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COMPONENT DEPRECIATION IN REAL ESTATE COMPANIES

DOES THE BENEFIT OF THE PROPOSED K3 REGULATION OUTWEIGH THE COST OF PERFORMING IT?

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ABSTRACT

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Title: Component depreciation in real estate companies - Does the benefit of the proposed K3 regulation outweigh the cost of performing it?

Background and problem discussion: In this thesis, we will focus on the K3 regulation, which is supposed to be the new main regulation for Swedish companies while creating their annual financial reports. In June 2010, Swedish Accounting Standards Board published an exposure draft and this thesis originated from the comment letters to the exposure draft, in which a debate has begun among real estate companies and other stakeholders that the real estate companies will be disfavored and negatively affected by the new K3 regulation. This since there will be strict policies demanding all companies to divide their tangible fixed assets into components and write them of separately. According to the majority of the comment letters to the K3 exposure draft, component depreciation is too expensive to establish, the administrative burden will increase heavily and thereby exceed the benefit provided by the added information. Therefore, we found it interesting to examine how real estate companies will be affected by the proposed demand for component depreciation.

Aim of the thesis: Our aim of the thesis is to illustrate the expected effects of component depreciation in real estate companies. We will examine how components will be decided within the entities, what internal and external factors will affect the decisions, and how component depreciation could contribute to real estate companies.

Scope: In this thesis, we are focusing on the K3 regulation, and therefore, we are only choosing to investigate Swedish real estate companies who will be forced to account according to K3.

Methodology: In this thesis we preformed a descriptive study. Trough interviews with real estate companies and accounting experts, we have been able to collect the empirical data needed for our study.

Conclusions: We conclude that even though a demand for component depreciation will result in some positive effects on the financial reporting process within real estate companies, they will ultimately be negatively affected by the proposed demand, since it will impose a huge administrative burden at the same time as it can be questioned if anybody benefits from the added information.

Suggestion of future studies: Since this thesis is based on the K3 exposure draft, it would be interesting to examine our chosen questions after the final draft has been published. It would also be interesting to examine how other lines of business will be affected by a demand for component depreciation. Another interesting aspect is to examine the topic in a few years to see if there has developed practice regarding what should be accounted for as separate components.

PREFACE

The authors would like to thank everyone who has contributed to this thesis. We would like to direct a special thanks to our tutor Kristina Jonäll for her support, time and interest during the working process of this thesis. We would also like to express our gratitude towards the opponents who, during seminaries, has helped us with the thesis and given us valuable opinions to be able to improve our work. Apart from this, we would also like to thank the respondents and other persons who have contributed to our work with their time and interest for the completion of the thesis. Finally, we would like to thank our families and friends for their support during this thesis.

Gothenburg, 25th of May, 2011

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DEFINITIONS AND ABBREVIATIONS

BFNAR	Swedish Accounting Standards Board General Advisement (Sw: Bokföringsnämndens allmänna råd)
CFO	Chief Financial Officer
CSE	Confederation of Swedish Enterprise (Sw: Svenskt Näringsliv)
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IFRS for SMEs	International Financial Reporting Standards for Small and Medium sized Entities
K3	The K-project of SASBs, Category 3
RR	The standards from the Swedish Financial Accounting Standards Council (Sw: Rådets rekommendationer)
SAAA	Swedish Annual Accounts Act (Sw: Årsredovisningslagen)
SASB	Swedish Accounting Standards Board (Sw: Bokföringsnämnden)

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CHAPTER ONE - INTRODUCTION

In this chapter we will present the background to our chosen subject; component depreciation in real estate companies. We will conduct our discussion based on the exposure draft to the K3 regulatory framework and the comment letters to the draft. Furthermore we will present a problem discussion, research question and our aim of the thesis. This is followed by the benefits and scope of the study.

1.1 Background

When accounting principles first developed around the world, it began on a national basis without the influence of other countries. Over the years, this lead to a significant variation in the way accounting principles was developed within countries worldwide. With time, the business climate has changed and corporations are now acting on a global market with a high level of integration between companies of different nationalities. As a result of the globalization, difficulties occurred for investors on the stock market to interpret and compare financial information between different companies, and an increased demand for more harmonized accounting principles arose. (Damant, 2000) This began the development of the International Financial Reporting Standards (IFRS), which is a harmonized set of rules and regulations created by the International Accounting Standards Board (IASB). The focus in these standards is accounting for investors and IFRS are now widely used around the world. Over 100 countries today either allow or demand IFRS to be applied. (Marton et al., 2010)

While IFRS spread around the world, it was discovered that it imposed a vast administrative burden and large accompanying costs on many minor corporations. Therefore, IASB started a five year development plan to decrease this burden for small and medium sized companies, which are estimated to represent over 95 percent of all companies using IFRS. This development plan resulted in IFRS for SMEs (Small and Medium sized Entities) which was published in July 2009. This is a simplified version of the full IFRS with the main objective of reducing the administrative cost for small and medium sized companies. (www.ifrs.org)

Affected by the change in the accounting climate around the world, Sweden set up a goal to reduce the administrative costs for companies with 25 percent by the year of 2010 (Månsson & Ohlson, 2008). If Sweden were to be able to accomplish this goal, a new legal framework was needed. This was the beginning of what became known as the K-project. The regulatory authority for accounting policies in Sweden, Swedish Accounting Standards Board, has since the year of 2004, been working on a new framework for annual reporting. The process is called the K-project, and the goal is to create four new sets of regulation (K1-K4), depending of the size of the company. (www.bfn.se$_1$) In this thesis, we will focus on the K3 regulation, which is supposed to be the new main regulation for Swedish companies while creating their annual financial reports. This set of rules is mainly based on IFRS for SMEs, with a few adaptations to the Swedish Annual Accounts Act and Swedish tax regulation. (www.bfn.se$_2$) Since the latest exposure draft to K3 was published in June 2010, SASB has received comment letters to the draft written by different stakeholders. With origin in these comment letters, a debate has begun among real estate companies and other stakeholders that the real estate companies will be disfavored and negatively affected by the new K3 regulation and that one specific rule will increase their administrative burden heavily. This issue is related to tangible fixed assets and its depreciation of value over time. With the new K3 regulation, there will be strict policies demanding all companies to divide their tangible fixed assets into components and write them of separately. Parts of a tangible fixed asset that are used in significantly different ways should be depreciated over different periods of its useful life. (Lundqvist, 2011) The reason for these more strict demands, provided by the legislator, is that it gives a better picture of the value of companies' assets, but it has been discussed that the administrative burden and costs that component depreciation imposes on companies, especially real estate companies, does not outweigh the benefit of it (Drefeldt, 2010).

1.2 Problem discussion

So why is this topic interesting to examine? Since the publication of the K3 exposure draft, a vast debate has begun through comment letters, regarding component depreciation as an unreasonable demand, because of the difficulties to perform this in different lines of business. A demand for component depreciation will have different effects on different lines of business depending on the types of assets held by the entity. Naturally, all entities with a large portion of tangible fixed assets will be affected by the demand for component depreciation because of the heavy workload it will impose. In consequence of this, the line of business that has been frequently discussed as especially stricken by the new demands is the real estate business (Lundqvist, 2011). The reason that real estate companies are seen as especially affected by the demand of component depreciation is that buildings consists of a lot of different components that can be hard to define. In theory component depreciation would probably be the best and most correct way to allocate costs to a certain period. However, even though it would lead to a true and fair view of an entity's assets, this form of depreciation is administratively complex to execute and the process is very costly. Beyond the initial problems, this complexity usually grows gradually while renovations are preformed on the buildings etcetera. (Eliasson, 2010)

According to the majority of the comment letters to the K3 exposure draft, component depreciation is too expensive to establish and the administrative burden will increase heavily and thereby exceed the benefits provided by the added information. Therefore, it has been suggested that the demand for component depreciation should be cut entirely, or at least rephrased so that it will be an optional rule to the same extent as in the regulation today. (Lundqvist, 2011) However, as we have already discussed, component depreciation is a complex matter imposing a huge administrative burden on the companies. Component depreciation is especially difficult in real estate companies and therefore seldom used today, according to the optional rules. However, if the SASB ignores the comments received regarding component depreciation, and the K3 regulatory framework remains unchanged in comparison to the exposure draft, these companies will be forced to account for their tangible fixed assets according to acquisition value with the use of component depreciation from the year of 2013 (www.bfn.se$_3$). Therefore it is interesting to study the thoughts of real estate companies as well as accounting experts on how the working process within real estate companies will be affected by a demand for component depreciation and what advantages and disadvantages they believe that a demand for component depreciation will have. Since K3 will be principle based, it will thereby permit the users to make own interpretations of the policies. The standard is also argued to be vaguely formulated when it comes to guidance of what should be classified as a component, which makes it interesting to examine what influential factors will affect the entities in how they decide what component to use and how these are accounted for.

1.3 Research question

How will a demand for component depreciation affect real estate companies?
- How are components expected to be decided within an entity?
- What external factors are expected to affect how components are decided?
- What are the expected advantages and disadvantages of component deprecation?

1.4 Aims of the thesis

Our aim of the thesis is to illustrate how real estate companies are expected to be affected from the proposed demand for component depreciation according to K3. The thesis will focus on real estate companies, since a demand for component depreciation particularly will affect the accounting process in companies which holds a lot of assets. Since K3 is principle-based, companies will be allowed to perform much judgment decisions on what constitutes a component. Because of this, we will examine how components will be decided within an entity and will also examine which internal and external factors can affect of the decision of what constitutes a component. With the help of this discussion, we will be able to answer our research questions.

1.5 Scope

In this thesis, we are focusing on the K3 regulation, and therefore, we are only choosing to investigate Swedish real estate companies who will be forced to account according to K3. Our respondents in this thesis consist of representatives from real estate companies affected by K3, as well as other accounting specialists well-informed on the topic of real estate companies and legislation concerning depreciation of fixed tangible assets, and therefore, our empirical findings are solely based on their reasoning regarding our chosen topic.

1.6 Benefits of the thesis

This thesis is meant to contribute to explaining the complex nature of component depreciation, mainly in the real estate business. One of our main target groups will therefore naturally be real estate companies and the thesis will explain how the industry expects the new demands of component depreciation to affect their accounting process. However, we also believe that these thoughts will be applicable on all type of asset intense businesses who will be faced with the demands of component depreciation according to the new K3 regulatory system. Since the demand for component depreciation undoubtedly will change the accounting process in these companies, another interest group will be auditors working in these types of businesses. We also believe that this thesis could be useful to the legislators responsible for the K3 regulatory framework since it presents the thoughts of companies regarding the effects of component depreciation in practice. Another party that could be interested in this thesis is different trade organizations, which may need to guide their members in the process of implementing component depreciation.

1.7 Continued disposition

CHAPTER 2 – METHODOLOGY

The aim of the methodology chapter is to clarify the procedure of writing this thesis. We will present our research method, collection of data and the type of business we have chosen. Furthermore we discuss the credibility of the thesis.

CHAPTER 3 – FRAME OF REFERENCE

In the frame of reference, we will present relevant theories on our chosen subject to clarify the content of the problem discussion. We will start with a description of tangible fixed assets, depreciation and component depreciation. To be able to answer our research question theories of principle based accounting, cost and benefit and relevant theories of accounting choice will be presented.

CHAPTER 4 – EMPIRICAL FINDINGS
In this chapter, we will present the empirical findings from our conducted interviews with the chosen respondents. We will present the material based on our chosen research questions.

CHAPTER 5 – ANALYSIS
Here, we will analyze our empirical findings using the chosen theories discussed in the frame reference.

CHAPTER 6 – CONCLUSIONS
In this chapter we will present findings from the analysis chapter and provide answers to our research questions.

CHAPTER TWO - METHODOLOGY

The purpose of the method chapter is to clarify the procedure of writing this thesis. This chapter will contain the working process, the collection of data regarding our chosen subject and describe which type of business we have chosen to focus on in this thesis. We will also discuss the credibility of the thesis.

