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Epistemological objectivity in financial reporting

Does internet accounting require a new accounting model?

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Abstract

Purpose – The purpose of the paper is to illustrate the complexity surrounding the meaning of the terms "economic reality" and "neutral representation" as these terms are applied to the resolution of financial accounting issues.

Design/methodology/approach – The paper examines the concept of epistemological objectivity in financial reporting through an analysis of issues raised by the US Securities Exchange Commission (SEC) with respect to accounting for internet activities and the concomitant manner in which the US Financial Accounting Standards Board (FASB) approached these issues.

Findings – An analysis of communications between the SEC and the FASB pertaining to accounting for internet activities reveals that, while these bodies seek to resolve issues in a manner that is neutral and objective, they often employ subjective reasoning in pursuing their regulatory purpose, thus raising questions about the extent of their concern with neutral representations of economic reality.

Originality/value – The paper adds to the criticisms of efforts which claim to be neutral representations of economic reality.

Keywords Economic performance, Financial reporting, Internet, Online operations, Accounting procedures, Epistemology

Paper type Research paper

Introduction

Many companies whose business models are based on increased use of the internet have argued that there is a need for a new accounting model in the internet environment. A spokesperson for Amazon.Com has been quoted as saying: "This is a New Economy and an Old Economy problem, and it's good that the SEC is addressing it" (Associated Press, 2000). This statement was made in conjunction with a public announcement that the SEC was planning to investigate the accounting practices of Amazon.Com; in particular, the way that Amazon.Com accounted for shares received from other companies in exchange for services rendered such as placing advertisements on the Amazon.Com web site. Several interesting questions are raised by the argument that there is a need for a new accounting model in the internet environment. First, we might ask whether there is such a thing as a "new" economy. To many people in the world, the internet is non-existent; they live pretty much as they have always lived, under the yoke of an oppressive system which requires all the strength they can muster merely to survive. At the same time, the assertion that there is something new about the internet environment that requires a new accounting model has raised some "old" accounting issues, along with the question whether the

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traditional accounting model is adequate to account for business activities in the internet environment. The growing number of companies with internet activities has prompted a discussion about accounting for such activities.

Even before the sharp decline in internet company share prices in the early 2000s, the Chief Accountant of the SEC sent a letter to the Director of Research and Technical Activities of the FASB, requesting that the FASB's Emerging Issues Task Force (EITF) consider a number of issues about accounting for internet activities (Turner, 1999; FASB, 2000a). The EITF responded by placing these issues on its technical agenda. Subsequently it reached consensus views on most of the issues. This paper analyzes the concerns raised by the SEC about accounting for internet activities and discusses how the EITF approached these issues. The overall purpose is to illustrate the complexity surrounding the meaning of the terms "economic reality" and "neutral representation" as these terms are applied to the resolution of accounting issues. To frame our analysis, we employ aspects of Mouck's (2004) description of Searle's (1995) arguments concerning institutional reality, which Mouck used to explore the debate between "neutral representation" and "social construction" in financial reporting. As the legally designated arbiters of Generally Accepted Accounting Principles (GAAP) in the USA, the SEC and the FASB have adopted a neutral representation perspective towards financial reporting. However, an analysis of communications between the SEC and the FASB regarding accounting for internet activities reveals that while these bodies often seek to resolve issues in a manner that is neutral and objective, they use subjective reasoning in pursuing their regulatory purpose, thus raising questions about the extent of their concern with neutral representations of economic reality.

The remainder of this paper is organized as follows. The next section discusses the debate that has occurred in financial accounting theory between "neutral representation" and "social construction" of economic reality and reviews Mouck's argument that there may be a middle way between these different perspectives based on Searle's explanations of institutional reality. That section is followed by an analysis of the SEC's concerns about accounting for internet activities as expressed in its communications with the FASB. Mouck's views about financial reporting are integrated with the discussion of the issues raised by the SEC. A final section discusses the implications for financial reporting and concludes the paper.

Neutral representation versus social construction in financial reporting

In a recent essay, Mouck (2004) summarized the principal points raised in John Searle's 1995 book, *The Construction of Social Reality* (Searle, 1995), and he explored various aspects of the relationship between economic reality and financial accounting numbers. Mouck cited Solomons' (1991) "neutral representation" perspective of financial reporting, which maintained that the purpose of financial accounting is to measure relevant attributes of economic reality in a neutral and objective manner. He contrasted this view with that of Tinker (1991), who stressed the political side of social constructions of economic reality. Mouck also cited the linguistic perspective of Macintosh *et al.* (2000), which relied to a great extent on the arguments of Morgan (1988) and Hines (1988), who stated that "in communicating reality, we construct reality". Mouck indicates that there may be a middle way between these different perspectives based on Searle's analysis of institutional reality.

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In *The Construction of Social Reality*, Searle (1995) makes a distinction between three philosophical perspectives: epistemic objectivity versus epistemic subjectivity; ontological objectivity versus ontological subjectivity; and intrinsic features of the world versus observer-relative features. The latter two distinctions appear to be variations on a similar theme. Essentially, for a statement to be ontologically objective it must represent an intrinsic feature of the world and not just an observer-relative feature. Thus, corporations, money, and accounting numbers, are not ontologically objective because they do not represent intrinsic features of the world (Mouck, 2004, p. 529). Nevertheless, as Searle points out, and Mouck emphasizes, "Ontological subjectivity does not prevent claims about observer-relative features from being epistemologically objective" (Searle, 1995, p. 13; Mouck, 2004, p. 530). Searle's analysis of the philosophical distinctions is illustrated in Table I.

