASB) has now done, but was politically prevented from doing so.

While little academic work has been done in recent years regarding the reporting implications of the two perspectives, the issue received considerable attention during the inflation accounting debate in the 1970s.⁹ In that debate, the issue in question was the definition of capital to be maintained in determining profit. Workshop participants noted that this is an issue on which both the existing CFs and the proposed changes to those frameworks are silent. This issue is likely to become more important, with some commentators suggesting the next crisis in accounting might be how to account for inflation—a prospect some economists suggest is a likely outcome of the current governmental stimuli to address the current financial crisis. One interpretation of the entity perspective is that all financial claimants should be treated equally for accounting purposes, with interest payable on debt being put on the same footing as dividends paid on share capital, that is, as appropriation of profit rather than an expense deducted in arriving at profit. In contrast, Anthony (1983) proposes that equality between capital providers be achieved by making a notional charge for interest on equity capital in arriving at profit, in the same way as interest on debt is currently treated as an expense, thereby defining profit as what is now commonly labelled in the literature as ‘residual income’. Workshop participants pointed out that any new CF needs to give explicit attention to the definition of income or profit, and with it whether there ought to be ‘layers’ of profit relevant to different kinds of users. The profession’s current cost accounting initiatives in the 1970s (and alternative proposals considered but rejected at that time) provide a rich source of ideas for developing this hitherto neglected aspect of the current CFs.

Participants noted that the focus on assets and liabilities without any concomitant attention to the definition of income leaves out distinctions that have a long history in accounting thought and continue to influence practice. For example, the CFs are silent on the role of the ‘going-concern assumption’—an assumption that is of considerable importance in practice to auditors in their process of verifying management’s presentations. The boards’ failure to provide a definition of income also leaves the CFs silent on the significance of the ‘matching process’ in accounting. Participants pointed out that it should not be assumed, as sometimes appears to be the case, that matching implies or is only consistent with historical cost accounting; Edwards and Bell (1961) and Schmidt (1921) long ago showed theoretically how the use of replacement cost could result in the matching of costs and revenues that was more informative than any based on historical costs. Matching not only results in better insights into firm performance—indeed, it is difficult to understand what is meant by performance without some notion of the matching of sacrifices with benefits. Matching can also be of use in predicting future cash flows. An exclusive

⁹ The debate has much older origins. In the English language, highly influential early discussions include Paton (1922) and Hatfield (1927). For an overview, see Hendriksen (1970, ch. 17).

focus on matching as simply the outcome of the recognition and de-recognition of assets and liabilities, rather than as an additional guiding principle, has resulted in a perspective on deferred tax accounting, for example, that differs in important respects from that which would be obtained if matching were to explicitly play a role in the process.

QUALITATIVE CHARACTERISTICS

The third session focused on the qualitative characteristics of financial reporting. The issue of the subsuming of reliability within faithful representation appeared to participants as an attempt to avoid the need for trade-off between relevance and reliability. The notion of reliability plays an important role in most scientific disciplines, where, typically, it is used as a criterion for choosing between different estimators of a pre-determined construct. In statistics and forecasting, it is standard practice to base such choices on criteria such as minimization of bias and average error, and to accept trade-offs between such criteria. However, the boards have, in effect, created an absolute hierarchy between bias and error by stating that accounting measures should be free from bias. Whether this is in the best interests of the users of financial statements is questionable. An analogy can be made with the choice between two watches, one of which is always ten minutes fast and the other which provides the correct time on average but is sometimes five minutes fast and sometimes five minutes slow. Most people would presumably prefer the first watch, on the ground that they can readily correct for the bias. This issue was also raised and discussed at the 2007 Siena forum.

The elevation of the concept of faithful representation was a source of unease to many workshop participants. It makes most sense when there is clear agreement as to what is being measured. The usefulness of the construct is much less obvious in accounting, where there has been much difficulty in getting agreement as to what the underlying construct should be. The issue becomes even more complex when there is uncertainty as to what is actually meant by 'accounting measurement'. This matter also has a long pedigree in accounting (e.g., see Chambers, 1966; Mattessich, 1964; and Ijiri, 1975). In many European languages 'measurement' is synonymous with 'valuation'. This is consistent with greater use of fair value accounting. Participants wondered whether the boards really were willing to contemplate with equanimity more recognition of 'day-one profits' when these have been arrived at not by reference to prices obtained in deep and active markets but rather by level three-type estimates that are essentially little more than forecasts. The disappearance of 'prudence' as a separate constraining qualitative characteristic would seem to make that a much greater possibility than hitherto.

