
Revenue recognition and real estate companies: A preliminary analysis

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Abstract

This paper offers a theoretical overview of the nature of revenue recognition through a literature review and empirical research. This is a pilot study intended to highlight the importance of the issue to property companies and offer a basis for further work, currently being undertaken by the authors. Revenue recognition — the point at which a firm is entitled to claim that a profit has been made — is theoretically and empirically unclear. This lack of clarity has repercussions for the production and interpretation of financial accounts. Property has been particularly affected due to the requirements enforced on certain companies by the regulators to restate published accounts. Moreover, since certain property companies have a stock market capitalisation that is below their net asset value, they are susceptible to any concerns over the accuracy of their reported revenue and turnover.

Keywords:

accounting standards, corporate governance, financial accounting, revenue recognition, economic consequences, legitimacy, institutionalisation

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INTRODUCTION

This paper offers preliminary findings upon the principle and practice of revenue recognition accounting and disclosure within the

annual reports of UK quoted property companies. The intention is to describe the issues surrounding revenue recognition, describe the basic theoretical models that underpin the various approaches and conclude with initial empirical analysis of 25 property companies over two contiguous reporting periods. Such research focused on the property sector seems timely, as Perry (2002a: 1) reports that:

‘ . . . revenue recognition is in a state of flux with a severe lack of consistency in accounting policies’.

Why is revenue recognition accounting so critically important? Company Reporting (2003: 1) suggests that:

‘ . . . the importance of revenue recognition cannot be understated as it is the vehicle that companies utilise to allow revenues to flow. Revenue is typically the single largest item reported in a company’s financial statements and is the basis of investment decisions.’

As the largest constituent of reported accounting information, it might be reasonable to expect revenue to be governed by a dedicated accounting standard. Not only is this not true, but it is also an international issue. Lynn Turner, Chief Accountant at the US Securities and Exchange Commission, describes it as the ‘largest single issue involved in restatements of financial statements’ (Company Reporting 2003). Despite the importance of revenue recognition disclosures, there have been few surveys investigating the quality of existing corporate practice, and none that focus exclusively on the property sector. One survey (Company Reporting 2003) of UK companies’ revenue recognition disclosures found that only 62 per cent of companies disclose a revenue recognition policy. This was a marked improvement on a previous survey by Company Reporting (2002), which found that 43 per cent of the 600 companies surveyed did not disclose their revenue recognition policy. Despite this improvement, the situation is far from satisfactory and led them to conclude that ‘UK companies fail on revenue recognition’.

CURRENT UK ACCOUNTING RULES ON REVENUE RECOGNITION

Somewhat surprisingly, the UK does not have an accounting standard dedicated towards tackling the issue of when revenue should be recognised in annual profit and loss accounts. The UK approach to revenue recognition accounting is to rely upon broad accounting principles such as those laid out in the Accounting Standards Board’s (ASB) ‘Statement of Principles’, Financial Reporting Standard (FRS) 5, ‘Reporting the Substance of Transactions’¹ and FRS 18, ‘Accounting Policies’.

It is beyond the scope of this present paper to review the

development of the present accounting guidance on revenue recognition in much depth, but there is an increasing realisation that present rules provide insufficient guidance when attempting to account for the revenue implications of modern business transactions (Barden 2001). Irrespective of industrial or commercial sector, there seems to be a growing acceptance that consistency in revenue recognition accounting practice is not universally attained. Such concerns have been heightened further by a number of accounting scandals, notably that of Enron, which directly involved the manipulation of revenue reporting, prompting discussion in many facets of society, especially those involved in the preparation of accounting information (see, for example, Holt and Eccles 2003).

A principle-based approach

The UK response to concerns over revenue recognition accounting was that the UK's current principle-based approach to revenue accounting became less susceptible to the sort of loop-holing to which US generally accepted accounting practice seems to have been afflicted. The authors have discussed this in a separate paper (Holt and Eccles 2003). Despite this, however, revenue recognition practice in the UK was further questioned when, in March 2000, the Financial Reporting Review Panel (FRRP) launched an investigation into Wiggins plc's treatment of costs associated with a particular project and its overall revenue recognition policies. The outcome of this investigation was that Wiggins plc had to restate its 1999 profit and loss account, resulting in a £25m profit becoming a £10m loss for the year. The Wiggins plc case represented just one of a growing number of apparent anomalies in revenue recognition practice in UK accounting, leading to the ASB finally taking action on the issue in 2001 (Parker 2003 and Company Reporting 2003).

Application Note

As an initial development towards a dedicated accounting standard on revenue recognition, the ASB issued a Discussion Paper, entitled 'Revenue Recognition', in July 2001. After analysing the responses to this paper, the ASB eventually issued an Application Note to FRS 5, 'Revenue Recognition', in November 2003. This Application Note was intended as an interim measure, pending the development of an internationally agreed standard with the aim of bringing enhanced consistency to UK revenue recognition and contributing to the overall debate. The Note set out the general principles to be applied to the recognition of income (and turnover) arising from the supply of goods and services. The approach of the Application Note was to base revenue recognition on changes in a seller's assets and liabilities arising from performance of the seller's contractual obligations. Only when a seller performs does it have the right to be paid (usually recorded as a debtor in the accounts), which is simultaneously recognised as turnover. Similarly, where payment is received in advance, the liability — equal to the amount received — is reduced only when performance takes place. In essence, the Application Note provides a recognition rule expressed in balance sheet terms, and appears to

be a 'patch hastily applied [to UK accounting] in order to import the requirements of IAS 18 *Revenue* into the UK' (Paterson 2003: 95). This accusation is supported by the failure of the Note to even define the term 'revenue'. Also, the proposals diverge from the existing principles of FRS 5.

