National accounting law in Norway, and in other Nordic countries

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<u>Summary</u>: The national Norwegian Accounting Act is based on what represents a modernized version of classical accounting principles. That is, most fundamentally, the approach is transaction based (historic cost) and result oriented. In this presentation, the focus is on Chapter 4 of the Act, i.e. the principles chapter of the Act.

Lecture offered at the Gdansk School of Banking, March 23 2010.

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First, some reflections on accounting regulation

Why do we need accounting law?

That is, legal regulatory regimes in the field of accounting.

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➲ Users of accounting information need protection.

➲ Protection is needed because producers of accounting information have a motive to mislead.

➲ Given regulation, producers of accounting information are able to act in being more trustworthy.

➲ Regulation is also standardization, and as such regulation contributes to reduction of transaction costs.

➲ Of course, tax authorities, and other public bodies, have an interest in accounting information.

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Very generally speaking, the history of financial accounting law and financial accounting regulation begins around year 1900.

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In principle, regulation should protect the user's need for information. But what are these needs? Presentation based on an illustration (needs are the results of user decisions!!).

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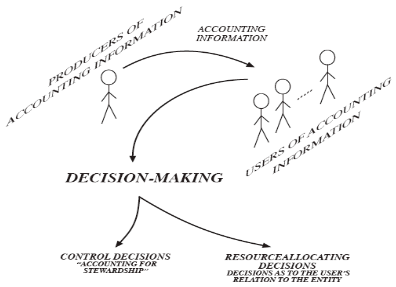

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Norwegian Accounting Act

Act relating to annual accounts etc.
of July 17 1998 no. 56

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Chapter 1. Scope, enterprises with statutory obligation to keep accounts, definitions

Chapter 2. Registration and documentation of accounting information

Remark: The chapter was a misconstruction and never implemented. Replaced 2004 by a specific law on registration and documentation.

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Chapter 3. Annual accounts and director's report

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Section 3-2a. True and fair view

The annual accounts shall give a true and fair view of the assets and liabilities, financial positions and results of the enterprise and the group.

If in certain exceptional cases the application of any provision in chapeters 4 to 7 should be inconsitent with the obligation pursuant to first paragraph, such provision shall be deviated from in order to give such true and fair view as set forth in first paragraph.

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Section 3-9. Application of international accounting standards

The EAA Agreement Appendix XII clause 10b (Regulation (EC) no. 1606/2002 regarding the application of international accounting standards with adaptations to the EAA Agreement) applies as law with such amendments and supplements that follow from the Protocol no. 1 to the Agreement and the Agreement itself.

The Ministry stipulates general regulations that correspond to Commission's Regulations laid down puruant to the Regulation (EC) no. 1606/2002 article 3.

Enterprises with statutory obligation to keep accounts that are covered by Regulation (EC) no. 1606/2002 article 4 may prepare company accounts also in accordance with the international accounting standards adopted puruant to second paragraph, cf. the Regualtion's article 5 litra a.

More next slide ……

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As a consequence of the European Economic Area agreement, Regulation 1606/2002 is implemented in Norway (a non EU country).

With Regulation 1606/2002, EU's more "soft line of harmonization" towards accounting regulation is abandoned.

In Europe, national accounting law is still effective for entities that do not report according to IASB standards.

July 9 2009, IASB made official a standard for small/medium sized entities (IFRS SME).

Section 3-9. Application of international accounting standards *(more ......)*

Enterprises with statutory obligation to keep accounts that are covered by Regulation (EC) no. 1606/2002 article 4 may prepare consolidated accounts in accordance with the international accounting standards adopted puruant to second paragraph, cf. the Regualtion's article 5 litra a. Such enterprise may prepare company accounts in the same way, cf. the Regualtion's article 5 litra b.

The Ministry may issue general regulation on simplified application of the international accounting standards according to general regulations laid down puruant to second paragraph. The general regualtion may grant exemption form the disclosure requirements in the international accounting standards. The general regulation may in certain cases permit deviation from provisions of the international accounting standards concerning recognition and measuement, and if necessary stipulate alternative accounting. The exemption in section 3-1 third paragraph from chapter 6 does not apply. The general regualtion my stipulate that other exemptions pursuant to section 3-1 third paragraph shall not apply.