The incidence and determinants of prudence (or conservatism as it is more commonly termed in the academic literature) has been the subject of considerable empirical research. Prudence-cum-conservatism comes in two forms. The first is unconditional, in the sense that it takes place regardless of what is known about the future, a prime example being always to write off research and development expenditures immediately they are incurred. The other form of conservatism is conditional

on news whereby bad news is reflected more quickly and strongly than good news. Basu (1997) devised a simple measure of this obtained by regressing earnings against contemporaneous stock return to determine whether the association was more strongly positive when the stock return was negative than when it was positive. This metric has been applied in a variety of economic settings. Studies have revealed, *inter alia*, that such conditional conservatism is more pronounced in economies where debt markets are relatively more important (Ball *et al.*, 2007) and where information asymmetries between managers and outside equity owners are pronounced (LaFond and Watts, 2008). The reason why conditional conservatism is important in these kinds of (commonplace) settings is because the provision of information is not a neutral act; it can affect the level of a firm's investment and its likely success in raising capital (Göx and Wagenhofer, in press). Thus, it is not simply a question of prudence—conservatism only being required for stewardship accounting. There is a decision-making as well as a stewardship demand for prudent accounting measures.

Participants urged the boards to attach more weight to the qualitative characteristic of 'comparability' than appears currently to be the case. Comparability is more than simply another component of faithful representation. Indeed, the quest for enhanced comparability of financial statements is what, at the most fundamental level, has been the rationale for having independently mandated accounting standards. This is doubly so for IFRS. The creation, implementation and policing of accounting standards is not without attendant costs, one of which is the stifling of accounting innovations and the loss of valuable variety. However, an essential use of financial statements is to make comparisons across firms and time. An example where this might arise is with allowing management to choose the definitions to use in segment reporting. A virtue of granting them this freedom could be that the results provide a more faithful representation of the operations of the business, but at the cost of making them less comparable to those of other firms. There will always be situations where a first-best solution is not attainable and the second-best solution is to base accounting on less relevant methods that yield more comparable statements. In terms of the CF, the importance of comparability might become downplayed if it is treated as simply an aspect of faithful representativeness.

THE REPORTING ENTITY

The final session dealt with the issue of the reporting entity. This is an area where it has proved exceedingly difficult for standard setters to establish clear principles. The problems are magnified considerably for the IASB, because of the greater variety of institutional circumstances. A clear example of this is provided by the question of the status of parent company statements for entities that also produce consolidated statements.

The workshop discussed the boards' apparent grudging acceptance of there being a possible role for parent company accounts. There was concern that over-reliance on U.S. traditions might be unwise in this area. In many countries, consolidated statements were introduced as supplementary disclosures, to augment the picture

provided by the primary, parent company statements, not the other way round.¹⁰ This stemmed essentially from a proprietary perspective. However, even if an entity view is adopted—something implicit in treating minority interests as equity claimants—it is far from clear that consolidated statements are of much informational value to minority interests.

A virtue of adopting the proprietary perspective that seems to have been overlooked or rejected by the boards is that it provides some potentially helpful parameters when determining the bounds of the reporting entity. In economic terms, a ‘group’ can encompass many kinds of contractual relationships, leading to definitions that are essentially just ‘virtual entities’. The growth of the shadow banking system provides a clear example, one that has posed considerable difficulties for financial regulators and FASB alike. With the entity perspective, a potential circularity emerges: The reporting entity has to be defined before it is possible to identify the primary users of financial statements. While a (parent) company has a clear legal identity, a ‘firm’ in economics is just a nexus of (explicit and implicit) contracts, and as such defies easy categorization. It is difficult to see how accounting standard setters can safely depart from treating the parent company as the basic building block, defining the reporting entity as an accounting construct from which to better portray the information needed by the parent company’s direct claimants (Clarke and Dean, 2007). The work the boards are currently doing on their separate consolidation project will hopefully address these sorts of issues.

CONCLUSION

In summary, the preparation of a new or revised CF raises many fundamental questions that have been debated again and again in the history of accounting thought. The lessons learnt from these discussions should be considered (more) carefully and comprehensively when the decisions are prepared and ultimately taken. An early involvement of the academic community in the development of discussion papers and exposure drafts will be useful. As the Siena Open Forum and this November EAA FRSC workshop demonstrated, there exists a knowledgeable and interested community of academics from many countries that will be happy to provide input into the discussions at the standard setting institutions.

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¹⁰ See Walker (1978) for an historical account of the development of consolidated accounting in several countries.

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