Thus, scientific endeavors attempt to make neutral representations about things and objects that are said to exist in the real world (upper left quadrant of Table I). Solomons' (1991) neutral representation view of financial reporting was congruent with this view, and the SEC and the FASB also purport to purse this neutral representation perspective. However, in their actual pursuit of the goal of achieving neutral representations of economic reality, the standard setters primarily rely on a consensus building procedure which does not accomplish the goal of achieving neutral representations of economic reality. Instead there is merely a consensus about the rules of the game, which permits the production of accounting numbers (i.e. "scores") which can be said to be "epistemologically objective facts".

Mouck (2004, p. 526) indicates that while accounting academics may not always agree with accounting standards setters that there are real economic referents underlying accounting representations, capital markets researchers base their research on an apparent correspondence between certain accounting numbers and share prices. Thus, capital markets researchers claim that neutral representations (in the form of accounting numbers) can validly be made about certain things existing in the real world (share prices). Despite the obvious scientism underlying in this line of accounting research, accounting standards setters usually do take into consideration whether a particular form of financial statement display or accounting recognition has a relationship with share prices. Instead, accounting standards setters rely on "due

	Ontologically objective	Ontologically subjective
Epistemologically objective	It is possible to make neutral representations about things existing in the real world (science)	It is possible to make neutral representations about socially constructed ideas (social science)
Epistemologically subjective	Only non-neutral (biased) representations can be made about things existing in the real world (radical social construction)	Only non-neutral (biased) representations can be made about socially constructed ideas (critical theory and postmodernism)

Table I. Searle's analysis of the philosophical distinctions

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process", which is a consensus building procedure that is intended to forge an agreement about the correctness of an accounting rule. This consensus building procedure places standard setters in the position of attempting to make neutral representations about socially constructed concepts (upper right quadrant of Table I) rather than making neutral representations about economic reality (upper left quadrant of Table I). Their criteria for determining whether a rule is "correct" include whether the rule is congruent with other rules, or with an overriding conceptual framework, and whether other standards setters agree that the rule is correct. Consequently, the standard setters rely on what Mouck and Searle refer to as the "status function" of institutional "fact" (Mouck, 2004, p. 531). This means that accounting rules are endowed with a "deontic status" which imposes rights, responsibilities, obligations, duties and privileges on various parties (Searle, 1995, p. 100; Mouck, 2004, p. 531). This deontic status is not politically benign. Instead, it is at the heart of many contemporary political disagreements (Mouck, 2004, p. 532).

Mouck goes on to argue that while the monetary amounts assigned to accounting numbers have no objective basis in either brute physical reality or institutional reality, a consensus about the rules of the game (i.e. GAAP) can lead to epistemologically objective facts (i.e. "scores" or accounting numbers). Mouck's views on this point are illustrated in the following quotation:

> Likewise, given the collective acceptance of the FASB's rules (in the United States) it is an epistemologically objective fact that, within the context of those rules, Amazon.com incurred a Net Loss for the fiscal year ended December 31, 1998. The outcome is epistemologically objective, give the "rules of the game", even though there is no objective basis for the rules themselves; even though there is no objective criteria for evaluating whether the rules (of the FASB or of American football) are good or bad, right or wrong, more useful or less useful (Mouck, 2004, p. 537).

What Mouck indicates is that accounting numbers (i.e. the "scores") can be epistemologically objective if there is consensus about the rules, and that the deontic status function of the rule making process assures that there will be a consensus about the rules of the financial reporting game. A troubling possibility remains, however, that while there may be a consensus about the rules of the game, the rules may contradict an underlying ontologically objective economic referent. Thus, there might be a consensus about the rules of revenue recognition in the internet environment, but the real driver of internet company share prices might not be reported revenues, but an irrational exuberance on the part of capital market participants. Thus, the SEC and the FASB can be seen to be deploying their "political" power to regulate what they believe to be misrepresentations of economic reality in the internet environment.

Concerns of standard setters with respect to accounting for internet activities

In the SEC's communications with the EITF, there were 20 issues divided into five categories (Turner, 1999). Each issue was assigned a priority level of 1, 2 or 3, indicating the degree of urgency that the SEC assigned to the issue. Five of the issues were assigned a priority level of 1; six were assigned a priority level 2, and five were assigned a priority level 3. The four remaining issues were addressed by the SEC through staff announcements. After receiving the communication from the SEC, the EITF placed its own numbers on the issues. Ten of the issues were resolved through

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consensus agreements. The remaining issues either were not resolved or became inactive, except for one, which was referred to the AICPA Accounting Standards Executive Committee (AcSEC). As will be seen in the following analysis, the EITF relied on consensus building and reliance on previously issued rules in reaching its conclusions.

Summary of the issues

The list of issues raised by the SEC was divided into five categories: Gross vs net; Definition of software; Revenue recognition; Prepaid/intangible assets vs period costs; and Miscellaneous issues. Table II summarizes the issues.