Norway ... two regulatory regimes in several versions

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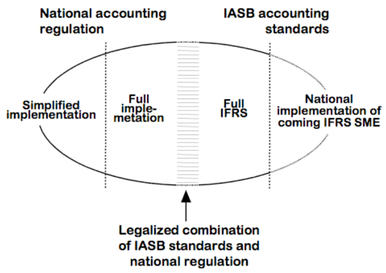

(See Section 3-9, paragraph no. 5)

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Chapter 4:

Basic Accounting principles and good accounting practice

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Section 4-1. Accounting principles

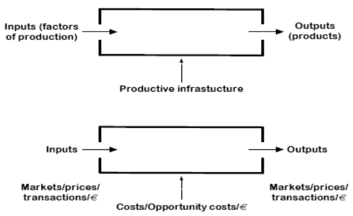
The annual accounts shall be prepared in accordance with the following basic accounting principles.

1. Transactions shall be recognised at the value of the consideration at the time of the transaction (the transaction principle).
2. Income shall be recognised in the income statement when it is earned (the earned income principle).
3. Costs shall be expensed in the same period as related income (the matching principle).
4. Unrealised loss shall be recognised in the income statement (the prudence concept).
5. When hedging exists, gains and losses shall be recognised in the same period.

More next slide ……

The problem of measuring (net) income

A simple picture of what is going on in the entity (firm):



Now, seemingly, we have an answer to the problem of "what is (net) income:"

€ amount of the output
– € amount of the input
– € amount for the infrastructure

However ....

(i) The output effects of the inputs are typically not instantaneous.

(ii) The costs of the productive infrastructure are difficult to measure.

The matching principle, the answer of Paton & Littleton (1940)

See also Paton (1922): Accounting Theory: With Special Reference to the Corporate Enterprise

The MATCHING PRINCIPLE of P&L (1940):

Income/revenue (i.e. before costs) is not the priced effects of input (manifest or planned).

Revenue is what is earned, i.e. the priced output effects that are manifest with some degree of certainty (output effects more or less at hand).

On the minus side we have expenses. What is relevant are the expenses associated, or necessary, for the revenue generated (matching).

Of course and in particular, there are some challenges associated with the identification of expenses due to the productive infrastructure.

SCHMALENBACH (1919) attacked the problem of “what is (net) income” in discussing the problem of allocating priced input and output events to periods as such (the problem of accrual accounting or “periodization.”)

This led to lots of complex “periodization” discussion, but no clear definition of (net) income.

However, Schmalenbach (1919) could be seen as an forerunner of Paton & Littleton (1940).

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We have referred to two very important classic contributions. In these contributions, recognition (the process of adding amounts to accounts) is mainly based on transactions of the past.

See the “transaction principle,” Norw. Acc. Law section 1, first paragraph no. 1.

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The accounting scholars referred to have all interesting biographies:

(Johann Wilhelm) Eugen Schmalenbach (1973-1955), Professor U. of Köln (Germany).

Ananias Charles Littleton (1886-1974), Professor U. of Illinois (Urbana-Champaign/USA).

William A. Paton (1889-1991), Professor U. of Michigan (Ann Arbor/USA).

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Section 4-1. Accounting principles ***(more .....)***

Small enteprises may deviate from the basic principles of earned income and matching cf. first paragraph nos. 2 and 3, if this is acceptable under good accounting practice for small enterprises. Small enterprises may deviate from the basic principle of hedging, cf. first praragraph no. 5.

Enterprises as mentioned in section 1-2 nos. 9, 10 or 11 and whose purpose is not commercial gain, may deviate from the basic principles of transaction, earend income and matching, cf. first paragraph nos. 1, 2 and 3, when this may be deemed good accounting practice for such enterprises.

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Section 4-2. Accounting estimates

In the event of uncertainty, the best estimate shall be applied, based on the information available when the annual accounts are prepared.

When accounting estimates are revised, the effect shall be recognised in the income statement in the period in which the estimates are revised, unless good accounting practice allows for the effect to be deferred.

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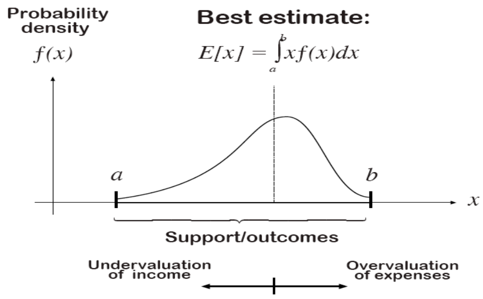

Examples of "conservatism" leading to reduced net income, and thus the generation of "hidden reserves."