2005

From 2005, UK companies have to adopt international standards, including International Accounting Standard (IAS) 18, 'Revenue'. This standard was last revised in 1993 and is currently under review as part of the general move towards EU adoption of IAS (see Eccles and Holt 2001a). IAS 18 states that 'the gross inflow of economic benefits resulting from an enterprise's ordinary activities is considered revenue provided those inflows result in increases in equity, other than increases relating to contributions from owners or equity participants' (International Accounting Standards Board 2004: 403). The general principle of IAS 18 is that revenue should be measured as the fair value of the consideration that has been achieved when the product or service promised has been provided to the customer (specific guidance applies to various categories of revenues). Thus, in the normal sale of goods, revenue is realised when:

- The significant risks and rewards of ownership are transferred to the buyer;
- Managerial involvement and control have passed to the buyer;
- The amount to be received can be measured reliably;
- It is probable that economic benefits will flow to enterprise;
- The costs incurred or to be incurred in respect of the transaction can be measured reliably.

Disclosure of
accounting policy

In terms of accounting disclosure, IAS 18 requires full disclosure of the revenue recognition policies used in the accounts. This is a major change from existing UK accounting requirements, as FRS 18.55(a) 'Accounting Policies' (Accounting Standards Board 2003) does not specify the need for a company *actually* to disclose its revenue recognition policy.

REVENUE RECOGNITION: INFLUENCES ON CURRENT PRACTICE

The authors will endeavour to outline briefly the relationship between a range of theories used to explain the present policy and practice of revenue recognition in the accounts of property companies. This necessitates an analysis of various literatures as mapped in Figure 1.

CORPORATE ACCOUNTABILITY

Accountability in its broadest sense simply refers to the 'giving and demanding of reasons for conduct' (Roberts and Scapens 1985: 447). Accountability is thus a continuous and never-ending process and may be discharged in a variety of different ways. For Gray *et al.* (1996: 38), accountability is defined as 'the duty to provide an

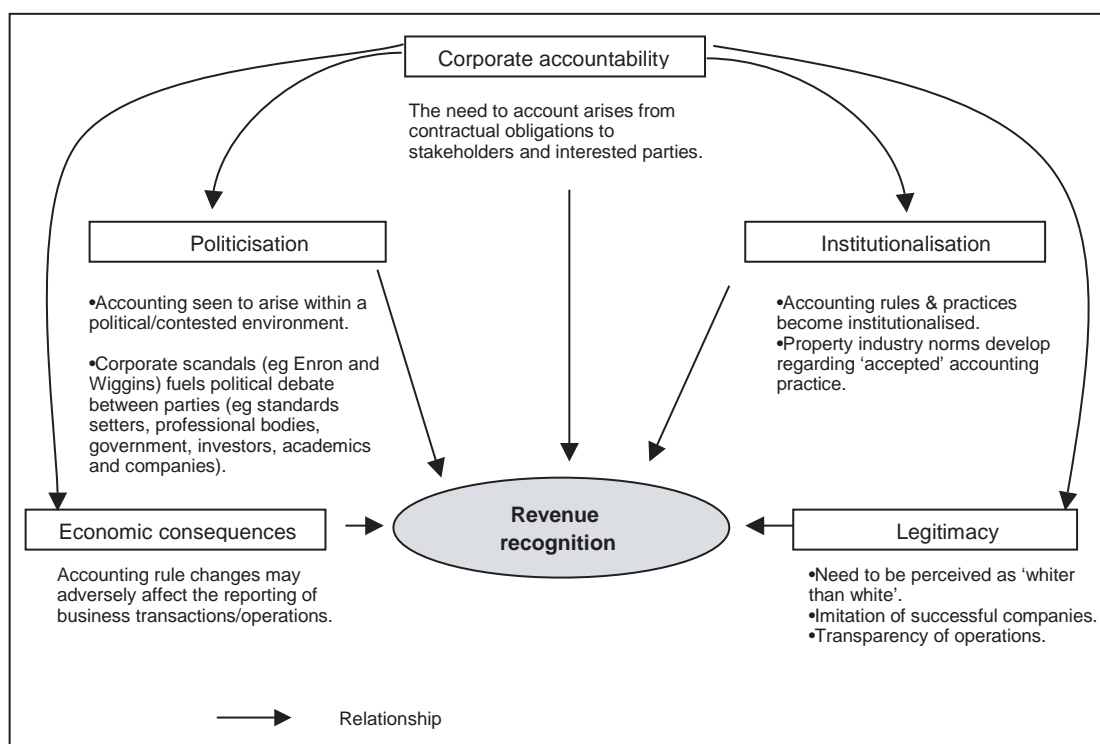


Figure 1: Accounting theories influencing revenue recognition policy and practice

account (by no means necessarily a financial account) or reckoning of those actions for which one is held responsible'. Tricker (1983: 32) sees accountability involving a:

'... requirement to give an account of actions taken. It represents a feedback mechanism by those held responsible for activities. Two parties are involved – the one with the right to demand accountability: the other one with the duty to be held accountable.'

Here then, accountability presupposes two parties (the principal and the agent) who are bound together by some contract that imposes responsibility on the agent. Corporate accountability recognises two responsibilities or duties: the responsibility to undertake certain actions (or forbear from taking actions) and the responsibility to provide account of those actions. This model is shown in Figure 2, with a 'principal' issuing instructions, granting rewards and ultimately controlling the resources available to an organisation. In turn, the 'agent' organisation must be seen to act in an appropriate manner and supply adequate information about its actions in order to discharge the accountability required.

Three important issues arise from this model (see Gray *et al.* 1991; Gray *et al.* 1996).

- The information needed to discharge the accountability arises from a duty upon the agent and the rights of the principal.