Gross vs net revenue display

Six issues were included in the category of Gross vs net revenue display. These issues focused on the question whether revenues should be presented on a gross basis, with rebates, coupons, discounts, incentives, shipping costs and other adjustments being included as part of revenues or reflected as operating expenses. The significance of this issue relates to the measurement of revenues for an internet firm. For example, companies like Priceline.com or eBay.com, may report revenues based on the full price of the products they sell (e.g. airline tickets; collectibles), or they might report as revenues only the commissions they earn from sales. The resolution of these issues relates directly to the meaning of economic reality for an internet firm, and also illustrates how accounting standards setters seek to reach a consensus regarding the "correct" way to account for this "reality".

Issue 1 – should a company that acts as a distributor or reseller of products or services record revenues gross or net? The SEC Staff assigned this issue a priority level 1. The EITF placed this issue on its technical agenda as Issue No. 99-19 "Reporting Revenue Gross as a Principal versus Net as an Agent." The FASB Staff summarized the issue in the following manner:

> The issue is whether a company should recognize revenue in the amount of the gross amount billed to the customer because it has earned revenue from the sale of the goods or services or whether the company should recognize revenue based on the net amount retained (the amount paid by the customer, as defined above, less the amount paid to the vendor-manufacturer) because, in substance, it has earned a commission from the vendor-manufacturer of the goods or services on the sale. How companies recognize revenue for the goods and services they offer has become an increasingly important issue because investors appear to value the stock of certain companies based on a multiple of gross revenues rather than a multiple of gross profit or earnings (FASB, 1999c).

The EITF discussed Issue No. 99-19 at its meetings in March and May 2000 and reached a consensus at its July 2000 meeting that revenue should be displayed net, not gross. In resolving this issue, the EITF relied on a previously issued accounting rule, namely SEC Staff Accounting Bulletin 101, in which the SEC stated that if a company acts as an agent or broker without assuming the risks and rewards of ownership of the product, revenues should be displayed net, not gross (FASB, 1999c; Moody, 2000).

The EITF's resolution of this issue demonstrates the approach taken by accounting standards setters which seeks to reach a consensus about the resolution of an issue through a reliance on a previously issued accounting rule. There was no consideration given to the capital markets research paradigm which would have examined the

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Category	Issue	Priority level	Pronouncement status
Gross vs net	1. Should a company that acts as distributor or reseller of products or services through the internet record revenues gross or net?	1	EITF No. 99-19, consensus reached
	2. Should a company that swaps web site advertising with another company, record advertising revenue?	1	EITF No. 99-17, consensus reached
	3. Should discounts or rebates offered to purchasers of PCs combined with an internet service contract be treated as a reduction of revenues or as marketing expense?	Not indicated	Combined with Issue 5, 6 and 20 under EITF No. 00-14, consensus reached
	4. Should shipping fees collected from customers be included in revenues or netted against shipping expense?	2	EITF No. 00-10, consensus reached
	5. Should the difference between the full list price and the actual sales price on free or heavily discounted promotional items be reflected as revenue, or should revenue be recorded at the actual sales price with the difference going to advertising expense?	Not indicated	Combined with Issue 3, 6 and 20 under EITF No. 00-14, consensus reached
	6. Should costs associated with service outages be treated as reductions of revenue or as marketing expenses?	3	Combined with Issue 3, 5 and 20 under EITF No. 00-14, consensus reached
Definition of software	7. Should accounting for products distributed via the internet, such as music or videos, follow pronouncements on software development or those for the music industry?	2	EITF No. 00-x1, inactive
	8. Should the costs of web site development be expensed in a manner similar to software developed for internal use (i.e. AICPA SOP 98-1)?	1	EITF No. 00-2, consensus reached
Revenue recognition	9. How should an internet auction site account for up-front and back-end fees?	3	SAB 101.EITF No. 00-x2, inactive status
	10. How should arrangements that include the right to use software stored on another company's hardware be accounted for?	2	EITF No. 00-3, consensus reached
	11. How should revenues associated with providing access to, or maintenance of, a web site, or publishing information on a web site, be accounted for?	Not indicated	SAB 101.EITF Issue No. 00-x3, inactive
	12. How should advertising revenue that is contingent on "hits", "viewings" or "click-throughs" be accounted for?	3	EITF Issue No. 00-x4, inactive
	13. How should "point" and other loyalty programs be accounted for?	2	EITF Issue No. 00-22, no consensus

(*continued*)

Table II.
Issued raised by the SEC

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Category	Issue	Priority level	Pronouncement status
Prepaid/intangible assets vs period costs	14. How should a company assess the impairment of capitalized internet distribution costs?	1	Discussed under EITF No. 99-14, no consensus
	15. How should up-front payments made in exchange for certain advertising services that are provided over a period of time be accounted for?	Not indicated	Discussed under EITF No. 99-14, no consensus
	16. How should investments in building up a customer or membership base be accounted for?	3	EITF decided not to address this issue
Miscellaneous issues	17. Should accounting by holders for financial instruments with terms that are variable based future events, such as IPO, fall under the provisions of SFAS 133?	2	EITF No. 00-8, consensus reached
	18. Should internet operations be treated as a separate operating segment in accordance with SFAS 131?	Not indicated	Refer to SFAS 131 for guidance.
	19. Should there be more comparability between internet companies in the way they classify expenses by category?	3	EITF decided not to address this issue
	20. How should companies account for online coupons?	2	Combined with Issue 3, 5 and 6 under EITF No. 00-14, consensus reached