2.1 Working process

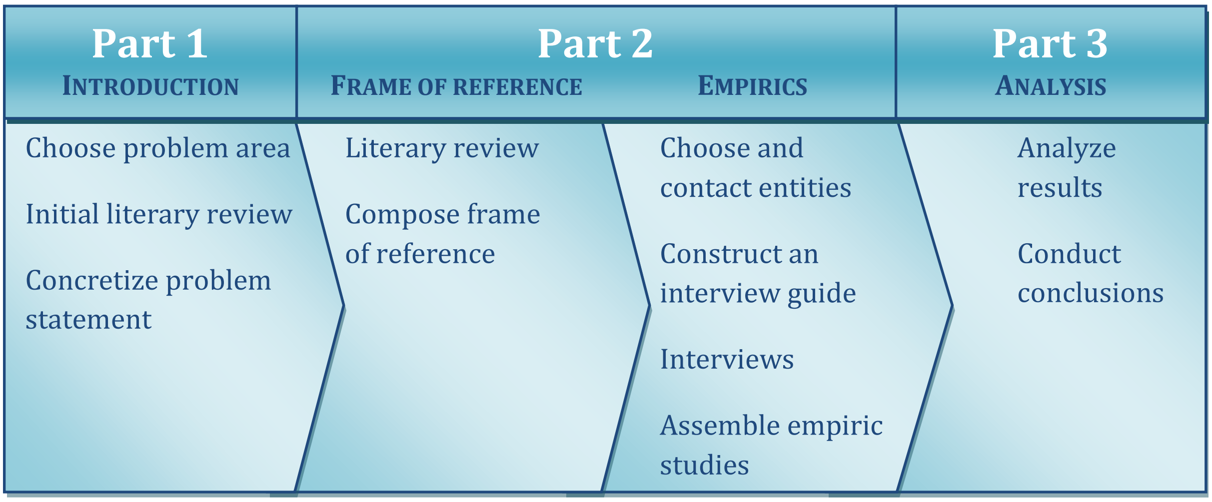

Figure 1 – Working process

The figure above illustrates the working process of this thesis, which started with the choice of a main subject, as is shown in part one. In part two, we constructed our frame of reference and conducted interviews with our chosen companies. The working process resulted in an analysis and a conclusion based on our empirics and the frame of reference.

2.2 Research method

In this thesis we preformed a descriptive study in order to analyze how entities expect an implementation of the new K3 regulatory framework, with the proposed demand of component depreciation, to affect their accounting process. This will help us answer our chosen research question concerning how K3 is expected to affect real estate companies regarding component depreciation. The topic of this thesis developed as we followed the ongoing debate concerning the exposure draft of the K3 regulatory framework. Early on, it was clear to us that the demand for component depreciation resulted in a significant change in accounting for tangible fixed assets, compared to the current regulation. As the debate continued, we realized that one line of business that would be especially affected by the proposed demand was the real estate business, because of the complexity to perform component depreciation in these entities. Therefore, we decided that the real estate business would be the focus group of our thesis.

After choosing our research question and focus group, we began planning how to execute our research and thus, our research method started developing. Since K3 only existed as a proposed exposure draft and because it was not decided how the final draft would be formulated, we would not be able to deduce our needed information from any financial reports or other financial data to see effects of accounting according to K3. Instead, we wanted to focus on the ongoing debate and bring forward the expectations of real estate companies regarding a proposed demand for component depreciation. For that reason, we decided that the best way to get the information needed to answer our research question would be to use a qualitative method and perform interviews. A qualitative method is used when you base your study on people's opinions and reasoning, rather than given data, and when the aim is to achieve insight, rather than affirming statistically ensured results (Blumberg et al., 2008). Since our research question is based on how companies reason regarding a possible demand for component depreciation, we needed to find the best way to bring forward these expectations from our respondents.

Early on, we understood that component depreciation is a complex matter, and therefore we realized that interviews were our best option to reach a discussion on the intricate subject. With qualitative interviews, it is possible to perform studies of more depth on our defined focus group (Jacobsson, 2002). Since we needed a discussion on a detailed level, we wanted to perform more flexible interviews where we would be able to ask attendant questions and also adapt our questions to different interviewees.

2.3 Literature review

Since the topic of our thesis originated in the exposure draft to K3, we began by trying to gain insight in the exposure draft as well as the process and underlying reason for developing the K-project. Since K3 is mainly built on IFRS for SMEs, the extension of our research was to gain further insight in both IFRS and IFRS for SMEs. To gain a better understanding of the chosen problem of our thesis, we continued our research by reading comment letters to the exposure draft of K3.

When we began producing our frame of reference, we thought that it might be important to initially explain the fundamental concept of tangible fixed assets, depreciation and also component depreciation. This, since knowledge of these concepts is necessary in order to be able to analyze the effects of component depreciation according to K3. The concepts above are based on words of act regarding accounting, mainly the exposure draft to K3 as well as IFRS for SMEs. Since component depreciation is complex to perform and since the words of act does not give much guidance to how components should be accounted for, it leaves much room for the entities themselves to interpret how they should account for components. This is in line with how a principle based regulatory framework, such as K3, usually is designed, so therefore we have chosen to further describe "principle based accounting" in our frame of reference, with the help of articles on the topic. When using principle based accounting, entities are supposed to choose how to account for their transactions based on the conceptual framework of the regulatory framework. Therefore, we have chosen to describe the qualitative characteristics of accounting which we believe will be most important while discussing component depreciation, namely reliability, comparability and a true and fair view.

To be able to get further insight in what affects companies' decision making while performing accounting based on principles rather than rules; we felt that we needed to look at why entities make certain accounting choices. We began by looking at other theses and dissertations as well as scientific articles on the topic of "accounting choice". Since there are a lot factors involved in the decisions of accounting choice, and a lot of different articles on the topic, we decided to use only a few of these articles to explain what could potentially affect companies decision making. To structure our frame of reference further, we have chosen to divide our chosen influential factors into internal and external factors. The factors we have chosen for explaining what might influence decision making internally within the entities are "earnings management" and "positive accounting theory". To gain a better understanding of the external factors which can be influential in the decision making process of entities, we have chosen to look at “institutional theory”. The reason for choosing these theories is that they all seek to explain what might affect mangers in their decision making even tough using different perspectives. Both of the chosen internal factors seek to explain why managers might choose to make accounting decisions that does not reflect the underlying economics of the transactions made by the entity. We are of the opinion that they are both valuable in explaining different aspects of internal factors and that they contribute to the thesis and enables a deeper analysis on the topic, using two different approaches. We have also chosen to use institutional theory to explain what external factors might affect the decisions made by the entities. There is a difference between our chosen internal factors and institutional theory, because while the internal theories explain why managers makes certain accounting choices for personal benefit, rather than to reflect the underlying economic substance, institutional theory tries to explain how companies become more alike each other due to different external factors. Institutional theory does not, per se explain deliberate accounting choices made to affect the financial information in a certain direction, but rather aims to explain why companies becomes more similar with each other through their accounting choices. Thereby, the external pressures are still factors that need to be considered when analyzing what effects accounting choices within entities. We believe that the chosen theories concerning internal and external factors affecting accounting choice, all help to analyze our research questions, and contribute to a better total impression of what might affect entities, both internally and externally. The reason for choosing this frame of reference is that in order to examine the thoughts of how K3 is expected to affect real estate companies regarding component depreciation we need to examine what is affecting decision makers in their choice of accounting methods. The databases primarily used were Business Source Premier, Emerald and Google Scholar. To simplify for our readers and to make our frame of reference easier to grasp, we have chosen not to present previous studies separately, but to present them continuously throughout our frame of reference.

2.4 Collection of data

2.4.1 Selection of respondents

We have chosen to study the real estate business, which is a business where it is voluntary but also unusual to use component depreciation today. To be able to draw conclusions based on our interviews we decided that we wanted to interview real estate companies. Through the database Retriever we were able to identify twelve potential companies for our study that we later on contacted with requests of interviews. We first sent emails with information about the topic of our thesis and what we wanted to discuss with them during a possible interview, so that our interviewees could get a better insight in our thesis and the discussion, before deciding if they wanted to participate. If we did not receive an answer by email, we later on chose to contact them by telephone. As we focus on the expectations of how a demand for component depreciation will affect the annual reporting process of real estate companies, we chose to contact chief financial officers or chief accountants in the chosen real estate companies. Of these companies we ended up interviewing four real estate companies of different sizes. Since the real estate companies of our study wish to be anonymous we have, through our thesis, chosen to call them Company A, B, C and D. The reason for not interviewing more than four real estate companies is that we soon realized that the real estate companies were not that well informed on the subject of component depreciation according to K3, since K3 only exist as an exposure draft and has not been completed. Although the companies were able to discuss how a demand for component depreciation would affect their working process we realized that to gain more depth to our empirics and to better be able to analyze our results, we needed to gain a deeper insight in how a demand for component depreciation could affect real estate companies. Therefore, we decided to interview other respondents to gain a broader picture of component depreciation.

2.4.2 Presentation of respondents

Apart from our four chosen real estate companies, we have also interviewed Peter Wallberg a representative for the trade organization of real estate companies: SABO (Sveriges Allmännyttiga Bostadsföretag), to get a better picture of the expectations of other real estate companies. SABO had written one of the comment letters to K3, expressing their concerns on how a demand for component depreciation would affect real estate companies. To gain further insight in the topic of component depreciation in real estate companies, we interviewed Bo Nordlund, who has a background as CFO of a real estate company. He has also worked as a real estate company analysist at Föreningsbanken, as an auditor and accounting specialist within the real estate group of KPMG, and has also been a previous member of FARs policy group. Now, he runs his own consulting business, Brec, and has written many articles on the topic of component depreciation in real estate companies. Another accounting specialist we chose to interview was Magnus Nilsson at Grant Thornton, who is specialized at both K3 and IFRS.

To gain a broader perspective of the demand for component depreciation, we also chose to interview Caisa Drefeldt, member of Swedish Accounting Standards Board as well as accounting specialist at KPMG. She has previously been employed at FAR Akademi and is also active as the author of many accounting articles. Now, she is a member of working group for K3 within the SASB, and has therefore been active in the development of K3. In addition, we have also interviewed Claes Norberg who works as an accounting specialist at Confederation of Swedish Enterprise, and is also a member of working group for K3 within the SASB, together with Caisa Drefeldt.

Company	Respondent	Position
Company A	Anonymous	
Company B	Anonymous	
Company C	Anonymous	
Company D	Anonymous	
SASB/KPMG	Caisa Drefeldt	Comissioner/Accounting Specialist
SABO	Peter Wallberg	Business area of Econmics & finance
Grant Thornton	Magnus Nilsson	Accounting Specialist
SASB/ Svenskt Näringsliv	Claes Norberg	Comissioner/Accounting Specialist
Brec/KPMG	Bo Nordlund	Consultant and sole trader in the real estate business/Accounting Specialist

Table 1 – Respondents

2.4.3 Interview process

Interviews are the source of information for our empirical findings and were used to take part of the respondents' opinions on our chosen subject. When preparing for our interviews, we studied annual reports and other relevant information regarding the companies we were interviewing. This helped us to be well-grounded and have a fundamental understanding of their business prior to the interviews, which enabled us to adapt our questions during the interviews and to ask relevant questions. As far as possible we have held personal interviews but since our respondents Bo Nordlund, Claes Norberg and Peter Wallberg are not located in Gothenburg, we chose to perform telephone interviews with these respondents instead.

Before our interviews, we chose to give the respondents a short explanation of what our questions would concern, so they could understand our desired direction of the interview. When possible, we always chose to perform the interviews together, but we had different tasks so that one of us asked most of the questions while the other kept notes. In addition to this we chose to record the interviews so that we could be more active and focus on the conversation rather than writing down all the answers. This helped us to get highly accurate statements of the respondents' answers.

There are different ways to conduct interviews while doing a qualitative study. The interview techniques are often categorized into three main categories; structured interview, semi-structured interview and unstructured interview. The classification depends on how much room you leave for the interviewee to add more information to the answer (Blumberg et al., 2008). During our interviews, we used a semi-structured interview technique, which usually starts with a specific question, but still leaves room for the respondent to make his or her own reflections. We have also constructed interview guides to control the interviews in our desired direction. Since we interviewed both real estate companies and auditors, we had to adapt our interview guide depending on who our respondent was. Our chosen interview guides is attached in Appendix 1.

2.5 Analysis

The analysis is based on our conducted interviews with real estate companies and accounting professionals. We have taken into account the responses from our nine interviews and based on them, distinguished patterns between the answers we received. We have then analyzed these patterns with the help of our frame of reference. Our frame of reference is constructed so that the different sections will support and help us analyze all of our sub-questions, to finally, in the conclusion, achieve an answer to our principal question. To help us with the analysis, we have adapted our frame of reference, simultaneously while conducting our interviews, which enabled us to draw connections between the answers we received and the support of our frame of reference. The analysis has therefore been planned at the same time as our empirics were constructed. To simplify for our readers we have also chosen to use the same headlines in the chapters Empirical findings, Analysis and Conclusions.