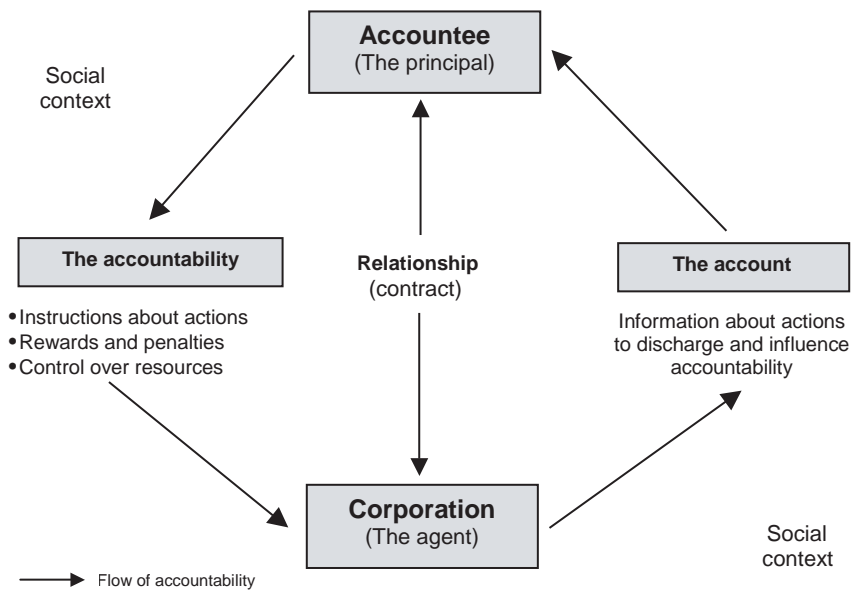


Figure 2: A basic model of corporate accountability

- Accountability expresses a power relationship recognising the boundaries of the organisation and the moral values of the principal.
- Accounts discharging accountability need not be ‘formal’ accounting records. The mere existence of a channel of accountability (a means whereby the information can be obtained) may be enough to discharge certain forms of accountability (Gray 1978).

Problems

Within accountability theory, there are two conceptual and practical problems that should be considered (Tricker 1983; Gray *et al.* 1991; Gray 1992):

- Determining the exact responsibilities under each contract; and
- Determining exactly when an accountability contract actually exists.

Establishing the exact accountabilities of such a contract is not easy, but this problem is never sufficient to question the ultimate requirement for accountability (Gray *et al.* 1991). There is considerable disagreement on whether an accountability contract exists. Tricker (1983: 33) argues that unless a principal has the power to enforce the accountability, then no accountability is due.

‘Accountability is not discretionary. It involves rights and duties, not interests and options. To be able to demand accountability presupposes the potential to exercise power — whether it is based on legitimate authority or the wielding of some other sanction.’

The voluntary disclosure of information by an agent is a mere *ex gratia* act, and should never be classified as accountability. Accountability involves a right and duty. It must not be confused with socially responsible behaviour, which involves discretion. An agent only owes an account to those principals who choose to demand it *and* show an ability and willingness to enforce their contractual rights. If the principal fails to exercise their rights to accountability, those rights are extinguished. Tricker's (1983) view of accountability has been critiqued by Gray *et al.* (1991) and Gray (1992). They argue that accountability also arises from 'moral rights' to information.

'We insist that accountability can be due, even when it cannot be enforced. A moral or natural right to information flows from an established (legal or non-legal) responsibility' (Gray *et al.* 1996: 44).

Here, accountability need not be legally enforceable and can emerge from the moral and natural rights present within society. The production and issue of corporate reports becomes an acceptable mode of discharging accountability because professional standards and legal requirements govern such reports.

Applying the theory of accountability to the disclosure of revenue recognition leads to the question: Does a company have a legal or moral duty to disclose details of its policy? As discussed above, FRS 18 'Accounting Policies' (Accounting Standards Board 2003) requires a disclosure and description of each 'material' accounting policy, but does not specify in FRS 18.55(a) the need *actually* to disclose a revenue recognition policy. Not surprisingly, as a direct result of FRS 18, many companies either fail to disclose or only partially explain their revenue recognition accounting policy in the accounts. This might be partially explained by a widespread corporate belief that there is no fundamental or material need to disclose such a policy in order to understand the accounts. There does seem to be an increasing demand from interested parties, however, for greater accountability from companies about their revenue recognition policies. IAS 18 'Revenue', which must be applied from 2005 by all EU-listed companies, specifically requires full disclosure of corporate revenue recognition policies.

Legal duty

INSTITUTIONAL AND LEGITIMISATION THEORIES OF ACCOUNTING

Institutional theory suggests that the environment in which it operates shapes a business. As business practices, activities and structures become legitimised within society, then they become accepted norms and are 'institutionalised' (DiMaggio and Powell 1983; Zucker 1988). Accounting and business practices are further legitimised by their adoption by 'legitimising bodies' in society such as the state and the professions. Companies then adopt these

accounting practices that grant them legitimacy and autonomy to operate freely within society.

DiMaggio and Powell (1983) use the term ‘institutional isomorphism’ to describe the process whereby organisations of the same type move to resemble one another — the process of institutionalisation. They identify three sub-processes by which this occurs, namely:

- Coercive isomorphism;
- Mimetic isomorphism; and
- Normative isomorphism.

Coercive isomorphism

Zucker (1988: 82) explains coercive isomorphism as ‘organisations adopting certain features because of pressure from the state, other organisations, or the wider society’. She gives examples of the pressures, which include force and legal compulsion. DiMaggio and Powell (1983: 67) suggest that these coercive means ‘may be formal or informal and may lead to compliance or only a ritualistic appearance of compliance’.

Mimetic isomorphism

DiMaggio and Powell (1983: 69) define mimetic isomorphism as ‘imitation of one organisation by another’. They suggest that the reason for this imitation is that the mimicking organisation sees the other as ‘more legitimate or successful’ (*ibid*: 70).

Normative isomorphism

Normative isomorphism arises as a result of professionalisation. Members of the professions receive similar training (such as that received by accountants and surveyors), which socialises them into similar worldviews. They then interact through professional and trade associations diffusing ideas (Mizruchi and Fein 1999).

Campbell *et al.* (2002) suggest that a feature of legitimacy theory is the assumption of a reciprocal social contract (expressed or implied) between an organisation and society (Shocker and Sethi 1974; Donaldson 1982). Lindblom (1994) defines legitimacy as:

‘ . . . a condition or status which exists when an entity’s value system is congruent with the value system of the larger social system of which the entity is a part. When a disparity, actual or potential, exists between the two value systems, there is a threat to the entity’s legitimacy.’