Table II.

statistical correlation between share prices and the display of revenues on a gross basis or net basis. The EITF seemingly concluded that there would be no share price reaction arising from a particular form of revenue display, therefore, their primary concern was to reach a consensus on a clearly defined rule. This approach to resolving an accounting issue is consistent with Mouck's (2004) interpretation of Searle's idea of a deontic status function that imposes obligations and duties, rights and privileges. Moreover, it reveals that the rules of financial accounting do not exist in a "compartmentalized realm that is separate and distinct from practices involving regulatory rules" (Mouck, 2004, p. 536). The practices involving regulatory rules of financial accounting are more clearly demonstrated in the resolution of the following issue.

The second issue relating to Gross versus net revenue display dealt with barter transactions. This issue arises from the practice of many internet companies in which they exchange advertising on each other's web sites.

Issue 2 – should a company that swaps web site advertising with another company, record advertising revenue and expense? The SEC assigned this issue a priority level 1. When advertising revenue and advertising expense are recognized in a barter transaction, the amounts are presumably equal, consequently, there is no impact on net profits. Nevertheless, the reported amount of revenue would increase. Some observers

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believe that is this increase in revenues would cause an increase in the market value of the internet company shares (Krantz, 1999). The EITF placed this issue on its technical agenda under EITF Issue No. 99-17, "Accounting for Advertising Barter Transactions." The FASB Staff summarized Issue No. 99-17 in the follow way:

> It has become increasingly popular for internet companies to enter into transactions in which they exchange rights to place advertisements on each others' web sites. Some entities record an equal amount of revenue and expense for the space they sell and for the space they purchase resulting in no effect on net income or cash flows. To the extent that revenues include barter transactions for which there is no ultimate realization in cash and no effect on net income, the practice may lead to overstated revenues and artificially inflated market capitalization. The issue is whether internet barter transactions that involve a nonmonetary exchange of rights to place advertisements on web sites result in recorded revenues and expenses (FASB, 1999b).

At its January 2000 meeting, the EITF reached a consensus that revenue and expense would be permitted to be recognized in a barter transaction if the fair value of the advertising exchanged was determinable based on a company's historical practice of cash sales of a similar type of advertising with buyers unrelated to the company (FASB, 1999b). The historical practice of cash sales must have occurred no more than six months prior to the barter transaction. Because previous cash sales were used as a criterion for measuring the fair value of the barter transaction, barter revenues and expenses could be recognized only to the extent of a previous cash sale. The decision reached by the EITF on this issue is particularly evident as being subjectively bases. A contrary argument could have been made to the effect that exchanges of advertising which never result in cash realization cannot represent an underlying economic reality. Moreover, the rule's specification of a criterion based on cash sales of similar advertising made within six months is completely arbitrary. Why six months? This rule is clearly based on achieving a consensus among the rule makers, and not to achieve a better representation of economic reality.

A third issue relating to the issue of revenue display dealt with the treatment of discounts and rebates. Discounts and rebates may be deducted from gross revenues to arrive at a net revenue figure. However, this treatment is not always followed by internet companies where discounts and rebates are sometimes reflected as operating expenses rather than as reductions of revenue.

Issue 3 – should discounts or rebates, offered to purchasers of personal computers in combination with internet service contracts, be treated as a reduction of revenues or as marketing expense? The SEC did not assign a priority level to this issue, but indicated that discounts of this type should be reflected as reductions of revenue. Since Issues 5, 6 and 20 (discussed below), have aspects in common with Issue 3, the EITF placed all four of these issues under EITF Issue No. 00-14, "Accounting for Coupons, Rebates, and Discounts." The FASB Staff summarized Issue No. 00-14 in the follow manner:

> This Issue is scoped broadly and involves the accounting for sales subject to rebates and revenue sharing arrangements as well as coupons and discounts. This Issue addresses the income statement classification of rebates and other discounts (including the income statement classification of the cost of refunds and commitments to provide future service made in connection with service outages) as well as the accounting for those rebates and discounts (including the accounting for free or heavily discounted products). Required disclosures with respect to these transactions are also considered by the EITF (FASB, 2000e).

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At its May 2000 meeting, the EITF reached an agreement that discounts and rebates should be treated as reductions of revenue and not as marketing or promotional expenses. At the same time, the EITF decided that, contrary to accounting for discounts and rebates, accounting for coupons should follow the accounting practices of other industries. In other words, recorded as a marketing expense and a related liability in an amount equal to the estimated value of the coupons that will be redeemed. Thus, the form of the discount/rebate/coupon was considered to be determinative of its accounting treatment. This approach was seemingly prompted by the desire of the accounting standards setters to reach a consensus on a rule that was consistent with previous issued rules regarding coupons, even though the economic substance underlying these three types of incentives is similar if not identical.

A fourth issue relating to Gross versus net revenue display dealt with the treatment of shipping and handling fees. Internet companies often deliver the products they sell using delivery services like United Parcel Service or Federal Express. Delivery charges may be treated as credits against selling and administrative expenses, but some internet companies reflect delivery charges as revenues.