2.6 Validity and reliability

The validity of a study is determined by how well the study succeeds to reflect what it is intended to reflect (Blumberg et al., 2008), which determines the study's ability to reflect reality. Trough choosing a wide group of respondents with different competences and connections to component depreciation and real estate companies, we have strengthen our study's validity. However, we are aware of that it is almost impossible to measure the reality trough interviews, because the results of an interview is affected both by the questions asked during the interviews as well as the interpretations of the answers of the respondents (Erikson and Wiederscheim-Paul, 2001). This leads to difficulties in determining the validity of the study. We have, however, tried our best to strengthen the validity throughout our study. Apart from choosing a wide range of respondents, we concluded that it was important that the right questions were asked during the interviews. Therefore, we used a lot of time in the beginning, to read about component depreciation and the real estate business, so that our questions would be relevant.

The reliability measures the study's ability to give reliable and stable results (Blumberg et al., 2008). To achieve a high reliability of a study, if the same study was performed again, the same results would need to be achieved. At a qualitative study, performed by interviews, reliability might be harder to achieve compared to a quantitative study, because with a qualitative study you interpret the answers of your interviews more and if the study was preformed again, different interpretations might occur. We have, however, tried to ask neutral questions to our respondents and not affect the interviews with personal opinions. Another action made to receive reliable answers is to choose a wide range of respondents, some of which we already knew were proponents or opponents of component depreciation, to receive answers from both parties.

CHAPTER THREE - FRAME OF REFERENCE

In the frame of reference, we will present relevant theories on our chosen subject to clarify the content of the problem discussion. We will start with a description of tangible fixed assets, depreciation and component depreciation. To be able to answer our research question theories of principle based accounting, cost and benefit and relevant theories of accounting choice will be presented.

3.1 Tangible fixed assets

Although some changes will occur in the accounting of entities with the implementation of the K3 regulatory framework, one thing that will remain unchanged is the definition of an asset. According to the definition in the second chapter of K3 as well as IFRS for SMEs, an asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. The main characteristic of an asset, according to K3 chapter 2, is that it is supposed to bring future economic value and, directly or indirectly, contribute to the inflow of liquid recourses to the company. An asset should be accounted for when it is probable that it will bring about future economic benefits for the entity and its acquisition value can be measured reliably.

Since this thesis focus on real estate, our continued frame of reference will focus on tangible fixed assets in property plant and equipment, which is regulated in K3, chapter 17. However, in K3 chapter 16, there are separate rules for Investment Property, which needs to be mentioned before we can continue the frame of reference. The definition of an investment property is property held by the owner to earn rentals, for capital earnings or both. There is a difference in how investment property is allowed to be accounted for according to IFRS for SMEs and according to K3. In IFRS for SMEs chapter 16, it is stated that investment property is accounted for in accordance with fair value trough profit or loss, but only if the fair value of the property can be measured reliably. Otherwise it will be accounted for according to the cost-depreciation-impairment model used for all other property, plant and equipment in IFRS for SMEs chapter 17. However, in K3 chapter 16 concerning investment property, there is a demand to disclose the fair value of the entities properties, but the entities are not allowed to account for their investment properties according to fair value. The underlying reason for this is that valuation at fair value for tangible fixed assets is not permitted according to Swedish Annual Accounts Act chapter 4. Investment property should instead be accounted for according to K3 chapter 17, investment, property and plant which will be clarified in the section below.

3.2 Depreciation

Tangible fixed assets with a limited lifetime should, according to K3 chapter 17 as well as IFRS for SMEs, be depreciated systematically over their useful time of life. The definition of an assets useful life is the period during which the asset is expected to be available for usage. It is important for entities to choose a useful life that represents the actual usage of an asset. Choosing a shorter period of time for depreciation than needed, will lead to higher costs and a lower result the initial years, but will reduce the costs and give a higher result further on. If the actual lifetime of an asset differs from the chosen time for depreciation, this will affect the balance sheet. If the period for depreciation is longer than actually needed, the effects caused will be overvalued assets and equity, and due to this the company's debt ratio will be overstated. If instead, the period for depreciation is shorter than needed, it will result in the opposite effect. In a line business, as for example the real estate business, where tangible fixed assets are a major part of the assets held by the entity, a correct depreciation is therefore important for a fair reflection of the company. (Lind & Bejrum, 2002)

According to the K3 regulatory framework the depreciable amount is the cost of acquisition after a possible reduction of the assets residual value. The depreciation should be accounted for as a cost in the income statement in order to match the asset's future economic benefits, in agreement to the matching principle. In chapter 17 of the exposure draft, another important amendment is stated, namely the demand of dividing assets into components. According to the words of act; if major components of property, plant and equipment have significantly different useful life, an entity shall allocate the initial cost of the asset to its major components and depreciate each such component separately over its useful life.

3.3 Component deprecation

When acquiring a tangible fixed asset you usually, as mentioned before, depreciate the whole value of the asset over a period of its useful life. However, according to the K3 exposure draft, if a tangible fixed asset consists of multiple substantial parts with different expected useful life, it shall be separated into components that will be depreciated and accounted for separately. The depreciation will be affirmed trough the acquisition value, the useful life and residual value of each component. Buildings could, for example, be divided into facade and pipe system as separate components that will be depreciated over each of their expected useful life. The rest of the assets within the building, which will not be accounted for as separate components, are written off as a single unit over its mutual useful life. This will be illustrated in the following example.

Component	Acquisition value	Useful life	Annual depreciation
Facade	12,000,000 SEK	30 years	400,000 SEK
Pipe system	5,000,000 SEK	20 years	250,000 SEK
Remaining assets	15,000,000 SEK	15 years	1,000,000 SEK
Total value	**32,000,000 SEK**		**1,650,000 SEK**

Table 2 – Component depreciation

When you, later on, for example replace the pipe system, the cost of the new pipe system is accounted as an asset balance sheet and the eventual residual value of the old pipe system is accounted as a cost in the statement of income. (Lind & Bejrum, 2002)

3.3.1 Component depreciation according to Swedish legislation today

Today companies account for their tangible fixed assets according to Swedish accounting standards RR12 and BFNAR 2001:3. In RR12 as well as BFNAR 2001:3 it is described that certain parts of assets may need to be replaced regularly. These components should, if possible, be accounted for separately, since they often have a separate useful life, and therefore a different depreciation period than the rest of the asset. Investment property is mentioned separately in RR23, but regarding depreciation of investment property, RR23 refers to RR12 with the clarification that the property should be accounted for as acquisition value reduced with depreciation over its useful life. As a result, real estate companies can today voluntarily choose, but are not forced to use component depreciation while accounting for investment property.

3.4 Motivations for accounting choices

In contrast to Swedish regulations today, the K3 exposure draft demand component depreciation to be executed on property, plant and equipment and will therefore affect many entities in their accounting process. However, the phrasing of what constitutes a component is vaguely specified in the exposure draft, leaving much room for the entities to create their own interpretations of how detailed they will need to be when specifying their tangible fixed assets. Therefore, it would be interesting to see what will effect entities decision making regarding component depreciation, both internally through principle based accounting, positive accounting theory and earnings management, as well as externally trough institutional pressure.

3.4.1 Principle based accounting

With the implementation of K3, Sweden will take on a more principle-based approach regarding the accounting standards. There are significant differences between a rule-based and principle-based approach, where a principle-based approach tries to help the preparer or the auditor of the financial reports to decide what needs doing, rather than guiding them in exactly how to perform the accounting. The rule-based approach has also been referred to as 'the cookbook approach' by the chairman of the International Accounting Standards Board Sir David Tweedie, and it has been critiqued for merely resulting in engineering techniques on how the accounting should be performed and designed, rather than to achieve economic objectives. In contrast to a rule-based approach, the main purpose of principle-based accounting is to reflect the underlying economics in the balance sheet of an entity. (Alexander & Jermakowicz, 2006) It is argued that the economic substance, not the form, of transactions within an entity should guide financial reporting and standard setting, and that principle-based accounting is the best way to achieve this. With the help of rule-based standards, the entities are able to structure accounting according to detailed accounting rules, however it might not always lead to financial reports that reflect the true economic substance of the transaction within the entities. (Maines et al., 2003)

It has been discovered that during a transition from a rule-based approach to a principle-based approach, it is common that companies may request more guidance than provided by principle-based standards. Above this, it becomes important that managers as well as auditors are able to make informed professional decisions, since principle-based standards demands more managerial judgment while implementing the standards, in comparison to rule-based standards. For example, if the depreciation rules would be extremely rule-based, they would tell you exactly how much you should depreciate your tangible fixed assets each year. This would lead to comparability and consistency between different entites, but it would probably lack relevance due to its inability to reflect the underlying economics which could differ between entities and over time. A principle-based rule however, would instead tell you that the annual depreciation should reflect the decline in economic value of the asset over its useful life. Such a standard leaves much room for managerial judgment and interpretations; however the understanding of the economic depreciation of an asset should be something that the manager arguably knows better than anyone else. It is clear to many people that the principle-based rules, if applied correctly, better reflects the underlying purpose of financial reporting. The response on the other hand is that it could be too costly to implement and that it would probably decease comparability both between companies and over time. (Maines et al., 2003)

A principle-based standard leads to a larger spread of options for entities, which could have both positive and negative effects on the financial reporting of companies. The large variety of options allows managers to make accounting decisions which better reflect their informed understanding of the underlying economics of a transaction. However, on the negative side, it could also lead managers to making accounting choices which do not reflect the underlying economics of a transaction. Therefore, in order to achieve accounting standards which result in financial reporting that reflects the underlying economics, managers, auditors and audit committee members must possess both expert judgment as well as the ability to make unbiased reporting decisions. With principle-based standards, it is important that managers can base their accounting choices on a conceptual framework for the financial information. The conceptual framework should be the foundation for financial reporting and define the main characteristics of economic transactions, so that they better reflect the substance of each transaction in the financial reports. This will help create a better understanding of the underlying economic transactions, on which accounting is built upon, such as the qualitative characteristics of accounting. (Maines et al., 2003).

3.4.2 Qualitative characteristics of accounting

As mentioned above, with a principle based accounting regulation, comes greater attention to the conceptual framework of accounting as well as the qualitative characteristics. One of the first and most important characteristics of accounting, according to K3 chapter 2, is reliability since the users of the financial information should be able to rely on that the information provided is correct and that it represents faithfully what it is supposed to, or is expected to, represent. Information is reliable if the financial statement shows a true and fair view of the financial position and result of the company, as well as its cash flows. A true and fair view, also known as fair presentation, is according to the Swedish Annual Accounts Act, a fundamental characteristic upon which accounting is built. This implicates that the balance sheet, income statement and notations of a company should show a fair presentation of the position and economic result of the entity. To achieve a fair presentation, it is necessary with a correct representation of partly effects of transactions, partly of other events and conditions in agreement with the definitions of assets, liabilities, income and expenses made in the regulatory framework.

Except for reliability and a true and fair view, another important aspect and fundamental characteristic of accounting, according to K3 chapter 2, is comparability. A user should be able to compare financial statements of an entity over a period of time to recognize the financial position of an entity as well as its performance. Above this, users must be able to relate this information and compare it to different entities and their financial position and performance. For this to be possible, the financial effects of similar transactions and other events must be presented consistently, both within an entity over time, as well as in comparison to other entities. Because of this, users of the financial reports must be informed of the accounting policies used when creating the financial information.

3.4.3 Balance between cost and benefit

As mentioned above, difficulties can occur when companies lack specific directives for how to account for their tangible fixed assets and which components they should be divided into, and it might be hard to determine what the “correct” way to account for their assets is. One thing that will be important for the companies to discuss is therefore the balance between benefits and costs when creating their annual accounting. The K3 regulatory framework is based on a few qualitative characteristics of the information in financial statements, also discussed in the previous section. These characteristics should always be taken into account unless otherwise is stated in the legislation. This qualitative characteristic states that the benefits that can be derived from the information in the annual reports should exceed the cost of providing it. However, the use of managerial judgment is a subjective process to evaluate what benefits and costs can be derived from the financial information. Also, the costs are not necessarily borne by those users who enjoy the benefits. The benefits of the financial information provided by the entities can also be enjoyed by a broad range of external users, according to IFRS for SMEs, chapter 2.