The disparity alluded to in Lindblom’s definition of legitimacy is commonly referred to as a ‘legitimacy gap’. The occurrence of such a gap threatens organisational legitimacy. With revenue recognition under analysis here, companies choosing to adopt the suggested disclosure of revenue recognition policies in their accounts, sooner rather than later, avoid the formation of this legitimacy gap. Lindblom (1994) suggests four strategies that a company may adopt in order to achieve social legitimacy.

- The organisation may seek to inform its ‘relevant publics’ about (actual) changes in the organisation’s performance and activities

(a strategy chosen in response to recognition that the ‘legitimacy gap’ arose from an actual corporate failure);

- The organisation may seek to change the perceptions of the relevant publics — but not change its actual behaviour (a strategy adopted where the legitimacy gap arises through misperceptions on the part of the relevant publics);
- The organisation may seek to manipulate perception by deflecting attention from the issue of concern to other related issues through an appeal to, for example, emotive symbols (a strategy of manipulation); and
- The company may seek to change external expectations of its performance (a strategy chosen when the organisation faces unrealistic expectations).

Campbell *et al.* (2002: 559) suggest that ‘legitimacy theory assumes a broadly adversarial relationship between the business and its constituencies such that the implied contract that is at the centre of the theory requires that re-legitimation becomes necessary as societal opinion changes’. Failure to close a perceived legitimacy gap results in a company’s legitimacy being withdrawn by some constituencies. Campbell *et al.* (2002: 560) suggest that companies must manage these ‘conferring publics’ in order to close the legitimacy gap.

Application

Applying institutional theory to revenue recognition, the first of DiMaggio and Powell’s (1983) three processes of isomorphism, coercive isomorphism, is the simplest to identify in practice. The adoption by Wiggins plc of a new revenue recognition policy was forced on the company following an investigation by the UK FRRP for inaccurate accounting and provides an example of coercive isomorphism in operation. Isolating and classifying a change in a corporate revenue recognition policy as mimetic isomorphism would be more subjective, unless the company’s reason for the change was expressly stated as copying ‘best corporate practice’. This is unlikely to be publicly admitted but will be a focus for later work. Normative isomorphism is prevalent in accounting since accounting standards are issued as a direct result of the convergence of opinion on how to address a particular matter, in this case that of recognition of revenue.

In considering the application of legitimacy theory to the disclosure of revenue recognition policies, *ab initio*, clarification is needed as to who is seeking legitimisation and by whom. For this, reference is made to Figure 2 and the existence of a principal (the accountee) and the agent (the corporation). The corporation seeks to legitimise its actions to the accountee. The social contract referred to within legitimacy theory can be regarded as ‘the contract’ in the corporate accountability model (Figure 1). The production and issue of the corporate report is then used as the medium to communicate the legitimising action.

Wilson Connelly’s change of revenue recognition policy can be

cited as an example of a company seeking to legitimise its actions. Perry (2001) suggested that the intention of the change in policy was 'to fall into line with rivals on revenue recognition'. Prior to the change, Wilson Connelly had received adverse coverage as a result of its revenue recognition policy, because it had allowed a legitimacy gap to form between its practice and that of its competitors. A second example, MyTravel's change in revenue recognition policy, can be cited to demonstrate the concept of a 'legitimacy gap'. MyTravel received adverse press attention (Parker 2003) when its revenue recognition policy was scrutinised, after a change in auditor, and was found wanting in comparison with other companies in its sector.

THE ECONOMIC CONSEQUENCES OF ACCOUNTING

Accounting rules and standards should not have the potential to alter business transactions within an economy. Accounting statements should be neutral, reflecting the economic reality of business transactions rather than influencing what types of transactions are made. It has long been realised, however, that inappropriately devised accounting standards alter the way businesses conduct their affairs, and create the potential for negative 'economic consequences' within society. Zeff (1978: 58) defines the term 'economic consequences' of accounting as:

' . . . the impact of accounting reports on the decision-making behavior of business, government, unions, investors, and creditors etc . . . It is argued that the resulting behavior of these individuals and groups could be detrimental to the interests of other affected parties. And, the argument goes, accounting standard setters must take into consideration these allegedly detrimental consequences when deciding accounting questions.'

Thus, the choice and acceptance of accounting rules and standards may be partly governed by anticipated economic consequences rather than simply the logical appeal of a chosen framework (Rappaport 1977). Recognition of the 'economic consequences' of accounting has been largely brought about by the fact that previously uninterested societal groups are now invoking non-accounting arguments to criticise the accounting standards process. For example, the proposed accounting standard on UK pension accounting, FRS 17, is being widely criticised for its negative 'economic consequences', as its introduction is believed to encourage companies to close their defined benefit pension schemes for employees.

Rappaport (1977) suggests that accounting standards have the potential to alter behaviour in the economy in three distinct ways:

- By their impact on the behaviour of intended recipients of accounts, eg shareholders.

- By their impact on the behaviour of ‘free riders’, ie those for whom corporate reports are not directly intended but who use them, eg competitors, employees, suppliers, customers etc.
- By their impact on the behaviour of the reporting company which, in anticipation of potentially adverse feedback arising from its reporting according to the required accounting standards, might choose to alter its economic behaviour.

Financial accounting standards shape the amount of profits, assets and liabilities shown in the accounts. It is critical that such standards reveal the economic reality of business transactions while minimising the economic consequences they might cause. A number of empirical studies have shown a relationship between accounting numbers and share prices, with investors giving due consideration to the accounting methods employed to generate those numbers. As accounting standards govern both what is to be disclosed and the basis of measurement, then it can be concluded that financial accounting standards have an economic impact due to their influence on share prices and market capitalisation of companies. If, for example, corporate profits are reduced by making changes in accounting standards, the economic behaviour and decision making of the company and other groups may be adversely affected by such changes. Hawkins (1969: 15) highlights this issue:

‘To the extent that accounting principles are used to construct corporate financial statements, our society’s resource allocation decisions rely in part on these principles. If these principles bias management toward unsound economic decisions or lead to financial reports which are misleading, then the effectiveness of society’s resource allocations will be unnecessary.’

It has been shown already that the ‘economic consequences’ argument applies to property accounting by an analysis of the adoption of international accounting standards, which have the potential to adversely affect the reported profitability of certain property companies (see Eccles and Holt 2001a).