Issue 4 – should shipping and handling fees collected from customers be included in revenues or netted against shipping expense? The SEC assigned this issue a priority level of 2. The EITF added this issue to its technical agenda as Issue No. 00-10, "Accounting for Shipping and Handling Revenues and Costs." The FASB Staff summarized this issue as follows:

> Shipping and handling costs are a major expense for online product sellers. Many sellers charge customers for shipping and handling in amounts that are not a direct pass-through of costs. Some display the charges to customers as revenues and the costs as selling expenses, while others net the costs and revenues. The SEC staff notes that companies generally do not provide any separate disclosure of shipping revenues and costs (for example, by reporting shipping revenue and costs as separate line items, or by providing footnote disclosure of the gross shipping revenues and costs). Additionally, companies appear to classify shipping and handling expenses inconsistently within expenses. Some companies include shipping and handling expenses in cost of goods sold, while others include shipping and handling expenses in selling expenses. The issue is how shipping and handling costs should be reported (FASB, 2000d).

The EITF reached a consensus on this issue at their July 2000 meeting; however, because of continuing controversy about the issue, it was reopened in September 2000. Ultimately, the EITF decided that amounts billed to customers for shipping and handling costs would be allowed to be treated as revenue if properly disclosed as such (FASB, 2000d). Thus, the accounting standards setters decided not to decide. They permitted internet firms to continue the practice of including shipping and handling costs as revenues as long as the practice was disclosed. For some internet companies, this issue is substantial. For example, in a typical sale for an internet bookseller (e.g. Amazon.com), the shipping and handling fees can equal the price of the book or other item. This is a particularly obvious example of the difficulty of determining "economic reality" and achieving "neutral representation" in financial reporting. If a company is in the business of selling books through the internet, what are its revenues – the fees it charges for its books, or the fees it charges for the delivery of its books? What is the economic reality of the business? In effect, the standards setters' resolution of this issue involved a decision to let the capital market decide. In other words, if the information

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was properly disclosed in the financial statements, the users of the statements could decide for themselves what the nature of the economic reality was underlying the accounting treatment. The standards setters essentially avoided the issue through an epistemologically subjective indecision.

As mentioned previously, Issue 3 (discussed above), and Issues 5, 6 and 20 were combined under EITF Issue No. 00-14, "Accounting for Coupons, Rebates, and Discounts" (FASB, 2000e).

Issue 5 – should the difference between the full list price and the actual sales price on free or heavily discounted promotional items be reflected in revenue, or should revenue be recorded at the actual sales price with the difference going to advertising expense? See the FASB Staff summary of Issue No. 00-14 under Issue 3, above.

Issue 6 – should the costs associated with service outages be treated as reductions of revenues or as marketing expenses? See the summary of Issue No. 00-14 under Issue 3, above.

In all of the gross versus net display issues, the primary concern of the standards setters was to reach a consensus on a clearly defined rule. In pursuing their consensus, the EITF based its decisions on previously issued rules. As an example, with respect to displaying commission revenue on a gross or net basis, the standards setters relied on a SEC Staff Accounting Bulletin, and with respect to barter advertising, they relied on several FASB Statements pertaining to revenue recognition for non-monetary transactions. There was no discussion of the capital markets paradigm, which might have examined relationships between share prices and the inclusion or lack of inclusion of a particular item in revenues. Instead, the standards setters concluded that there would be no capital market reaction due to a particular form of revenue display. Thus, they concentrated their efforts on reaching a consensus about revenue display. In particular, the six month rule for barter advertising transactions appears to have had no other rationale other than to establish a rule upon which a consensus could be reached.

Definition of software

In the second category of issues, the focus of the standards setters was on accounting for the costs of products delivered through the internet and the costs of web site development. The general question was whether the costs of internet activities ought to be viewed as similar to software costs, and therefore governed by previous rules dealing with software, or whether there should be some other accounting rule applied. While the standards setters continued to focus on reaching a consensus, the issues in this category were of lesser significance than the issue of revenue display, therefore they will be discussed briefly.

Issue 7 – should accounting for products distributed via the internet, such as music or videos, follow pronouncements dealing with software development or those of the music industry? The SEC assigned this issue a priority level 2. Initially the EITF combined this issue with Issue 8, below. Subsequently the EITF decided to deal with the issues separately, and they assigned Issue 7 a temporary number under Issue No. 00-x1, "Accounting for the Costs of Computer Files that Are Essentially Films, Music, or Other Content." Eventually Issue No. 00-x1 was made inactive by the EITF. Therefore, the SEC decided on its own that the costs of software which includes music and video elements should be accounted for under the provisions of the accounting rules dealing

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with software and not those of the music or film industry, thus demonstrating once again the reliance on previously issue rules. At the same time this indicates that accounting standards setters are not always about to reach a consensus; the SEC adopt a view that the FASB is not willing to support. This can then erupt into a political dispute. However, because the SEC has more power (more deontic status) it is often able to impose its rules even when the FASB is reluctant to do so.