The financial information provided by the entities is mainly useful for capital providers to make better decisions regarding possible investments. It will be useful for individual entities in terms of improved access to capital markets, favorable effect on public relations, and perhaps lower costs of capital. Another benefit could be better management decisions because information used internally is often based on the information prepared for financial reporting purposes, according to IFRS for SMEs, chapter 2.

3.4.4 Earnings management

This section will present earnings management which attempt to describe what internal pressures can affect the decision making within entities. Earnings management has been discussed by many economists and in 1998, Paul M. Healy and James M. Wahlen, discussed earnings management and its implications for standard setting. They argue that the primary role for standard setters is to define the accounting language used by managers in the communication with the company's external stakeholders. The focus of the standard setters is that the standards add value if they lead to financial reports that correctly illustrates differences between companies' financial positions and performance to the external users. The best way to portray the accurate position of the company is if managers are allowed to use their knowledge about the business and its opportunities, and thereby use judgment to decide what accounting methods to use in their financial reporting. This will potentially lead to accounting that better reflect the economic position of an entity. However, even though allowing managers to use judgment creates a more accurate accounting in theory, in practice it could create opportunities for managers to use "earnings management", where managers choose reporting methods and estimates that do not reflect the underlying economics of the transactions within the entity. (Healy & Wahlen, 1998)

Another study on the topic of earnings management is written by Mark W. Nelson, John A. Elliott and Robin L. Tarpley in 2002. They define earnings management as non-neutral accounting where managers intentionally intervene in the financial reporting process to affect the earnings of the entity in a chosen direction, and thereby receive private gain. This is achieved by adjusting how they interpret financial accounting standards and accounting data to suit their own goal, rather than to reflect the underlying economics of the entity in the financial reports. The interventions made by managers can also be difficult for external users to distinguish from the proper use of accounting legislation, by interpreting the financial reports after they have been produced. (Nelson et al, 2002) Because of the problems with earnings management, it is important for standard setters to decide how much judgment they want to allow managers to exercise in financial reporting, for instance in which accruals are used to manage earnings. There are many ways that managers can, and need to, use judgment to influence their financial reports, for example to estimate the useful life and residual value of tangible fixed assets. Managers must also often choose between several acceptable accounting methods for reporting the same economic transactions. (Healy & Wahlen, 1998)

3.4.5 Positive accounting theory

Positive accounting theory was founded by Ross L. Watts and Jerold L. Zimmerman during the 1970s, and is another theory which attempt to describe the aspects of what might affect internal decision making within entities. Since then, the theory has continued developing within the accounting literature and the explanations for accounting choice are now more detailed and improved, in comparison to the simple definition made in the 1970s. Watts and Zimmerman explain that managers who perform the accounting of an entity act within an "accepted set" consisting of the allowed accounting choices that the manager can take on. Managers have discretion to choose any method within the accepted set, which is determined by the standards of the government, as well as the practice created by stakeholders within the firm and ultimately by the auditors of the firm. Therefore, even though the legislation is the same for all entities, the accepted set that managers have discretion to act within can vary across different entities or lines of business. After determining what constitutes the accepted set of accounting methods, the manager must choose which one to use in the accounting of the entity. This is where Watts and Zimmerman explains that managers might not always act in the best interest of the company, but instead focus on what will be in the best interests for themselves. When the exercised discretion of a manager makes the manager better off, at the expense of other stakeholders, the manager has acted "opportunistically" and with a self interest, rather than in the interest of the stakeholders. (Watts & Zimmerman, 1990)

Positive accounting theory is further explained by Collin et al., as a theory that derives predictions about accounting choice from the wealth effects the choice would have on important stakeholders. The manager's main objective is to represent the company's best interest; however he might hold his own interests to a higher priority. This creates an underlying agency problem that might explain one aspect of how accounting choices are made within entities. Accounting is, according to Collin et al., perceived as having two main functions: producing information for decision makers and distributing the results of the entities production. Both of these functions have wealth effects on stakeholders of the organization, depending on how well they reflect the true value of the company, and what conclusions stakeholders draw from the presented information. (Collin et al, 2009)

3.4.6 Institutional decision making

This section describes the external pressures that can affect the decision making within entities. The institutional theory is built upon the belief that organizations adjust, not only to internal goals, but also to the expectations of society. Aside from the economic and technical pressure of producing goods and services, organizations are also under the pressure of their surrounding through social and cultural demands. Depending on whether the economic and technical pressure or the social and cultural pressure is dominating the surroundings of the organization, different companies will succeed according to the institutional theory. (Hatch, 2002)

There are different interpretations of the institutional theory. One interpretation is that organizations after some time are able to control their surroundings rather than be controlled by it. This process of homogenization is often called isomorphism. (DiMaggio & Powell, 1983) For example if the structure of the majority of the companies in a line of business is alike, it will probably create an institutional pressure on the rest of the companies to use the same structure. Companies that are unable to adapt to this structure may risk not surviving. (Deegan, 2002)

The theory of isomorphism divides institutional influence into three categories. The first are mimetic processes which are explained as a reaction on insecurity that leads organizations to make decisions similar to other organizations. This kind of isomorphism shows when an organization has unclear goals or they have difficulty to understand and follow their surroundings. (DiMaggio & Powell, 1983) Mimetic processes are often identified in organizations such as banks, schools, manufacturing firms, accounting bodies and hospitals were there are often strong incentives to look alike (Maingot, 2006). The second category of isomorphism is coercive isomorphism, which is when organizations are forced to adjust to a certain type of behavior according to rules and regulation, other organization upon which they are dependent or the cultural expectations from the society. (DiMaggio & Powell, 1983) Changes occurring due to dependency on other organizations are coercive changes, but even though these coercive forces can make an organization look more effective, thus making it legitimate in environment of the organization, this is not always the case (Maingot, 2006). The last category of isomorphism is normative pressures, which are built upon the cultural expectation on organizations from the professionalization. The professionalization is for example often trying to define its goals, methods and expectations on the profession and thereby gain legitimacy. (DiMaggio & Powell, 1983) The reason organizations accept changes, due to normative pressure, is that they feel obliged to by the professional norm. Although there are some cases were the normative forces fail to make organizations do the right thing, for example Enron. (Maingot, 2006)

All three categories of the isomorphism can be combined in order to achieve a better legitimacy in the institutional environment. The theory of isomorphism explains why organizations although their natural differences still seem more homogeneous. (Maingot, 2006) Institutional isomorphism can also help to explain the adoption of a new legal framework between countries. For example organizations, as well as nations, can be forced to adopt new standards due to coercive institutions. Through studies of the adoption of IFRS, mimetic isomorphisms have been seen to influence the adoption of new accounting standards through social systems and professionalism. Studies have also shown that the accounting profession often has a greater impact on companies than the national cultures. (Judge et al., 2010)

CHAPTER FOUR - EMPIRICAL FINDINGS

In this chapter, we will present the empirical findings from our conducted interviews with the chosen respondents. We will present the material based on our chosen research questions.

4.1 How are components expected to be decided within an entity?

Since the K3 regulatory framework has a principle-based approach there is much room for the user to make own interpretations on what constitutes a component. Therefore the aim of our first research question is to find out how our respondents make their decisions regarding what a component is and how they look upon the vague definition of a component in the legal framework.

After performing all of our interviews with the respondents, it became clear that all the real estate companies have basic knowledge of the K-project and especially K3. They are informed about the ongoing debate concerning a possible demand for component depreciation but choose to await the final draft before gaining full insight on the matter, since they do not wish to spend time and effort on something that is not certain to ever be adopted. The entities consider it unnecessary and time-consuming to do this before the final draft of K3 is published. This is something that Peter Wallberg, at the trade organization SABO agrees with. He is of the opinion that this is something general for the real estate business and nothing typical just for our chosen real estate companies. According to Caisa Drefeldt at the Swedish Accounting Standards Board, this strategy is not unique for the implementation of K3 but rather common when implementing a new set of rules or making changes in general. Her experience is that many companies do not take action before the changes are certain to happen.

Even though the companies do not know for sure what the effects of a demand for component depreciation will be, they have still been very willing to discuss the possible effects of the implementation and to talk about how they think they will proceed in distinguishing components. Overall, the interviewed real estate companies had a negative attitude towards the possible demand for component depreciation, mainly of the reason that they find it especially difficult and time consuming to determine components in a real estate business.

According Company B, they have an awaiting approach to component depreciation but they are certain that the process of determining components will contribute to an increased workload for the company. Today they are not sure how many components will be reasonable to use but if there will be a demand for component depreciation they think that a standardized method will be necessary while dividing the current assets into components. According to a standardized method, they believe that real estates' will be divided into components by estimating how many percent of the whole building a specific component compose. However, they empathize that component depreciation will probably be easier to perform on future investments. Based on the fact that it is hard to determine a component, Company B would like to have seen more concrete words of act. At Company A the respondents agree that a more specified set of rules for what constitutes a component would be preferred. They do not believe that a demand of component depreciation is reasonable without a more specific explanation of how it should be performed. They argue that there is a risk of companies choosing an easy way of component depreciation and divide their buildings into as few components as possible, for example to only account for two components, and thereby still be able to call it component depreciation. At Company A they have not yet agreed on what could be seen as suitable components in a building but their view is that it is important that the number of components used is reasonable. At their guess a building could come to be divided into five to ten components. More than this would according to them be both unreasonable and too much to handle. Company D also believe that it is hard to predict how many components a property should be divided into, since buildings are complex, but they argue that at least ten would be needed. Examples of components are according to them roof, windows and foundation, which all have different expected useful life. To be able to make classifications, they believe it to be necessary to have someone that is competent in both depreciation and real estate, while deciding what components to use and how to account for them. This is a competence they believe that Company D already contains within the company.

At Company C, in contrast to the other interviewed real estate companies, they examined the possibility of using component depreciation in their financial accounting a couple of years ago. The reason for investigating this possibility was the belief that they considered component depreciation to be the most natural way to account for their real estate. However, the outcome was not satisfying and they soon realized that component depreciation was too complicated to perform and thereby; they chose not to use it. Company C agrees with the other interviewed real estate companies that it will probably be difficult to determine what constitutes a component. Trough the investigation made a couple of years ago they decided that seven to eight components would be a reasonable amount to use, for example facade, roof, foundation and elevator. While conducting their study, they also contacted an accounting specialist. He was of the belief that a building could not be divided into less than 15 components in order to account for their property correctly. In the end, Company C also believes that the only possible way of determine components in practice will be as percentage of the property.

In contrast to our other interviewed real estate companies, Company C has a more positive attitude towards the vague definition of a component in the K3 exposure draft. They believe that it could lead to a more optional accounting but at the same time they are worried that it will lead to huge differences in the financial reports between the real estate companies, thus negatively affecting the comparability. However, the vaguely formulated definition of a component in K3 leads to difficulties in the determination of what constitutes a component. Company C question the necessary quantity of components to account for, and what these components will include. To exemplify the complexity of the problem they mention the difficulties that can occur while accounting for a roof as a component, in accordance with K3. It is wrong to see a roof as just one type of component since there are several types of roofs made of different material with different expected lifetimes. This will lead to difficult interpretations and an immense administrative burden for the real estate companies.

Caisa Drefeldt is an accounting specialist at KMPG and member of the workgroup developing K3 within SASB. This gives her an understanding of the complicity that real estate companies may experience if the demand of component depreciation will be realized. Although, if the definition of a tangible fixed asset according to K3 should be achieved in the financial reports, she find component deprecation the only correct option to account for tangible fixed assets. However, Drefeldt finds it important to reach a pragmatic solution in how to perform component depreciation, especially while determining essential components with a significantly different pattern of economic life. According to Drefeldt, essential components could for example be: roof, foundation, pipe system, windows, balconies and maybe laundry rooms, but the most important thing is that the component is determined according to what is considered to be essential parts of a building. Drefeldt find the ongoing debate on component depreciation pushed to the limit and that people are debating over component depreciation as if every nail should constitute a separate component. This is, according to Drefeldt, wrong since the most important thing is to find the essential components. Company B believe that the way real estate companies already split up their assets into property, plant and equipment could be seen as easy version of component depreciation. Drefeldt shares this viewpoint.