THE POLITICISATION OF ACCOUNTING STANDARDS

Linked to the idea of economic consequences of accounting is the realisation that accounting standards setting is an extremely political and contested process. As accounting is not a science, accounting rules and standards cannot hope to satisfy all interested parties (Watts and Zimmerman 1979). Solomons (1978: 65) suggests that accounting is political because:

‘. . . the numbers that accountants report have, or at least are widely thought to have, a significant impact on economic behavior. Accounting rules therefore affect human behavior. Hence, the process by which they are made is said to be political . . . such

rules are properly to be made in a political arena, by counting heads and deciding accounting issues by some voting mechanism.’

It has long been acknowledged that accounting rule changes may only be achieved through political compromise between the standards-setting body and interested parties (Gerboth 1973; Zeff 1978) and that this prevents the development of one single conceptual framework for accounting. Watts and Zimmerman (1979: 301) suggest that no normative accounting theory exists because:

- Accounting standards are justified using the theory (excuse) of the group with a vested interest which is benefited by the standard;
- Groups with a vested interest use different theories (excuses) for different issues; and
- Different groups with a vested interest prevail on different issues.

In the absence of a normative accounting theory, setting accounting standards will be political. This is a contention that the authors have empirically examined previously (see Eccles and Holt 2001b, 2001c) and there is a plethora of accounting literature that deals with the lobbying of accounting standards setters. Fogarty *et al.* (1994: 27), citing Hope and Gray (1982), exemplify this in their lament that ‘there is very little to be said other than to report on the explicit and legitimate attempts to sway the results’.

Political pressure also results from the heightened scrutiny to which accounting standards and standards setters are subjected. This scrutiny stems from increased media coverage that brings accounting policies to the attention of the general public, or those publics from where the economic consequences arrive. Zeff (1978: 63) reports that ‘before the 1960s, accounting controversies were rarely reported in the financial press and it was widely believed that accounting was a constant, if not a fixed parameter, in the management of business operations’. Zeff adds that this transfer of information to ‘accounting outsiders’ (and this would include surveyors and other property professionals) has resulted in the realisation that ‘accounting may be a variable after all — that the rules of accounting are not unyielding or even unbending’. The authors have discussed this issue elsewhere (see, for example, Eccles and Holt 2001b, 2001c).

Examining the relationship between the politicisation of accounting and the setting of a revenue recognition policy raises questions about what prompted revenue recognition to be seen as problematic, who the interested constituents in the policy-making process were and, specifically, whether there was interest from property companies in the consultation process. There is evidence to suggest that revenue recognition only became topical as a result of high-profile accounting failures in the UK and across the Atlantic. For example, Perry (2002b: 2) believes that following the Enron

collapse there was 'increased pressure from institutional investors . . . on the publication of a new standard on revenue recognition', and Parker (2003) suggests that the publication by the ASB of revenue recognition guidance was as a result of 'pressure from ministers and MPs'.

METHODOLOGY FOR INVESTIGATING REVENUE RECOGNITION DISCLOSURES OF PROPERTY COMPANIES

In order to investigate the importance of revenue recognition policies within the property sector, this pilot study initially obtained the views and opinions of accounting practitioners. This research was carried out through unstructured, in-depth interviews with accountants. In order to provide a context for this interview data, an actual survey of published property company annual reports was conducted with the aim of ascertaining current levels of revenue recognition disclosure. Since this was a pilot study, only three interviews were carried out, and the findings are thus qualified by the size of the sample. In total 25 property company accounts were analysed over a two-year period for the pilot study survey.

The survey

For the purposes of the survey of corporate reports, keywords and terminology were identified and located in the published accounts in order to determine the extent of a company's disclosure and policy on accounting for revenue. Two revenue streams (2001–2002 and 2002–2003) were investigated for 25 property companies. For the pilot study, companies with a turnover of over £25m were analysed. This initial work sought only to examine the existence of a clear and transparent revenue recognition policy in the accounts; further work will examine the validity of the method of accounting actually used by each company. For the recognition of revenue on property transactions, 'exchange of contract' and 'legal completion' were the two phrases looked for in order to differentiate between different stances on revenue recognition policy. 'Invoicing' and 'staged recognition' were the two bases considered for the recognition of rental income.

ESTABLISHING THE IMPORTANCE OF REVENUE RECOGNITION

Interviews were conducted in order to confirm the assumption that revenue recognition is an important issue (to accountants in practice). The answer from the first set of interviews was a resounding 'yes'. Respondent C (all interviewees will remain anonymous) stated that 'revenue recognition is important because turnover is the biggest number, probably in the company'. The consensus view of the interviewees was that revenue is extremely important in order to give a 'true and fair view' of a company's turnover. Respondent B pointed out that revenue is important because 'investors and account users often focus on revenue growth as an important indicator of performance'. Respondent A went further in his discussion of the importance of revenue, arguing that 'the value of the company is its profit and its return back to the

shareholders’, but ‘if you go back from where you are in terms of profit and move back to where your starting point is, the starting point is turnover’.

In his explanation of the importance of revenue, Respondent C suggested that it became of particular importance in the dot.com boom, when companies were being valued on their turnover and new means of generating revenue were being formulated. He gave the example of ‘per hit valuations’, whereby companies were recognising revenue every time there was a ‘hit’ on their site. In explaining the importance of a robust revenue recognition policy, Respondents C and A suggested that there are various ways in which companies can manipulate their reported revenue, and therefore a standard governing revenue needs to be as robust as possible. While Respondents B and C suggested that disclosing a revenue recognition policy was important, Respondent A suggested that since disclosures simply go in the notes of the accounts, and that this makes them very long, ‘you can actually lose sight of what is actually in the accounts by having to read all of the notes’. His solution was that ‘there might be an argument for saying, “ignore disclosure and actually only record what is a true sale and true purchase”’.