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Two interpretations of probabilities:

➲ Objective probabilities (as when flipping a coin) – classic statistics.

➲ Subjective probabilities (as when making judgements) – Bayes'ian statistics. Relevant approach to uncertainty in accounting.

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Section 4-3. The all-inclusive income concept

All income and expenses shall be recognised in the income statement.

The effect of a change in accounting policies and correction of errors in previous annual accountis shall be charged to equity. Other exemptions from the all-inclusive income concept shall be made when in accordance with good accounting practic.

Notwithstanding the provision in second paragraph, small enterprises may charge the effect of a change in accounting policies and the correction of errors in previous annual accounts over the income statement.

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Section 4-4. Application of policies

The annual accounts shall be prepared pursuant to uniform policies, applied consistently over time. The consolidated accounts and the company accounts may apply different policies.

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Section 4-5. The going concern assumption

The annual accounts shall be prepared on the basis of a going concern assumption insofar as it is not likely that the enterprise will be wound up. If is is likey that the enterprise will be wound up, assets and liabilities shall be valued at net realisable value.

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Section 4-6. Good accounting practice

The preparation of the annual accounts shall be in accordance with good accounting practice.

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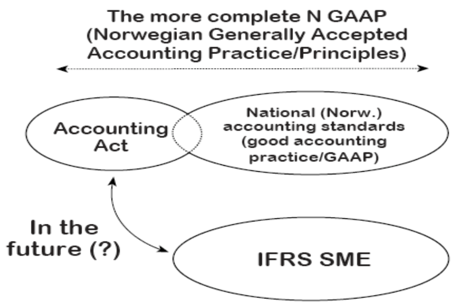

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In 1989, the national standard setter was established organized as a private foundation –
– Norwegian Accounting Standards Board (NASB).

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A picture of settings over time ....

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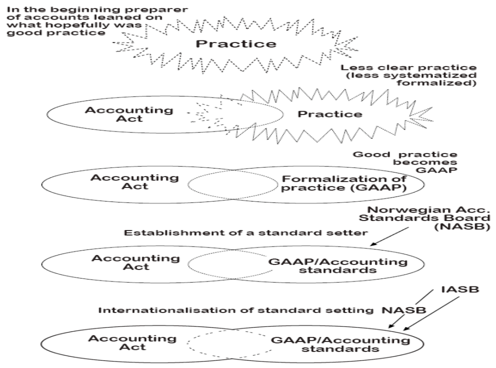

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Chapter 5:

Valuation rules

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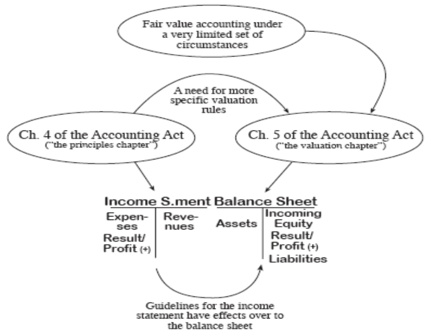

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Chapter 6. Income statement, balance sheet and cash flow statement

Chapter 7. Notes disclosure

Chapter 8. Publicity, filing the accounts, penalty

Chapter 9. Miscellaneous provisions

Chapter 10. Final provisions

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In Denmark, the national Accounting Act of 2001 is said to be "balance oriented." That is, the act does not have a clear reference to the "matching principle" as in N GAAP.

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In Sweden, the national Accounting Act of 1995 is structured in very much looking to EU's accounting directives.

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In Finland, the national Accounting Act of 1997 is in substance similar to N GAAP, but does not have a clear cut formulation of principles.

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Thank you for your attention!

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Some old stuff:

Paton, W.A. and A.C. Littleton (1940): *Introduction to Corporate Accounting Standards.* American Accounting Association.

Schmalenbach, E. (1919): “Grundlagen dynamischer Bilanz-lehre.” *Zeitschrift für handelswissenschaftliche Forschung,* 13. Volume pp. 1-60 and pp. 65-101 (as reprint 1920 G.A. Gloeckner). Afterwards revised, and from 1926 on under the title of *Dynamische Bilanz.* Later on in many versions, last time in 1962 (13. edition by R. Bauer).

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