Regarding the vague definition of a component according to the words of act, Drefeldt consider it to be necessary since K3 is a principle based legal framework. Her viewpoint is that it would send the wrong signals if the legislator exemplifies how the entities should account for their components, due to that K3 is a principle based legal framework. The reason for this is that it would probably lead companies to follow the examples instead of making their own decisions on how to determine and account for their components. According to Drefeldt, the intention of SASB is not to make an exemplifying legal framework but to make a principle based one. Due to this, the demands on both the creators and the user of the financial information will be immense, since it will be crucial to always keep in mind the economic meaning of a transaction. Drefeldt is of the opinion that companies seek an easy solution to simplify their assignment. Magnus Nilsson, accounting specialist at Grant Thornton is of another opinion; in order to maintain comparability between companies he believes that it will be necessary to have some kind of guidance regarding component depreciation. Otherwise, companies will account for their components differently due to their individual interpretations. At Company A as well at Company C the opinion is that the vague definition of a component and the lack of guidance will lead companies to try and find shortcuts and an easy way out of component depreciation.

Bo Nordlund, who is an accounting specialist in the real estate business, thinks the amount of components chosen by the companies will differ due to the differences between real estates. A technically complex building consisting of both apartments and commercial shops will probably be divided into ten to fifteen components, while a simple warehouse will probably consist of fewer components. The most important thing is that the choice of what components to use is supposed to add value to the user of the financial information, when entities choose to handle larger expenses as investments rather than costs. Nordlund is of the opinion that the processes of determining components will depend on the structure of the company and of their internal routines, for example regarding handling reparations. It is important to consider the company’s type of business and the way of handling replacements of components. Nordlund as well as Drefeldt, is of the opinion that in the big picture, the most important thing is to find a pragmatical solution in which companies are allowed to focus on essential components of their property.

Claes Norberg, accounting specialist at Confederation of Swedish Enterprise and active at SASB in the working group developing K3, enhance the importance of remembering to focus on essential components. Examples of components that he believes to be essential are foundation, roof, facade, preparation of the ground as for example drainage, windows, ventilation and pipe system. In excess of this, interior equipment will be handed as residual components according to a rough classification of how to determine components. Wallberg, working in the business area Economics & finance at SABO, is also of the opinion that component depreciation is the only right thing considering the correct definition of a tangible fixed asset, although he is of the opinion that there can be a gap between economical theory and practice. Practical problems that may arise when using component depreciation, according to Wallberg as well as many other of our respondents, is to determine what constitutes a component. He believes that the most difficult thing will be to determine when to activate an expense in the balance sheet and when to account for it as a cost. Trough an example of how refrigerators in apartments needs to be replaced, he enlighten a problem of having to determine how many percent of the apartments which needs to recieve new refrigerators in order for the company to be able to account for the expense as a component. Wallberg is of the opinion that the companies will have to draw their own conclusions and a lot of difficult managerial judgment will be needed of the companies.

4.2 What external factors are expected to affect how components are decided?

Because of the wide range of choices available for companies under the proposed regulation, in how to determine what constitutes a component, it is relevant to consider what external factors may affect the process of the decision making within entities. This question will help us examine existing external influences on how companies behave.

According to our respondents, it seems as if it do not exist a uniform best practice for how the real estate industry make accounting decisions regarding their tangible assets. Company C reasons that there generally is a wide inconsistency in the degree to which real estate companies chooses to activate expenses in the balance sheet or account for it as a cost in the income statement. In their opinion, this inconsistency will remain and affect how companies define their components. However, they also maintain that the choices made usually do not create significant differences at the bottom line of the accounting, once costs and depreciations are accounted for. According to them, valuation principles are what primarily differentiate companies today and these principles are comprehensively communicated. In their opinion, this is what enables the comparisons between real estate companies. Both Company A and Company B claim the industry organizations, such as SABO, to be an important influence and they hope that for example SABO will construct and provide clearer guidelines regarding component depreciation according to K3. Company B hopes that there will be a discussion within the real estate industry on how to define components, and they also enhance the importance of an industry best practice.

Since component depreciation is very rare and basically non-existing within the real estate industry today, there has not yet developed an industry best practice. However, the vague language within the regulation will probably lead to the development of such an industry best practice, according to Nilsson, accounting expert at Grant Thornton. This development will require structure and Nilsson partly agree that trade organizations will play an important role, although he believes that FAR’s policy group will be the leading part. Since the policy group is exclusively composed by auditors and similar experts, without direct industry input, he also points out the importance of an ongoing discussion with the real estate companies, to ensure that relevant guidelines are created.

Drefeldt at SASB reasons that trade organizations such as SABO is responsible for formulating an industry best practice, although she do not believe it to be an easy task. Her view is shared by real estate accounting expert Bo Nordlund, however, he acknowledges that it will be hard to formulate a more detailed guidance of what actually defines a component. At SABO, Wallberg reasons that it is a difficult matter to formulate guidance for component depreciation, hence nothing he looks forward to. The economic useful life can diverge distinctly, not only between different components but also within the same component group. A facade, for example, might have separate useful life depending of material choice, such as plaster, tiling, or wood. However, Wallberg believes that it is important to somehow create guidance on the area, and he believes that SABO probably will have to join in with other trade organizations such as Fastighetsägarna and HSB, to create a joint suggestion for guidance. Wallbeg argues that since it is such a difficult area to evaluate, it is important that the trade organizations join together unanimously around the guidelines they choose to publish. Since the economic useful life differs widely, not only between different types of components but also within the same component groups, where material choice and quality play an important factor, Wallberg believes that it will be hard to create a guidance for how components should be accounted for and what depreciation period to use. Wallberg argue that one option might be to design guidelines where the depreciation period for different components is mentioned in several intervals, depending on the variations of the useful life. This point of view is also supported by accounting expert Bo Nordlund, who believes that the guidelines will have to be designed based on a standard house where different components will be specified, and within each component show how, for example, different facades are supposed to be depreciated.

Claes Norberg at CSE, as well as a member of SASB, states that if the legislator chooses not to further specify what constitutes a component, someone else will have to do so. He believes that this role ultimately will fall on the auditors, if the real estate companies do not agree amongst themselves on how to account for their components. The auditors will probably have to construct an operating manual for what constitutes component, which will be the only way to make it reconceptualised. Norberg argues that the reason Swedish Accounting Standards Board chooses not to publicize guidance is that it will probably be close to impossible to construct a general guidance which will be applicable on all different lines of business. For that reason, it will be better if an industry best practice were defined within the different lines of business instead. Company D agrees with Norberg that at the beginning of the adaption to K3, entities will turn to auditors for guidance. However, they and all of our other responding real estate companies believe that an industry best practice will develop, but that it might take a couple of years.

4.3 What are the expected advantages and disadvantages of component depreciation?

4.3.1 Advantages of component depreciation

In general, all the real estate companies in our study have a very negative attitude towards a demand for component depreciation and they cannot find any advantages of what it could contribute to in order to make the accounting better than it is today. However, Company C is of the opinion that if following economic theory, and disregarding the reality of most real estate companies, it would be the right thing to use component depreciation according to the definition of a tangible fixed asset. Furthermore, Company D find it possible that a demand for component deprecation could lead to an improved view of the assets held by the entity and that it could contribute to a higher amount of detailed knowledge of the properties, although they questions if it would add value in the big picture.

According to Drefeldt at SASB, the basic idea of component depreciation is for companies to always rely on the definitions of assets and debts when valuing their transactions. To be able to fulfill the definition of an asset and create economically correct accounting, component deprecation is the only right option, according to Drefeldt. When using component depreciation correctly, the balance sheet will show exactly how the assets are consumed. This will also, as Company D agrees, lead to a better possibility for companies to overview their assets and the plant registers of the entities will reflect the reality of how the property is used.

It will lead to a transparency of the real estate companies' financial obligations of reparations and maintenance and for the useful life to be shown in the balance sheet and income statement for each component. For example, if the foundation of a property has a useful life of 40 years and the roof has a useful life of 30 years; these will be deprecated over 40 respective 30 years while in use. In the end Drefeldt is of the opinion that this essentially is the right way for the companies to account for their assets. The idea of component depreciation and residual values is to show how the assets are used and there exists a deep economical reasoning behind this. According to the definition of an asset it would be incorrect to account for a new roof as a cost in the balance sheet. Drefeldt finds it a common mistake in the real estate businesses to account for expenses as costs in the income statement instead of activating them as assets in the balance sheet. What will happen is that the old roof will remain in the balance sheet, even if it is fully consumed and already replaced. Because of this the economic reality is not pictured in the real estate business today, according to Drefeldt.

Based on the fact that buildings are not homogenous, Norberg at Confederation of Swedish Enterprise agrees upon the belief that component depreciation has an information value. Therefore his opinion is that the accounting should reflect the properties actual value, but of course only to an essential amount. Nordlund, accounting specialist at the real estate area, is of the opinion that component depreciation will lead to a more consistent handling of incremental expenses. In that case, exactly as Norberg and Drefeldt points out, the most important is to focus on the significant expenses upcoming under a lifecycle, rather than details. This is, according to Nordlund, more consistent following the definition of an asset and will therefore not only lead to a more correct balance sheet but also more consistent income statement. One of the benefits of component depreciation will be it leading to that all incremental expenses are compared to the definition of an asset by K3. For example, Norberg points out, the differences in how real estate companies account for their reparations which often leads to differences in the income statement today. The benefit of component depreciation will therefore, according to Norberg, be that companies will account for their incremental expenses in a more similar way.

Nilsson at Grant Thornton is of the opinion that the most important benefit of component depreciation will be improved accounting in real estate companies. As the real estate companies will be forced to consider their handling of expenses as costs or activations, the quality of accounting will in the end most likely improve. Even though component depreciation probably will lead to an increased workload for the real estate companies, Nilsson points out, that K3 instead of this should be seen as possibility to refine the accounting further.

4.3.2 Disadvantages of component depreciation

One of the primary reasons for why real estate companies have a negative approach to component depreciation is that a demand for component depreciation will undoubtedly impose a huge administrative burden on them. At the same time they are questioning to what use they will be forced to account for their assets according to a demand for component depreciation. The overall critique from all of the interviewed real estate companies thus concerns how a demand for component depreciation would be practically operated within the real estate companies. All of or respondents argue that a demand for component depreciation would lead to an unreasonably vast administrative burden. They agree that it would be tremendously hard to decide what constitutes a component as well as to estimate the useful life of each component, from case to case. Company D argues that the hardest part with a demand for component depreciation will be to analyze every real estate owned by the company and estimate what reasonably should constitute components, and at the same time weigh this in comparison to the benefit and use received by accounting for the component. They also argues that initially, it will lead to a heavy workload and a lot of evaluations have to be made in the beginning. This is also the point of view of our three other interviewed real estate companies.

Company B believes that a demand for component depreciation will lead to considerable requirements on the plant register of the real estate companies. If each component should be accounted for separately in the plant register, it initially becomes difficult to separate a building into different components and evaluate their useful life. Secondly, it will lead to a direct increase in the number of assets in the plant register, which will contribute to an even greater workload for the real estate companies. At Company A, they believe that depreciation on real estates can be quite difficult to perform as it is today. It would therefore lead to a significant adjustment if the real estate companies also needed to divide their assets into components. Company A speculate that it probably will lead to that having to spend at least 3 or 4 times more on depreciation than used today, to be able to identify components. In addition, they believes that more time have to be spent to verify the value of the entire component, because it is important to account for the correct values in the balance sheet and income statement. Company C also believes that it will require huge amounts of time to identify components. When they, a few years ago, examined the possibility to use component depreciation, they finally chose not to, because it was too difficult to implement in the real estate industry. They also concluded that it did not add much value to the financial statements. Apart from this, they also realized that with the amount of difficult managerial judgment needed to be preformed about expected useful life, the results were just as often right as wrong in the accounting in the end. Because of this, they believed that it did not contribute to their financial reports. They also believe that a demand for component depreciation would lead to a lot of extra work throughout the whole company and they are unsure of weather the existing competence within the company will be enough to handle the extra workload that a demand for component depreciation would create.

Another aspect, which Company C sees as a difficulty, is that it will not only be the employees working at the economic department of a company that need to be agreed on how to conduct component depreciation. That way of thinking must be spread across the entire administration of the real estate companies. Even though the economic departments will be the ones to determining how many components will be used, and how to account for them, it will still be the administrative body that takes care of order procedures as well as receiving invoices from contractors. The economics division is solely responsible to enter the transactions in the books. Therefore, it will be of great importance that the administration of the company is informed about accounting for real estates and how it will be affected by a demand for component depreciation. Beyond this, invoices from contractors will have to be more detailed, with specifications at a component level. This responsibility will fall on the shoulders of the administration in the real estate companies and in the end, also at the hired contractors. They need to be able to report in a way that will be understandable and detailed enough for the economic department to receive and to enter the transaction in the books. Today, a real estate company might receive a total invoice of 5,000,000 SEK for a repairing job, but in the future, the administration will need to identify which components the invoice consists of. This creates immense requirements on the administration to be well informed within accounting, as well as that it will be extremely hard for them to decide and perform judgment decisions regarding what constitutes components.