In addressing the subject of revenue recognition in the property sector, there was some disparity between the interviewees. Two, Respondents C and A, felt that it was an important matter, while Respondent B felt that turnover was of less consequence to property companies than to other companies. ‘In many property companies, turnover is an irrelevant item. It’s more about recognised gains and losses and the value that the company adds year on year.’ By inference this appears to mirror the view of the Royal Institution of Chartered Surveyors (RICS). The RICS did not respond to the July 2001 exposure draft on recognition, nor did any of the major property companies.² In contrast, Respondent C felt that revenue recognition in the sector was very important and that disclosures for property companies could potentially run to ‘multiple pages’.

RICS

INSTITUTIONALISATION AND LEGITIMISATION OF ACCOUNTING PRACTICES

Respondent B believed that ‘companies will have chosen to disclose revenue recognition policies before this guidance to be seen as transparent and clean and maybe even put down a marker for industry’. Companies’ disclosures are seen by Respondent B as a means of enhancing their corporate image. The view that companies disclose their accounting policies as a means of achieving transparency was echoed by all three interviewees, with Respondent A suggesting that companies want to demonstrate that they are ‘whiter than white’. This conforms with the theory that organisations seek to legitimise their actions, and that they seek to enhance their corporate image as suggested by Gray *et al.* (1988).

Respondent A pointed out that a company needs an incentive in

order to change, or indeed disclose, a policy — in this case a revenue recognition policy. He suggested that a company might argue that they are providing all that they need to. ‘You can’t tarnish everyone with the same brush; they disclose everything that they need to.’ This echoes the sentiment of Tricker (1983) that accountability must be enforceable and that a company does not seek to legitimise its actions to stakeholders, but rather only discharges its accountability to principals. This is reinforced by the suggestion from Respondent A that:

‘. . . if you get an aggressive finance director he will say to you, “show me where, in the standard, it says I should do [disclose a policy]”. If it is not in the standard you cannot, so he says, “well we won’t disclose it”. There is not a lot the auditor can do because the auditor has to say that the accounts are prepared in accordance with the standards.’

Respondent A suggested that there are circumstances in which a company might disclose a policy in response to other companies in the sector doing so. In considering whether companies might be influenced and tempted to mimic the disclosures or behaviour of competitors, Respondent A said that in the case of:

‘public companies, then yes, I think to a certain extent that there is “peer pressure”. This might be driven by, let’s say for example, a company’s share price being driven down because the market has concerns about how they are accounting for turnover, whilst other companies are disclosing [a policy] and their share price is higher. If people think their share price is low and it might go back up again if they disclosed exactly what they were doing, then yes they would follow suit.’

This would suggest that legitimisation of behaviour occurs even in circumstances where the requirement to provide accountability is not enforceable — that is, the purpose of disclosure or providing accountability is not solely to discharge accountability. It also gives some weight to the suggestion by DiMaggio and Powell (1983) that ‘institutional isomorphism’ occurs within sectors and industries, and the first two sub-processes by which this occurs are relevant in this circumstance. It also supports Lindblom’s (1994) contention that company behaviour is influenced by the formation of a legitimacy gap. Respondent A suggests that a company may choose to disclose *exactly* what they are doing in response to the formation of a ‘legitimacy gap’ in corporate accounting. He asked: ‘If that was driving your share price down, the fact that you are not disclosing [a policy], will the fact that you are disclosing something that is more aggressive actually help your share price?’. By rectifying the absence of a disclosure, the company should in theory have ‘legitimised’ its actions. In practice, Respondent A does not believe this to be the

case. Therefore, it becomes necessary for a combination of institutionalisation and legitimisation needs to occur. The requirement is not merely for behaviour to change, but there also needs to be convergence with accepted practice within the sector, confirming Zucker's (1988) argument that for an idea to be institutionalised, the idea must be accorded legitimacy.

In Respondent B's discussion of why companies might adopt perceived best practice in the absence of an enforceable standard, he suggests a strategy by which this might be achieved without allowing an apparent legitimacy gap to form:

'[A company] might slowly change their policies without disclosing them so that by the time they are forced to disclose them they seem to be following either best practice or complying with [a standard] but without doing it so suddenly that it results in a massive fall off in revenue. I suspect that they will slowly change their policies to smooth their revenue and then they appear transparent.'

This complies with Lindblom's (1994) view concerning strategies used by companies seeking legitimacy, and is consistent with DiMaggio and Powell (1983) who state that institutionalised compliance may lead to either actual or mere 'ritualistic compliance'.

ECONOMIC CONSEQUENCES OF ACCOUNTING STANDARDS

Respondent B placed himself firmly within this framework when he declared that 'I am sometimes astounded by some of the accounting policies, such as FRS17,³ how accounting policies can really drive huge changes in behaviour if they are not very well thought out'. Respondent B argued that the effects of this policy stretched well beyond the users and preparers of accounts, in that many allege that it is responsible for the demise of the final salary pension scheme and affected all companies providing pension funds. Respondent A was not convinced of the economic consequences of creating a revenue recognition standard:

'There is also the argument that, so long as you are consistent in the way that you account for turnover, it should all come out in the wash. Taking a property company where they recognise turnover on the exchange rather than completion, then if for some reason it doesn't complete then it has to fall out of turnover next year.'

For Respondent A, the only economic consequences arising as a result of failing to have a prudent accounting policy would be that a company would lose aggressively recognised revenue in the subsequent years' accounts; regardless of accounting policy, correct revenue will eventually be provided. Of course, the consequences for firms with different policies might be serious. A company that more prudently presents a 'true and fair view' of its revenue by

recognising revenue upon legal completion of a contract might find itself penalised by investors, since its revenue would not appear as high as another company's adopting a less prudent policy, such as recognition upon the exchange of contracts. Therefore, 'the resulting behavior of these individuals and groups could be detrimental to the interests of other affected parties' (Zeff 1978: 56) and might cause a reversion to a 'less true' policy by a company being detrimentally affected. This appears contrary to the idea of legitimisation, where a more transparent or prudent policy is adopted. It should be considered therefore that a company (in certain situations) might 'trade-off' the benefits of legitimisation against the potential benefits of *appearing* to be legitimate. Respondent A continued by suggesting that where a company did not disclose a policy, 'this would force one to make assumptions about a company's turnover, which can be misleading'. Investors and accounts users are at a disadvantage, having to base their investment decisions upon assumptions. This might then be reflected in their willingness to invest in the company.