Issue 8 – should the costs of web site development be expensed in a manner similar to software developed for internal use in accordance with AICPA Statement of Position 98-1? The SEC Staff assigned this issue a priority level 1. The EITF added this issue to its technical agenda as Issue No. 00-2, "Accounting for Web Site Development Costs." The FASB Staff summarized this issue as follows:

> Costs of developing a web site, including the costs of developing services that are offered to visitors (chat rooms, search engines, e-mail, calendars, and so forth), are significant costs for many businesses. The SEC staff believes that a large portion of those costs should be accounted for in accordance with AICPA Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, as software developed for internal use. The SEC staff notes that SOP 98-1, paragraph 15, states that "If software is used by the vendor in... providing the service but the customer does not acquire the software or the future right to use it, the software is covered by this SOP" (FASB, 2000b).

At its March 2000 meeting, the EITF reached a consensus that accounting for web site development costs should follow the provisions of AICPA SOP 98-1, which specifies that the accounting for web site development costs is dependent on the development stage of the activity. During the planning stage, web site development costs should be expensed. During the infrastructure development stage, the costs should be capitalized. During the operating stage, the costs should again be expensed and amortization of any previously capitalized costs should begin (FASB, 2000b). This resolution demonstrates the reliance on previously established rules, in particular the rules related to accounting for fixed assets. The rationale underlying these rules is suspect, thus re-enforcing the conclusion that they are epistemologically subjective.

Revenue recognition

The third category of issues also dealt with revenue matters. As stated previously, theses issues were of concern to the SEC due to the belief that reported revenue was significant to the capital markets as a means of valuing internet companies shares (MacDonald, 1999). However, unlike the revenue display issues, the revenue recognition issues were not considered to be at the same level of priority by the SEC, consequently they will be discussed somewhat briefly.

Issue 9 – how should an internet auction site account for up-front and back-end fees? Internet auction companies often charge up-front or back-end fees to sellers, buyers or other participants in an internet auction (e.g. eBay). The SEC recommended that the FASB issue an interpretation that up-front fees should be recognized over the period of performance, which is normally the period over which the auction takes place. With respect to back-end fees, the SEC assigned a priority level 3, and indicated that the facts and circumstances of the internet auction may vary, making it difficult to provide guidance on the accounting treatment. The EITF concluded that the provisions of SAB 101 required that both up-front and back-end fees be recognized over the period of performance of the auction. While the EITF retained this issue on its agenda as Issue

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No. 00-x2, "Accounting for Front-End and Back-End Fees," the issue became inactive because it was resolved through reference to SAB 101.

Issue 10 – how should arrangements that include the right to use software stored on another company's hardware be accounted for? The SEC Staff assigned this issue a priority level 2. The EITF added this issue to its technical agenda as Issue No. 00-3, "Application of AICPA Statement of Position 97-2, Software Revenue Recognition, to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware." The FASB Staff summarized Issue No. 00-3 in the following manner:

> Some purchasers of software do not actually receive the software. Rather, the software application resides on the vendor's or a third party's server, and the customer accesses the software on an as-needed basis over the internet. Thus, the customer is paying for two elements-the right to use the software and the storage of the software on someone else's hardware. The latter service is often referred to as "hosting." When the vendor also provides the hosting, several revenue recognition issues may arise. First, there may be transactions structured in the form of a service agreement providing internet access to the specified site, without a corresponding software license. In such instances, it may not be clear how to apply SOP 97-2. Second, when the transaction is viewed as a software license with a service element, it isn't clear how to evaluate the delivery requirement of SOP 97-2 (FASB, 2000c).

At its March 2000 meeting, the EITF reached a consensus that SOP 97-2 applies to software hosting arrangements only if the customer has a contractual right to take possession of the software at any time during the hosting period without a significant penalty, and also if it would be feasible for the customer to either run the software on its own hardware or to contract with another party unrelated to the vendor to host the software. If the customer does not have an option to take possession of the software, then the hosting arrangement is a service contract. If the hosting arrangement is not a service contract, then delivery of the software occurs when the customer has the ability to take immediate possession of the software. If there are multiple elements to the product, revenue should be recognized on an element-by-element basis as individual elements are delivered. The amount of revenue recognized for each element should be in proportion to the relative fair values of the elements (FASB, 2000c). The resolution of this issue was based on a technical interpretation of previously issued rules. It is unclear why a distinction should be made between hosting arrangements where the customer can take delivery of the software versus where the customer cannot do so. There is little economic difference between these instances.

Issue 11 – how should revenues associated with providing access to, or maintenance of, a web site, or publishing information on a web site, be accounted for? The SEC did not indicate a priority level for this issue but recommended that the FASB Staff issue an interpretation that fees such as these should be recognized over the performance period (i.e. the period over which the internet company agrees to maintain the web site or the information on the web site). The FASB concluded that SAB 101 required that revenue recognition for fees like these should be recognized over the period of performance. The EITF retained the issue on its agenda as Issue No. 00-x3, "Accounting for Access, Maintenance, and Publication Fees, however, it was resolved by reference to a previously issued rule.