At SABO, Wallberg believe that it will be very hard for the real estate companies to judge when to activate an expense in the balance sheet, and where to draw the line concerning when to account for it as a cost in the income statement instead. He believes that this will create a heavy workload for the real estate companies. Also Nilsson at Grant Thornton, as well as Norberg at CSE believes that a demand for component depreciation will increase the administrative burden for real estate companies. They argue that it will mainly take place in two steps, first while determining what constitutes a component, but also while working with the components in their plant register. Nilsson is not surprised by the negative attitude towards component depreciation, since it will initially lead to both an increased administrative burden, as well as increased costs of introducing component depreciation. This is something that Bo Nordlund agrees with, since he argues that it will be both hard and time-consuming to, with a large amount of real estates, decide what constitutes an added value to a component and what is permitted to be accounted for as an expense directly. He also notes that administrative problems can occur with the plant registers if a company which has chosen to account for several minor parts of a real estate as one total component, later on realizes that they need to exchange one of these parts separately.

Caisa Drefeldt at SASB is in agreement with the real estate companies that it might be problematic to identify what constitutes a component and that it initially will create a lot of work, especially for real estate companies. However, Drefeldt argues that it is not enough to discuss positive and negative effects of component depreciation, solely based on the opinions of real estate companies, since they only represent a small fraction of the companies in Sweden. She also believes that eventually, routines will be created within the real estate companies, which will lead to that even the real estate companies, in the future, will be able to perform component depreciation rather painlessly.

4.3.3 Who benefits from component depreciation?

As earlier mentioned, the real estate companies we have interviewed cannot see any advantages of using component depreciation and the companies therefore also find it difficult to predict which benefits the change will lead to. Company C argue, that none of their stakeholders use bookkeeping values as a basis for evaluating real estates but instead use transaction value when analyzing the company. Also Company D agrees with the lack of importance of bookkeeping values for their stakeholders, as for example banks. According to them, this type of information could be of interest for a potential buyer of a real estate, since the division of components gives a better overview of what the buyer actually recieves. Also Company B has a hard time figuring out who could benefit from component depreciation while they reasons that the information this will add already exist in the real estate companies internal systems of follow-up, even though they do not exist in the financial reports. This is something that Drefeldt, at the Swedish Accounting Standards Board, do not agree upon and which she thinks is one of the great benefits of component depreciation for the real estate companies. While the companies are forced to reflect upon their plant register and how it actually works, this will lead the real estate companies to better be able to overlook their assets. The real estate companies difficulty to find benefits of the component depreciation are, according to Drefeldt, strange since they are the ones she believes would benefit the most from the ability to show a more accurate result and gaining a better insight of their real estates. This is something Nordlund agrees upon as he is of the opinion that the income statement will improve for the benefit of both the real estate companies themselves and analysts.

In opposite to the real estate companies, Norberg at CSE, find component depreciation to be a great contribution to the stakeholders of the real estate companies. He agrees that investors and creditors first of all are interested in the market value of real estates when evaluating the companies' ability to pay their debts and to determine their financial position. However, Norberg argues that fair value is not showing the whole truth about a company. For example, information of future replacement and reinvestments in the long run is needed to be able to make correct statements of cash flow for the real estate companies. This can, according to Norberg, easier be shown by component depreciation and therefore it should be interesting for real estate companies to show how their long-term holdings are changing.

4.3.4 Is component depreciation necessary?

None of our interviewed real estate companies believes that component depreciation will lead to a more true and fair view of the assets held within the entity, compared to what is stated in the financial information today. Company A argues that they already have such an open accounting that a demand for more detailed information does not exist. Company C agree that component depreciation could lead to a more true and fair view of the assets whitin a company in theory, but argues that it is non-essential in practice since there is a lack of interest in this type of information. Out of all the real estate companies we have interviewed, none of them believe that the benefits that component depreciation might result in, is even close to exceed the costs of performing it, not even in the long run. Company C is of the opinion that component depreciation does not create enough added value in the financial accounting, in comparison to the work it takes to perform it; especially since none of the stakeholders of the real estate companies uses this information. This argument is questioned by accounting expert Bo Nordlund, who argues that if the real estate companies do not understand the benefit of component depreciation, they are missing the point which is that component depreciation will lead to a better accounting at large. A demand for component depreciation would lead to a better balance sheet, but also to a more even and correct income statement, which the companies so far has failed to understand, according to Nordlund. This is something that Caisa Drefeldt agrees with, and states that if the real estate companies want to create an economically and theoretically correct accounting, it might be costly to initially implement component depreciation. However, she argues that it will be worth it in the end because the real estate companies will achieve a better income statement as well as a better overview of their real estates

This overview, however, is something that Company D argue that the real estate companies already have. They are able to achieve a detailed overview of their real estate's by performing annual business plans for each building. In the business plans, each building is analyzed in order to see what potential and development possibilities lies within the real estate. An administrator of the building survey the building together with a technical administrator, to evaluate if any work is needed to be performed on the building. After this survey, a maintenance plan covering a few years is constructed for each building, to illustrate what needs to be maintained, for example roof, windows, facade etcetera. Because of this, Company D claims that real estate companies already have got a detailed overview of their real estates, although it is not reflected in the balance sheet or income statement.

At Grant Thornton, Nilsson claims that component depreciation would lead to a more refined accounting within the real estate companies. However, he argues that when the real estate companies present critique concerning a demand for component depreciation, it is easy that they only focus on their own line of business. Because of this, Nilsson states that he believes it to be important to raise the view one level and also see to how this will affect other lines of business. It is necessary, not to be blinded by the concept of component depreciation and what it means in a narrow point of view, but at a wider perspective look at the whole real estate- and investment process and how it is supposed to be reflected in the financial reports made by the entities. If component depreciation is not used, it disregards a part of the process, and Nilsson argues that thereby, it is hard to claim that the accounting of today present a true and fair view of the assets of a company, when the investment process is not better reflected. Today, it is common to account for expenses as a cost, even though it could be seen as adding value to the real estate. Therefore, the real estates' are not correctly reflected in the accounting preformed today. Because of this, Nilsson claims that component depreciation would lead to that a more true and fair view reflected in the assets of companies.

CHAPTER FIVE – ANALYSIS

Here, we will analyze our empirical findings using the chosen theories discussed in the frame reference.

5.1 How are components expected to be decided within an entity?

During our empirical research, it has become clear that component depreciation is the best way to achieve a correct accounting according to economic theory, as the financial reporting of the assets will be in line with the definition of an asset according to K3. However, as Wallberg at SABO stated, there can be a large gap between economic theory and practice. This is also verified by our interviews, which affirms that while the legislators might have a theoretical approach to component depreciation, the real estate companies have, for natural reasons, a more practical approach, which leads to different attitudes towards component depreciation.

All of our respondents within the real estate business are very critical of the new demand for component depreciation, proposed by the Swedish Accounting Standards Board in the exposure draft to K3. The empirics show that the main reason for the negative attitudes is that it is very difficult and also time-consuming to distinguish components within a building. Our frame of reference, as well as our empirical findings support that this will be especially hard since K3 does not give much guidance to what constitutes a component. The reason for the vague definition of a component in K3 is, according to Drefeldt, that the view which SASB had in mind while writing K3 is that it is supposed to be principle based rather than guided by stated examples. This will require of managers to further analyze the economic substance of the transactions within entities, rather than to account for their tangible fixed assets according to given examples. This is in accordance with Alexander and Jermakowicz definition of principle based accounting, which aims to reflect the underlying economics in the balance sheet of an entity (Alexander & Jermakowicz, 2006). When it comes to component depreciation, Drefeldt argues that it will be of more importance according to K3 that the real estate companies account for their tangible fixed assets in accordance with the definition of an asset. She also states that component depreciation is the only acceptable choice if you wish to create financial statements that are theoretically and economically correct. The empirical findings support that the problem today is that the depreciation practice of buildings, with writing them of as a unit over 50 or in some cases 100 years, does not reflect how the benefits of the components actually are being used. Maines et al. argues that the economic substance of a transaction should guide financial reporting, rather than the form of the transaction. They believe that principle based accounting would be the best way to accomplish that objective (Maines et al., 2003). Therefore, we understand the intentions of SASB, while deciding that a demand for component depreciation is necessary if companies want to achieve a theoretically correct accounting. However, it is also important to analyze the practical implications of the K3 exposure draft on real estate companies.

If component depreciation becomes mandatory for companies, the empirical findings support that this will lead to many difficult judgment cases, especially for real estate companies, both when it comes to deciding what components to use, but also when deciding when to activate an expense and when to account for it as a cost. Meanwhile, a demand for component depreciation could potentially lead to financial reports that better reflect the economic reality, since the managers’ decisions hopefully lead to a better reflection of how the assets are being used within the company. This is supported by Healy & Whalen, who state that the best way to portray the accurate position of a company is if managers are allowed to use their knowledge about the business in judging and deciding what accounting methods to use (Healy & Whalen, 1998). Even though principle based accounting could lead to financial reports that better reflect the economic position of an entity, most of our respondents within the real estate companies would prefer a more concrete definition of what constitutes a component. The vague definition result in that it will be hard to grasp how many components a real estate preferably should be divided into, and what should be allocated to each component. Because of the vague definition, many of our respondents wish for a more detailed guidance in how to determine what constitutes a major component, and when these will need to be accounted for separately. This is, according to Maines et al., not unusual with a transition from a rules-based approach to a principle-based approach such as K3. Usually, entities initially request more guidance than what is provided by principle-based standards. (Maines et al., 2003)

Due to the vague guidance of what constitutes a component, most of our respondents believe that there will be significant differences in how real estate companies choose to account for their buildings and how many components they choose. Company A believe that they will account for between 5-10 components, since it would be very hard to manage more than that. However, Company D believes that it will be at least 10 components per building, since buildings are so complex and consists of a lot of components. On the other hand, when Company C earlier investigated the possibility to account for their tangible fixed assets, they found that to achieve a correct evaluation of their real estates, it would be hard to account for less than 15 components. This already shows that there are a lot of different opinions between our chosen real estate companies, concerning the right amount of components to account for. It is still important for the analysis to enlighten that this could partly be due to that the real estate companies are not yet completely educated on which effects a demand for component depreciation could bring. However, real estate accounting expert Bo Nordlund affirms that the amount of components chosen by different real estate companies most likely will differ due to the differences between real estates. Based on the empirical findings, it will be almost impossible to construct uniform financial reports within the real estate companies, when the managers are allowed as much room for the use of own judgment, as they are by K3. However, our concerns lie with how this will affect the comparability between real estate companies after the implementation of K3. Even though today's accounting regulations might not reflect the underlying economics of the transactions within the entity, it is better suited with the qualitative characteristic of comparability between entities. After the implementation, our empirical findings suggest that the financial reports will diverge more between entities, which will make it very difficult for users of the financial information to compare one real estate company to another. However, it is necessary to make a consideration of the importance of comparability, in contrast to the importance of a financial reporting process that better reflects the underlying economics.