UK v. USA

Accounting standards setters must consider economic consequences of transactions when setting standards. In the UK, a principle-based accounting approach has been adopted, with the idea of economic substance of a transaction taking precedence over the form of that transaction. The USA, however, has adopted a rule-based approach to accounting standards, with very specific industry-based rules being prescribed. By 2005, the property companies under scrutiny here will have changed accounting policies to reflect the adoption of IAS. All three interviewees were in agreement that a principle-based approach to standards was more effective in accommodating economic consequences in accounting standards. Respondent B suggested that 'the principle-based approach is fine but it still requires interpretation, and accountants in practice often struggle with that and actually prefer to have rules'. When discussing property companies, Respondent A stated that:

'I think if you made it industry based then I think you are going to miss something. I think what you are trying to do is get companies to represent a "true and fair view" of what their turnover is and therefore it ought to be possible to have generic principles which cover most of the industries.'

He did, however, agree that there may be particular industries in which specific policies may need to be provided, such as the oil and gas industries.

POLITICISATION OF ACCOUNTING

Respondent C was acutely aware of the potential to manipulate reported turnover: 'The forward sale of spurious profits being manufactured has been around for donkeys' years.' Respondent B thought the issue was of current interest due to recent events. 'I think it has become more important because of the increase in

failures or manipulations by certain high profile companies like Enron, Wiggins, Baltimore and MyTravel.' This view was shared by Respondent A, who suggested that 'normally to get something out quickly they must be reacting to something that has happened'. Respondent A was less certain that Enron was one of the factors that influenced the examination for a new standard in the UK. Respondent C, when asked whether he felt that Enron might have been one of the causes that prompted the ASB to issue the new standard, emphatically agreed 'yes, absolutely'. When asked whether the ASB issued the new revenue recognition standard as a result of its usual standards-setting process rather than as a reaction to accounting abuses, Respondent B answered 'I think it is very typical of the Accounting Standards Board that it is fire fighting and these are things that should have been anticipated many years ago'. These sentiments agree with Zeff (1978) when he proposed that as a result of increased press coverage (as issues become more topical), a reaction is prompted from standards setters. This also tends to align itself with the suggestion by Hussein and Ketz (1991) that the role of the accounting governing body is not as a participant in the standards-setting process but as a resolution facilitator. The revenue recognition standard is a facilitation of these forces by the ASB.

ASB's role

All the interviewees were of the view that the ASB should be more proactive in its response to accounting problems. This was especially clear when Respondent B suggested that 'it is always a case of fire fighting and they should be able to anticipate this'. Recognising the approach of the 2005 IAS adoption, Respondent A suggested that 'the UK is meant to be going into the IASs in 2005, so I would agree it seems unnecessary for the UK to suddenly change revenue recognition accounting, it seems like a knee jerk reaction to me'. Respondent A regards the ASB as reacting to extensive coverage of recent failures in the media acting as pressure to set a revenue recognition policy. Zeff (1978: 63) argues that such coverage brings accounting issues to the attention of numerous 'outsiders' and in doing so prompts the involvement of groups not normally associated with the setting of accounting standards. In discussing the impacts that pressure groups have on the standards-setting process, Respondent B said that:

'I am sure they [the ASB] do take account of these groups. Hopefully that input makes the standards more agreeable when they come out.'

This agrees with Gerboth (1973: 479), who suggests that 'in the face of conflict between competing interests, rationality as well as prudence lies not in seeking final answers, but rather in compromise'. The ASB will not be able to satisfy all the parties involved in the standards-setting process but instead will facilitate a compromise (this facilitation was also discussed by Hussein and

Ketz 1991). In the interview with Respondent C there appeared to be a view that related to the submissions by Solomons (1978) and Hawkins (1975), who both suggest that accounting policies may be influenced by government in this ‘political’ process, in order to meet government’s own short-term objectives. When discussing accounting in the public sector, Respondent C suggested that the private finance initiative was not a dissimilar tool to that used by Enron to manipulate its accounts, that is, ‘off balance sheet financing’. Government itself will manipulate accounting methodologies as a means of meeting its own short-term objectives.

PROPERTY COMPANY ACCOUNTS: SURVEY AND ANALYSIS

The interviewees generally expected the number of revenue recognition disclosures to increase over the two financial years examined within this survey. The accounting models critiqued above would also tend to support this outcome, since revenue has become very topical and is an area being scrutinised by the media and accounting standards-setters — it has become politicised. Press attention has resulted from large-scale failures leading to significant economic consequences as a result of abuses of revenue recognition. Certain companies within the property sector already adopt revenue recognition policies, and therefore the disclosure of such policies should start to normalise (normative isomorphism). One would also expect that companies will seek to legitimise their actions in light of the heightened awareness of this issue, and they will do so by discharging their accountability through disclosing a revenue recognition policy.

REVENUE FROM PROPERTY TRANSACTIONS AND RENT

Forty-four per cent of the companies surveyed disclosed accounting policies for revenue obtained from both property sales and rental transactions in the first year of the accounts studied, increasing to 48 per cent in the second year’s accounts (see Table 1). Five companies failed fully to disclose accounting policies explaining their treatment of either type of revenue stream. Of these five companies, four failed to provide any type of policy disclosure and guidance about their calculation of yearly revenue generation, while the other disclosed the components of its revenue streams but failed to add value to the disclosure by stating the basis on which revenue was recognised. An example of this uninformative revenue accounting policy disclosure is found in the accounts of Workspace Group plc (2003):

‘Turnover comprises rental income and other sums receivable from occupiers of investment properties (including insurance charges, service charges, other recoverable costs, supplies of utilities and any premia associated with tenancies) together with commission fees and other sundry income.’

PROPERTY TRANSACTIONS REVENUE DISCLOSURE

There tended to be two trends that emerged when examining the disclosures on when revenue is recognised for property transactions (see Table 2). The majority of companies, 44 per cent and 40 per cent of companies in the first and second years, respectively, stated that they recognised revenue upon the legal completion of the transaction, that is, when the payment is received. Seven of the remaining eight companies chose to recognise revenue when unconditional contracts had been exchanged and physical completion had occurred.