Issue 12 – how should advertising revenue that is contingent on "hits, "viewings" or "click-throughs" be accounted for? The SEC Staff assigned this issue a priority level 3. The FASB Staff summarized this issue in the following manner:

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> Many internet companies enter into various types of advertising arrangements (sometimes with other internet companies) to provide advertising services over a period of time. These arrangements often include guarantees on "hits," "viewings," or "click-throughs." It isn't clear how the provider of the advertising takes progress towards these minimums into account in assessing revenue recognition. This issue could show up in various other industries as well (sales reps who guarantee they will reach a certain level of sales, advertising in other kinds of media, and so forth). The SEC staff observed that the terms of these arrangements vary somewhat from contract to contract. To the extent that payment for these arrangements is made with equity securities, any consensus reached should be reconciled with the consensus in EITF Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services" and any consensus reached in EITF Issue No. 99-Q, "Accounting by the Holder of an Instrument (That Does Not Meet the Definition of a Derivative Instrument) with Conversion or Exercisability Terms That Are Variable Based upon Future Events".

This issue was placed on the EITF's technical agenda under Issue No. Issue No. 00-x4, "Accounting for Advertising or Other Arrangements Where the Service Provider Guarantees a Specified Amount of Activity." The issue was not resolved and it remains in an inactive status.

Issue 13 – how should "point" and other loyalty programs be accounted for? The SEC Staff assigned this issue priority level 2. The EITF added this issue to its technical agenda under Issue No. 00-22, "Accounting for 'Points' and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future." The FASB Staff summarized these issues as follows:

> There is a growing number of "point" and other loyalty programs being developed in internet businesses, in addition to similar programs in the airline and hotel industries. There are companies whose business models involve building a membership list through this kind of program. In some cases, the program operator may sell points to its business partners, who then issue those points to their customers based on purchases or other actions. In other cases, the program operator awards the points in order to encourage its members to take actions that will generate payments from business partners to the program operator. The Issue is how point and other loyalty programs should be accounted for. The Issue is scoped broadly to include all industries that utilize point or other loyalty programs, including the airline and hospitality industries (FASB, 2000f).

The EITF did not reach a consensus on this issue. Discussion regarding the issue was intended to encompass all industries that use point or other loyalty programs, including airline and hotel industries. However, there is not much guidance provided in previous rules about this issue. For example, the AICPA Industry Audit Guide, *Audits of Airlines*, does not address accounting for frequent flyer programs.

Prepaid/intangible assets vs period costs

The fourth category of issues raised by the SEC dealt with payments that an internet company makes to build up a customer base, or to obtain advertising space, distribution rights, or supply agreements. Whether these costs should be capitalized or expensed is not clear, and the issue of how to assess the impairment of a capitalized asset is not straightforward. In some cases, companies assert that distribution rights are immediately impaired because the best estimate of the expected future cash flows would indicate that the asset (i.e. capitalized cost) is not recoverable. Expensing such costs would be a conservative treatment, but the SEC was concerned that aggressive

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expensing of such costs would lead to future earnings management. While the issues in this category were viewed as being of high priority to the SEC, the EITF did not place them in a high priority status, thus demonstrating again that the standards setters do not always reach a consensus.

Issue 14 – how should a company assess the impairment of capitalized internet distribution costs? The SEC Staff assigned this issue a priority level of 1. Because this issue had similarities with situations in which there is an economic loss on a firmly committed contract, the EITF addressed this issue, and Issue 15, below, under EITF Issue No. 99-14 "Recognition of Losses on Firmly Committed Executory Contracts." The FASB Staff summarized the issue as follows:

> FASB Technical Bulletin No. 79-15, Accounting for Loss on a Sublease Not Involving the Disposal of a Segment, states that "the general principle of recognizing losses on transactions and the applicability of that general principle to contracts that are expected to result in a loss are well established" (paragraph 2). Nevertheless, in numerous situations explicit loss recognition guidance is not provided; for example, whether to recognize a loss on an operating lease when a lessee expects to continue utilizing the leased asset, and internet arrangements (such as a fixed up-front cash payment to become a sole search provider). The issue is whether and, if so, under what conditions a loss should be recognized on firmly committed executory contracts (FASB, 1999a).

The EITF did not reach a consensus on this issue.

Issue 15 – how should up-front payments made in exchange for certain advertising services provided over a period of time be accounted for? The SEC indicated that this issue could be considered in combination with Issue 14, above. Issues 14 and 15 were addressed by the EITF under Issue No. 99-14, but no consensus was reached. The SEC Staff indicated that there should not be an automatic presumption of impairment leading to an immediate write-off of an up-front payment, and that impairment should not be recorded unless it can be shown that conditions changed after making the up-front payment.

Issue 16 – how should investments in building up a customer or membership base be accounted for? The SEC Staff assigned this issue a priority level 3, with the comment that most companies appear to be expensing these costs as incurred. Therefore, there was little diversity in practice. The EITF decided not to address this issue, but suggested that the AICPA might consider the issue.

Miscellaneous issues

Finally, in the fifth category of issues, there were several questions, none of which were considered to be of high priority.

Issue 17 – does the accounting by holders for financial instruments with exercisability terms that are variable based future events, such as IPO, fall under the provisions of SFAS No. 133? This issue arose because internet companies often raise capital through issuance of options on shares that could become valuable if the company undergoes an initial public offering. The SEC Staff assigned this issue priority level 2. The EITF addressed this issue in Issue No. 00-8 "Accounting by a Grantee for an Equity Instrument to be Received in Conjunction with Providing Goods or Services." The FASB Staff summarized Issue No. 00-8 as follows:

> Instruments often have conversion or exercisability terms that are variable based upon future events, such as the attainment of certain sales levels or a successful IPO. The issuer's

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> accounting does not appear to raise new issues as it is covered by EITF Issues No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services," and No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios." For the holders, the instruments may be within the scope of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. However, because one or more of the underlyings are often based on the holder's or issuer's performance, Statement 133 will not always apply.