Drefeldt at SASB understands that there might be a lot of confusion within the real estate companies as to how many components that needs to be accounted for, and that it calls for a lot of difficult managerial judgment decisions. She underlines that it will be necessary to find a pragmatic solution for how real estate companies practically can perform component deprecation, and emphasize that it will only be major components that needs to be accounted for separately. Most of our respondents are however in agreement about that major components will probably include for example foundation, pipe system, roof, facade, windows, balcony and laundry room, amongst others. After deciding what components of a building to account for separately, they should, according to K3, be allocated separate expected useful life during which they will be depreciated. Our empirical findings support that this will demand a lot of managerial judgment from the real estate companies, not only in deciding what components to use, but also to decide how to account for them. It will probably not be enough to account for a roof in one specific way for all buildings owned by a real estate company. As Company C expressed it, a roof can be constructed from a lot of different materials. The extension of this is that the different materials probably have significant different useful life and will therefore need to be separated into different components. Based on this, we argue that if you need to make this type of judgment decisions within each significant component group, and also perform it on 500 different real estates with different qualifications, it instantly becomes clear how component depreciation will be quite difficult to perform in real estate companies. Above the difficulties in deciding what components to use, another aspect that we have detected where managerial judgment is needed is where to draw the line between when to activate an expense and when to account for it as a cost. For example, Wallberg at SABO, reasons regarding if a company chooses to conduct repairations or replacements of components in some, but not all of the apartments in an apartment building. If, for instance, a company chooses to account for refrigerators as a separate component; how many apartments need to get their refrigerators replaced for it to be handled as a component exchange which in turn should be activated in the balance sheet, and where is the line drawn for when it is accepted to account for the expense as a cost instead? Based on our empirical findings, we agrue that this is only one of many examples that make it clear that it will not only be difficult to decide what components to use but also to decide when components are accounted for. As Maines et al. states, a principle based standard leads to a larger spread of options for entities, which could lead to both positive and negative effects on companies financial reporting. It will hopefully lead to accounting that better reflect the underlying economics and give a better picture of the financial position of the company. It could however instead lead managers to make decisions which do not reflect the underlying economics, but rater serves a personal interest instead. (Maines et al., 2003)

According to Healy and Whalen, they believe that the best accounting is created when managers are allowed to use their knowledge about their business to decide what accounting methods to use in their financial reporting. However, they have identified a potential problem with use of managerial judgment, as it could give rise to an opportunity for companies to use “earnings management”; that is when managers choose reporting methods that do not reflect the underlying economics of the transactions within the entity. Although we have not detected concrete evidence during our interviews that companies might use component depreciation as a way to mislead the users of the financial information, we have however detected that the interviewed real estate companies believe that there lies a risk in allowing the companies to choose components themselves. Company A believes that a demand for component depreciation creates such an administrative burden for real estate companies, that the principle based rules will lead these companies to take the easy way out and for example only account for two components and thereby still perform component depreciation, although it does not reflect the underlying economics. Company C also believes that companies might try to find shortcuts and make it as simple as possible for themselves, due to the vague definition in K3. Another problem presented by Nelson et al., is that the intervention used by managers can be difficult for users of the financial information to detect, but can very well be an important factor while discussing how managers might be tempted to, and easily could, manage earnings (Nelson et al., 2002), because of all judgment decisions made concerning the depreciation of their chosen components.

Another theory that might help to explain what could affect managers decision making is Watts and Zimmermans study of “positive accounting theory”. It states that managers who act with discretion within an accepted set of accounting choices, might not always act in the best interest of the company and its stakeholders, but instead act in the best interest of himself (Watts & Zimmerman, 1990). Company B believes that it will lead to such an administrative burden for the real estate companies to account for separate components, that component depreciation in practice will be performed based on a stated model. According to this model, they believe that the decisions of what components to use and how to account for them are based on predetermined percentages of the total value of a building, rather than the economic substance of the chosen component. Based on our empirical findings and our frame of reference, we argue that this will be a way that many of the real estate companies chooses to account for their components, but the question is whether it will contribute any value to the accounting, or if it will simply be a way for the real estate companies to make it as easy for themselves as possible, without the consideration of their stakeholders. To Drefeldt at SASB, it is not surprising that companies might try to simplify for themselves, and argues that companies often tries to find finished solutions to their difficulties, to simplify their work. This is, however, not the intention of the principle based rules which instead aims to create better financial information for the stakeholders of the entities.

5.2 What external factors are expected to affect how components are decided?

When putting together our empirical findings, it becomes clear that the respondents have a lot of thoughts and reflections on what are going to be influential in the process of determining components. According to the institutional theory of isomorphism organizations adjust not only to internal goals but also to expectations of society. (Hatch, 2002) Both the real estate companies and our other respondents argue that real estate companies are affected by external pressure when determining what constitutes a component. However, there is a disagreement between our respondents of what external factors will be the most influential.

Coercive isomorphism explains that organizations are forced to adjust to certain types of behavior, for example rules and regulations. (DiMaggio & Powell, 1983) Even though all of our interviewed real estate companies have a negative attitude towards the proposed demand for component depreciation in the K3 exposure draft, accept the fact that the demand could potentially become reality, and that they, in that case, will have to adhere to the new regulation. We are therefore of the opinion that companies are under the pressure of coercive isomorphism even though the companies argue that the definition of a component according to the K3 exposure draft is vague, which leads to a risk for significantly different interpretations of the words of act.

The lack of instructions from the words of act on how to determine what constitutes components will, according our respondents, lead to a demand for guidance from someone other than the legislator. According to our respondents, there is no practice of accounting for components in real estate companies today. However, in the absence of directions it is, according to mimetic isomorphism, natural for organizations to seek guidance elsewhere, and make similar choices as other organizations. (DiMaggio & Powell, 1983) Nilsson at Grant Thornton finds it crucial that the real estate companies come together in order to create a best practice of what constitutes a component and how to account for them. Our impression is that the real estate companies are open to discuss component depreciation with each other in order to decide on a best practice, even if it will take time. As explained by DiMaggio and Powell (1983) the desire to look alike is especially strong within, for example accounting departments, which we have been able to verify from the interviewed real estate companies. The general opinions among the real estate companies are that best practice is of great importance to be able to maintain a correct accounting. Although a best practice regarding component depreciation has not yet been developed, we find it most likely that this kind of influence will be stronger over time, and that the mimetic isomorphism will be more common in a few years, since the development of a best practice within the real estate business will take time.

Organizations can also be affected by normative pressure, which is built upon the cultural expectations that organizations receive from the professionalization (DiMaggio & Powell, 1983). Since the proposed demand for component depreciation only exists within the K3 exposure draft, which has not been implemented, there has not yet developed expectations from trade organizations such as SABO or CSE. However, it is our understanding that these kinds of trade organizations are a strong normative influence from whom real estate companies seek guidance. Even though all the interviewed real estate companies agree upon the need for guidance if component depreciation will become a demand, there are still different opinions regarding who should be responsible for creating such guidance. Both Company A and Company B hope that trade organizations such as SABO will contribute to creating an industry best practice within the real estate companies. This opinion is shared by Caisa Drefeldt at SASB, as well as real estate accounting expert Bo Nordlund, who believes that the responsibility of developing of an industry practice should fall on the trade organizations, as it should lie within the obligation to their members. This is something Nilsson at Grant Thornton agrees with; however apart from trade organizations, Nilsson also believe that the FAR Policy Group will be another part leading the development of guidance for the real estate business. However, he also sees this as potentially problematic since the members of FAR Policy Group solely consist of auditors and accounting specialists, and lack representatives from entities. Through this study, we have not been able to confirm if FAR Policy Group is planning to publish any guidance on the matter of component depreciation according to K3. However, according to normative isomorphism, they could potentially be one of the organizations representing the professionalization, which will be influencing the real estate companies.

The first years after implementing K3, Company D believe that auditors will have a huge impact on how to perform component depreciation within the real estate companies, since the development of a best practice within the real estate business probably will take a few years. Norberg at CSE also believes that more guidance is needed and if the real estate companies will not agree on an industry best practice themselves, auditors will be the most important source of guidance for real estate companies. Until the development of an industry best practice from the real estate companies or their trade organizations, our empirical findings as well as our frame of reference support that auditors will have an important role in determining how to account for components within the real estate companies. They will probably have to provide some kind of guidance for how many components their clients are expected to divide their assets into, as well as how they will account for them. Our empirical findings show that all of our respondents express a strong demand for normative pressure to achieve legitimacy in the institutional environment. However, also mimetic processes and coercive isomorphism will help in explaining which external factors are expected to affect real estate companies in their process of determining what constitutes a component.

5.3 What are the expected advantages and disadvantages of component depreciation?

After interviewing our real estate companies, it is fair to say that all of them had a negative view towards component depreciation, and strongly questioned how it would contribute to the accounting today, especially in comparison to the administrative burden it imposes. However, Caisa Drefeldt at SASB argues that the contribution made to the financial reports is that the balance sheet, as well as the plant register will show exactly how the assets are consumed within the entity. Our empirical findings and our frame of reference support that accounting policies used today do not lead the financial reports to reflect how the assets are being used in detail, and therefore, we can see how component depreciation could contribute in this matter. Another aspect is expressed by Norberg at CSE, who argues that component depreciation will lead to a more consistent handling of incremental expenses. Norberg also argues that the differences in how real estate companies account for their reparations today often lead to differences between income statements of the entities. He believes that one benefit of component depreciation is that it will lead to a more consistent handling of incremental expenses within the real estate business. This is, however, something that we question since our empirical findings suggest that principle based accounting could lead to more differences in judgment decisions between companies. The extension of this could lead to even larger differences in the accounting choices made by the entities and therefore, the comparability between different entities might be obstructed. Another aspect discussed during the interviews is if component depreciation will lead to a fair presentation of the assets in the financial reports. According to the conceptual framework to K3 a fair presentation, also known as true and fair view, is achieved when the balance sheet, income statement and notations of a company show a true and fair view of the position and the economic result of an entity. Based on our frame of reference as well as our empirical findings, a demand for component depreciation will probably lead to a more true and fair view of the balance sheet, since the usage of the assets will be better reflected. Apart from this, a demand for component depreciation could also lead to a better income statement since companies probably will choose to account for fewer expenses as costs and rather activating them in the balance sheet instead.

However, one of the main arguments against a demand for component depreciation is that it imposes a vast administrative burden on the real estate companies. The interviewed real estate companies also argues that it will demand difficult managerial judgment, both while deciding what constitutes a component and how to handle them in the plant register. Another problem will, according Company A, be to verify the values of each component to decide if they are accounted for correctly in the financial reports. When Company C examined the possibility to use component depreciation a few years ago, one of the main reasons for choosing not to use it, was that it was considered to be too complex and difficult to implement in the real estate industry. They also realized that it would be both time consuming and difficult to determine the useful life of each component, which might result in that the components could be valued incorrectly, thus not adding much value to the financial reports. Our standpoint is that even though component depreciation could be argued to contribute to a fair presentation of the assets if reported correctly, it will probably be hard for the real estate companies to decide and make reliable managerial judgment concerning their components. Reliability is another important qualitative characteristic which is of great importance while discussing the effects of component depreciation. According to K3, reliability is achieved if the information in the financial reports is neutral and free from material error. However, if the demand will lead to a lot of needed judgment decisions from managers, and the result will be in accordance with the conclusions made by Company C a few years ago, the fair presentation will not be of any value or importance, if the financial information itself is not reliable. Another problem that could be seen as a cost of applying component depreciation is the argument made by Company C concerning a need to educate the administration within real estate companies to understand the effects of component depreciation.

The matters of discussion for the opponents of component depreciation are mostly based on the balance between benefits and costs, which is an important qualitative characteristic of accounting. It is stated in K3 that the benefits that can be derived from the information in the annual reports should not exceed the cost of providing it. However, none of our real estate companies believe that the benefits of component depreciation will be even close to exceeding the costs of performing it, not even in the long run. According to the real estate companies, a demand for component depreciation will impose a vast administrative burden on them, and at the same time, they are very skeptical to who will benefit from it. However, the proponents of component depreciation argues that it will be of great value, both to the real estate companies themselves, as well as to analysts who will be interested in how the long term holdings within the real estate companies will change. Drefeldt at SASB believes that component depreciation will be of greatest value to the real estate companies as it will enable them to better overlook their assets in the balance sheet, as well as leading to more accurate results in the income statement. At the same time, the real estate companies argue that they do not need a better overview of their assets. Even though their real estate holdings are not specified in the balance sheets, they believe that their financial reports reflect a fair presentation of their assets and that the added information will not add enough value in comparison to the efforts in work load that it will demand. The overview of the assets is already achieved trough external systems which are not connected to the financial accounting, but still enables the real estate companies to create a detailed overview of their assets to identify what work needs to be done in the future. They believe that it is enough for the real estate companies to have this overview in their external systems, since their stakeholders have no use for the additional information in their financial reports anyway.

Based on our empirical findings, as well as our frame of reference, we believe that the arguments delivered from the proponents and opponents of component deprecation will ultimately be based on a discussion considering the importance of different qualitative characteristics of the accounting. The proponents main argument is that a demand for component depreciation will lead to a more true and fair view of the assets held by the entity and thus, a better accounting at large. However, the opponents' arguments are mostly based on the balance between benefits and costs of performing the accounting, as well as the reliability of the accounting after performing difficult judgment decisions concerning their chosen components. In the end, the conclusions of this thesis must be derived from the importance of different qualitative characteristics stated in the conceptual framework regarding how the accounting should be performed.

CHAPTER SIX – CONCLUSIONS

In this chapter we will present findings from the analysis chapter and provide answers to our research questions.

6.1 How are components expected to be decided within an entity?

Since K3 consists of principle based standards, it will demand a lot of managerial judgment while entities determine how to account for their tangible fixed assets. The aim of creating principle based standards has been to force managers to analyze the economic substance of each transaction within an entity, rather than to account for tangible fixed assets according to stated examples. Component depreciation is argued to be the only choice if entities wish to create financial statements that are theoretically and economically correct. However, our study has shown that there is a large gap between conducting component depreciation according to economic theory and performing it within in reality. Our conclusion is that there are a lot of different internal factors that could affect how companies account for components in practice.

We conclude that a demand for component depreciation would lead to a lot of difficulties while implementing the standards within the entities. Since the standard is vaguely formulated, there is no clear guidance on how to perform component depreciation within the real estate companies. According to K3, the companies are supposed to account for major components with significantly different patterns of consumption separately, and depreciate each such component over its useful life. Because of the vague guidelines in K3, we have acquired a lot of different perspectives concerning how many components a real estate company should account for, during our interviews. We believe that the decision will ultimately be based on the complexity of the real estate held by an entity. Due to this, we believe that immense difficulties will occur, both while deciding which components to use but also whilst deciding when to account for an expense as a cost and when to activate it in the balance sheet. Another difficulty will be deciding the useful life for each identified component. Because of this, we have concluded that there will, most likely, occur vast differences in how real estate companies account for their components. We believe that it will be almost impossible to construct uniform financial reports within the real estate companies, when managers are allowed as much room for the use of judgment as they are according to K3. However, a demand for component depreciation could potentially lead to financial reports that better reflect the economic reality, since managers' decisions hopefully lead to a better reflection of how the assets are being used within the company. On the other hand, it is necessary to make a consideration of the importance of comparability, in contrast to the importance of a financial reporting process that better reflects the underlying economics. Even though a demand for component depreciation will lead to a reflection of the true and fair view of the position of an entity, we believe that component depreciation will harm the comparability between different entities, which will ultimately create difficulties for the users of the financial information.

Another important aspect, which came to our attention during our conducted interviews, is that there might be a risk in allowing the managers to make judgment decisions about the chosen components themselves. Since component depreciation will impose a vast administrative burden on the real estate companies, many of our respondents believe that the principle based rules will lead to an opportunity for the companies to make it as easy as possible for themselves. They believe that companies might choose to only account for a few components, to reduce the administrative burden, thus creating an accounting mainly based on the burden it imposes on the entity, rather than the value it contributes to the users of the financial information.

6.2 What external factors are expected to affect how components are decided?

After conducting our empirical research and analysis, we conclude that a lot of factors are affecting real estate companies regarding how to decide what constitutes a component. Even if real estate companies will be affected by internal factors while making decisions concerning their components, we can also conclude that external factors are important for the real estate companies in their decision making process.

Since most of our respondents agree that an industry best practice will be the most influential factor, we can conclude that institutional theory will help explaining the accounting choices made by companies in their process of determining what constitutes a component. As the theory of mimetic isomorphism explains, it is natural for companies to seek guidance from external sources when directions from the words of act are vague. This is in accordance with the vague formulation of the rules regarding component depreciation in the K3 exposure draft. We believe that the insecurity within the real estate companies is natural, since K3 is a new regulatory framework, and it probably will take some time before the entities become accustomed with the new rules. Hence, some insecurity and confusion is expected, which makes it natural for the entities to seek guidance on the matter. However, we can also distinguish a risk in jeopardizing the reliability within the financial reports if companies seek guidance from each other rather than performing their own classifications of components.

Since it will take a while to develop an industry best practice, companies will probably seek guidance from other sources in the mean time. From our empirical findings and analysis we find it most likely for companies to act according to the normative pressures from the professionalization, as for example guidelines provided by trade organizations and auditors. Our empirical findings support that normative pressure will affect how companies account for components during the adaption to K3, but it will also be important while developing an industry best practice in the future. Regarding coercive isomorphism, we believe that it explains why real estate companies will use component depreciation, but since K3 consists of principle based standards, coercive isomorphism will not contribute to explaining how the companies will account for their components.

To summarize our conclusion in this question, we believe that all the three categories of isomorphism can be helpful regarding explaining the factors affecting real estate companies while determining how to account for components. However, our conclusion is that the three different categories of isomorphism will affect the real estate companies to different degrees as time goes by. From our study, we can identify a strong demand for an industry best practice, even if we believe that guidance from the professionalization will be of great importance, until such an industry best practice has been developed.

6.3 What are the expected advantages and disadvantages of component depreciation?

The proposed demand for component depreciation is argued to impose a vast administrative burden on real estate companies, which has lead to an overall negative attitude towards component depreciation amongst the interviewed real estate companies. At the same time, they are questioning why they should perform component depreciation since they do not see how stakeholders would benefit from the added information in the financial reports. This is argued against by some of our respondents, with the main argument that component depreciation is the economically and theoretically correct way to account for tangible fixed assets, and that it will contribute to a balance sheet and income statement that gives a more true and fair view of the assets held by the entity. We believe that there exist both benefits and costs with component depreciation in real estate companies. First of all, we agree with some of our respondents in that component depreciation gives a true and fair view of a company's assets, since it will show exactly how the assets are consumed within the entity. A problem today, is that many companies have different approaches on how to handle incremental expenses. While some chooses to activate a lot of expenses in the balance sheet, others choose to account for them as costs in the income statement instead, which has lead to large differences in the income statement between real estate companies today. Therefore, we conclude that if an industry best practice was developed for component depreciation in real estate companies, it could lead to a more even income statement, both while comparing financial reports from different years within entities as well as when comparing different entities with each other.

However, the arguments made by the opponents to component depreciation is that the benefits of component depreciation, as discussed above, will not be even close to exceeding the costs of performing it, not even in the long run. Although we agree that component depreciation is the correct way to account for tangible fixed assets according to economic theory, there can be great differences between accounting in theory and in practice. We believe that a demand for component depreciation would cause an unfavorable effect on real estate companies, due to the vast administrative burden it imposes. It will also demand a lot of difficult managerial judgment on how many components to account for, how to handle them in the plant register and how to decide each components useful life. It will also be hard for the real estate companies to draw a line for when to account for an expense as an asset and activate it in the balance sheet, and when to account for it as a cost in the incomes statement. We believe that all of the above will both be costly for real estate companies to implement, as well as time consuming to perform. At the same time, the question is who will benefit from component depreciation. The proponents of component depreciation argue that it will be of greatest value to the real estate companies themselves, as it allows them to reach a better overview of their asset holdings. However, real estate companies claim that they already have achieved this overview trough external systems. The only difference is that it is not reflected to the same detailed level in the financial reports. It is also information that the real estate companies claim to be unnecessary since none of their stakeholders are interested in book keeping values, but first and foremost base their analyses on the fair values of real estates.

In conclusion, we believe that this question needs to be answered with attention to the balance between cost and benefit according to the conceptual framework in K3. It is stated that the benefits that can be derived from the information in the annual reports should not exceed the cost of providing it. Even though component depreciation might reflect a more true and fair view of the assets held by the entity, as well as contributing to a more even income statement, we cannot conclude that the benefits of component depreciation exceed the cost of performing it. Especially since it is unsure if any stakeholder will benefit from the additional information in comparison to the workload which will be demanded by the real estate companies. On the other hand, we would like to take into consideration that even though component depreciation might not be worth its costs in the beginning of the implementation, it could still be worth it in the long run if an industry best practice is defined and also well-functioning routines for component depreciation within the entities.

6.4 Reflections of the authors

To provide an answer to our principal question, "How will a demand for component depreciation affect real estate companies?", we have taken into account all of our sub-questions above. We conclude that a demand for component depreciation will cause some positive effects on the financial reports within real estate companies, such as a more true and fair view and more correct financial reports that better reflects the usage of the assets held by the entity. However, these benefits need to be analyzed with the help of the balance between benefits and costs of performing the accounting. We believe that the real estate companies mainly will be affected negatively by a demand for component depreciation. It will impose a huge administrative burden for the real estate companies, and we believe that it will significantly change the accounting process regarding how they account for their real estates. More hours of work will be necessary to be able to handle a demand for component depreciation and in some cases; the companies are concerned that the existing staff on hand might not be enough to handle the increased administrative burden. At the same time, it is questionable who will benefit the most from component depreciation. Since our empirical findings show that component depreciation is not so important for external stakeholders and since the real estate companies argues that they already have a detailed overview of their asset holdings within the entity, it is hard to argue for component depreciation. Especially with attention to the balance between cost en benefit. Therefore, our final conclusion is that we cannot state that component depreciation is beneficial enough for any party within the real estate business, and that the real estate companies will be negatively affected by a demand for component depreciation. However, we find it important to clarify that this thesis does not provide an answer to the question of whether component depreciation is a reasonable demand in K3. To be able to provide an opinion in this matter, we would have needed to analyze component depreciation in each line of business affected by K3.

6.5 Suggestion of future studies

In this thesis, we have studied a draft to the future K3 regulatory framework. This draft has lead to a lot of debate regarding component depreciation, especially concerning real estate companies. At the moment, we do not know when the final draft will be published or if the Swedish Accounting Standards Board has taken into account the massive critique regarding component depreciation. It will therefore be interesting to study what happens when the final draft is published. If there will be a demand for component depreciation, it would be interesting to study other lines of business with a lot of tangible fixed assets and see how they will be affected by a demand for component depreciation. It could also be interesting to look at this topic in a longer term and examine what has happened since the demand of component depreciation was first initiated, for example, has an industry best practice been developed regarding what should be accounted for separately as a component?

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APPENDIX 1

Interview guide 1 – Real estate companies

HOW DO YOU ACCOUNT FOR YOUR TANGIBLE FIXED ASSETS TODAY?

- Have you discussed component depreciation within the entity earlier?
- Today, you can voluntarily choose to apply component depreciation. Has this ever been discussed within the entity?
- Why have you/have you not chosen to account for your real estate holdings as components?
- Do you believe that your chosen accounting method illustrates a true and fair view of your assets?

HOW WELL-INFORMED ARE YOU REGARDING THE ONGOING DEBATE CONCERNING COMPONENT DEPRECIATION ACCORDING TO K3?

- What are your opinions of the debate?

HOW WOULD A DEMAND FOR COMPONENT DEPRECIATION AFFECT YOUR WORKING PROCESS?

- What are the greatest benefits of component depreciation?
- What will be most difficult with component depreciation?
- Do you believe that component depreciation would contribute to a more true and fair view of your asset holdings?
- Do you find the demand for component depreciation to be reasonable?
- What are your opinions concerning the benefits of component depreciation in comparison to the cost it will demand to perform it?

WHAT INFLUENCED THE DECISION OF HOW YOU ACCOUNT FOR YOUR ASSET HOLDINGS TODAY?

- From where did you receive your decision basis?
- What was the most influential factors to your decisions?

IF THE DEMAND FOR COMPONENT DEPRECIATION WOULD BECOME REALITY:

- What would be needed within the entity, to be able to perform component depreciation?
- What is your opinion regarding the vague definition of a component in K3?
- How do you believe that you will decide what constitutes a component?
- How do you keep updated of changes in accounting principles in general?

Interview guide 2 – Other respondents

HOW WOULD A DEMAND FOR COMPONENT DEPRECIATION AFFECT YOUR WORKING PROCESS?

- What are the advantages of component depreciation?
- Who would benefit the most from component depreciation?
- What are the disadvantages of component depreciation?
- Who would be the most disadvantaged from component depreciation?
- What are the greatest difficulties with component depreciation?
- Do you believe that a demand for component depreciation contributes to a more true and fair view of the assets held by an entity?
- Do you believe that a demand for component depreciation is reasonable?
- What are your opinions concerning the benefits of component depreciation in comparison to the cost it will demand to perform it?
- Do you believe that the negative debate concerning real estate companies overshadows the positive effects in other lines of business?

IF THE DEMAND FOR COMPONENT DEPRECIATION WOULD BECOME REALITY:

- What would be needed within entities, to be able to perform component depreciation?
- What is your opinion regarding the vague definition of a component in K3?
- How do you believe that real estate companies will decide what constitutes a component?
- How do you believe that companies should act while deciding what constitutes a component?

IS THERE A CLEAR ACCOUNTING PRACTICE AMONGST REAL ESTATE COMPANIES TODAY?

- Do you believe that an industry best practice will be developed?
- Who will be responsible for developing this best practice?