At its March 2000 meeting, the EITF reached a consensus view that the previous rules dealing with derivatives should apply when an equity security is received in conjunction with providing goods or services. Subsequently, the EITF decided to add the following paragraph to the Issue No. 00-8 consensus:

> In accordance with paragraph 28 of APB Opinion 29, the Task Force observed that companies should disclose, in each period's financial statements, the amount of gross operating revenue recognized as a result of nonmonetary transactions addressed by Issue 00-8. Furthermore, the SEC representative reminded registrants of the requirement under Item 303(a)(3)(ii) of Regulation S-K to disclose known trends or uncertainties that have had or that a registrant reasonably expects to have a material favorable or unfavorable impact on revenues.

Issue 18 – should internet operations be treated as a separate operating segment of the business in accordance with SFAS 131? The SEC did not assign a priority level to this issue but indicated that they would monitor the issue. The FASB felt that the previous rules dealing with disclosure of segments (i.e. FASB Statement No. 131, "Disclosures About Segments of an Enterprise and Related Information," and the related FASB Staff Implementation Guide, "Segment Information: Guidance on Applying Statement 131"), provided sufficient guidance on this issue.

Issue 19 – should there be more comparability between internet companies regarding the classification of expenses by category? The SEC Staff assigned this a priority level 3. The FASB Staff summarized the SEC's concerns as follows:

> The SEC staff noted that classification of expenses between various categories (for example, cost of sales, marketing, sales, and R&D) sometimes varies significantly among internet companies for costs that appear similar. Examples include web site development costs and expenses related to various contractual rights. As noted in the SEC Letter, it is difficult to identify common elements between the classification issues that have arisen, making the preparation of general guidance difficult. Further, EITF consensuses normally do not specify how expense items should be classified on the income statement, and classification conventions frequently develop based on industry practice.

The EITF decided that this item should remain on the agenda in an inactive status pending further progress on related issues.

Issue 20 – how should companies account for online coupons? The SEC Staff assigned this issue a priority level 2. As previously discussed, the EITF included this issue with Issues 3, 5 and 6, under EITF Issue No. 00-14. See the FASB Staff summary of Issue No. 00-14 under Issue 3, above.

Discussion and conclusion

While the capital markets research paradigm has concluded that there is a correlation between financial accounting numbers and share prices (see for example: Beaver, 1998;

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Dyckman and Morse, 1986), this paper argues that accounting standards setters do not consider whether a given form of financial statement display has a relationship with share prices. Instead, accounting standards setters focus on forging a consensus about accounting rules. In particular, with respect to accounting for internet activities, the standards setters did not consider whether there would be a share price reaction arising from a particular form of revenue display or revenue recognition. Moreover, they may have been correct in adopting this assumption, because, while there have been allegations that internet companies engaged in questionable accounting practices, there has been little evidence that share prices were actually affected by such practices. Nevertheless, internet companies apparently believed that if they presented their accounting numbers in a particular way, the mere form of presentation would cause an increase their share price. In retrospect, this was an untenable belief. In fact, an economic bubble occurred, in which there was little attention paid to the economic "reality" underlying accounting numbers. Furthermore, it was irrational to conclude that a particular form of revenue display would have had an impact on share prices. This is because the form of an accounting display has no relationship with the economic "reality" which the display purportedly represents. The accounting numbers are a social construction.

The concentration of accounting standards setters on reaching a consensus about the rules can be more clearly explained by the theoretical framework offered by Mouck (2004) who argues that while some financial accounting representations (e.g. monetary assets and obligations; ownership claims) may be connected with knowable facts (i.e. epistemologically objective), other financial accounting representations come into existence only through a set of rules. Thus, the rules of financial accounting are like the rules of a game. Once the rules are established, the representations made in accordance with the rules can be said to be "objective" with respect to the rules, even if they do not represent an underlying economic reality (Mouck, 2004, p. 540). With respect to accounting for internet activities, the standards setters were primarily concerned with achieving a consensus rather than trying to achieve a better representation of economic "reality". Perhaps this was a conscious effort on their part. By adopting a stance as a "neutral" arbiter, they avoid conflicts about possible connections between rules and economic consequences. As "neutral" arbiters, accounting standards setters do not permit themselves to be influenced by consequences. However, as Mouck's analysis helps us to understand, in spite of the vagaries surrounding the notion of economic "reality, real winners and losers can be decided by the rules of the game. Thus, there is a type of economic reality situated in the consequences, where the winners are those who most forcefully play the game (i.e. the most powerful). The standards setters seek to control excessive exuberance and unacceptable forcefulness on the part of the players through a consensus about the rules. This consensus building process reveals the underlying regulatory function of accounting. When there is a consensus about the rules of the game, the scores that are produced can be said to be epistemologically objective, thus reducing conflict about the outcomes. However, if there is a dispute between the players, or an obvious lack of fairness about the rules, abuses can result, leading to an outcome where winners and losers are determined through arbitrary processes largely controlled by the most powerful interests in society.

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