The number of companies choosing to recognise revenue upon the basis of exchange of contracts increased in the second year, from 36 per cent to 40 per cent. This increase was as a result of Freeport plc changing its accounting policy from legal completion. The policy disclosure in the second year noted that the directors believed that this basis better reflected the commercial and legal circumstances of the company:

'The recognition of profit from the sale of a development property on exchange of contracts represents a change in the previous accounting policy which was to recognise profit on the completion of the sale. This change has no effect on previous years as there were no development property sales. The directors are of the opinion that the policy better reflects the commercial and legal circumstances of the disposal.' (Freeport plc 2003)

This change in policy resulted in turnover of £16.5m and a gross profit of £3.8m on the sale of property being recognised in the 2003 accounts, whereas under the previous policy it would have been recognised in the following year. This change in policy generated some conflict, as it was pointed out in Company Reporting (2004) that the directors' bonuses are based upon growth in profit after taxation compared against the previous year's results. Without this change, it was suggested that the directors would have received little

Directors' bonuses

Table 1: Revenue recognition policy disclosure survey results

Property transaction and rent disclosure	Year 1 % of sample		Year 2 % of sample	
Neither disclosed	5	20%	5	20%
Both disclosed	11	44%	12	48%

Table 2: Property transaction survey results

Property transaction	Year 1 % of sample		Year 2 % of sample	
No disclosure	5	20%	5	20%
On exchange of contract	9	36%	10	40%
On legal completion	11	44%	10	40%

or no bonus, but this conflict of interests was not disclosed. With reference to the models analysed above, this would seem to suggest that accountability has not been discharged and therefore the action has not been accorded legitimacy. Economic consequences arise here, as shareholders' wealth is affected by the adoption of a different accounting policy. On a more general level, it might be seen as further support for Zeff (1978), who highlights the effects of accounting policies and brings them to the attention of publics not involved in the adoption of an accounting policy.

Board manipulation

There are examples of companies whose revenue recognition policies are subjective and might be manipulated by the board without any change in policy. Helical Bar plc recognises revenue based on the opinion of the directors that a binding contract exists:

'Turnover represents rental income, the proceeds from the sale of trading properties and developments and proceeds from the sale of listed investments. For funded developments, turnover comprises the increase in the valuation of work during the year and profit recognised on each development. Income from the sale of trading properties is included in the P&L account when, in the opinion of the directors, a binding contract of sale exists.' (Helical Bar plc 2003)

Subjective judgments

This policy allows directors of the company to incorporate revenue into a particular year based on a subjective judgment, and is evidently open to abuse. Equally, such a policy leads to economic consequences whereby Helical Bar plc might elect to manipulate its revenue by employing this tool as a means of smoothing results from year to year.

Warner Estate Holdings plc recognised revenue from property transactions on both bases, that is, exchange of contracts and legal completion. 'Sales are recognised when unconditional contracts are exchanged for commercial properties and on completion for residential properties' (Warner Estate Holdings plc 2003). Grainger Trust plc provides a second example of a disclosure containing a combination of recognition bases. 'Sales of land and properties are only accounted for when the cash proceeds are received in full *or* the group has entered into a legally binding undertaking' (Grainger Trust plc 2003). This disclosure makes it difficult to judge which revenues may have been included in reported accounts, since revenue might have been recognised on an exchange of legally binding contracts or when cash has been received.

RENTAL REVENUE DISCLOSURE

As with the disclosures of property transaction policies, there were two trends that emerged in the disclosures on when rental revenue is recognised (see Table 3). In the first year, 44 per cent of companies disclosed a rental revenue recognition policy, increasing to 48 per cent of the survey sample in the second year. The recognition of

Table 3: Rental income survey results

Rental Income	Year 1 % of sample		Year 2 % of sample	
No disclosure	14	56%	13	52%
Invoiced	6	24%	7	28%
Staged	5	20%	5	20%

rental revenue was split between those companies recognising revenue upon invoicing (24 per cent in year 1 and 28 per cent in year 2) and those companies recognising income on a staged basis throughout the year or at specific junctures through the year (20 per cent of the survey sample in both years).

Grainger Trust plc added its rental disclosure in the second year; in the prior year, it disclosed no rental income recognition policy. The following extract from the company's September 2003 accounts shows the turnover disclosure:

'Turnover comprises gross sale proceeds of trading properties and developments, gross rentals and sundry other income, and is exclusive of VAT. Sales of land and properties are only accounted for when the cash proceeds are received in full or the group has entered into a legally binding undertaking. Gross rentals are recognised as they fall due.'

The prior year's accounts made no mention of when rental income was recognised. Without this disclosure, there was a lack of certainty as to what rental revenue was included in the results of the company.

Prudent

Companies tended to be somewhat more prudent in their recognition of rental income than they were in property transactions. Many companies disclose when they recognise any increase in rental income. The majority recognise rental increases upon agreement of terms with tenants. One such example is Quintain Estates and Developments plc, which has the following turnover policy.

'Rent increases arising from rent reviews due during the year are taken into account only to the extent that such reviews are agreed with tenants at the accounting date' (Quintain Estates and Developments plc 2003).

CLS Holdings plc also discloses what action is taken with regard to the early receipt of rental income with the following disclosure in the annual report for the second year. 'Rents received in advance are shown as deferred income in the balance sheet' (CLS Holdings plc 2002). By disclosing that advanced rental receipts are treated as deferred income, the company displays a degree of transparency and

allows a clear understanding of the revenue streams contained in its reported revenue.

CONCLUSIONS

The various theories identified in this paper (institutional theory, economic consequences and politicisation of accounting), underpinned by the model of corporate accountability, have been developed in order to explain the behaviour of companies and accounting standards setters in the UK. In general, the accountants interviewed expressed similar views, suggesting that these models are useful in developing paradigms to help to explain the nature of the accounting framework. To the accountants, particular issues of relevance to the property profession were not seen as deserving of unique treatment. Analysis of the corporate accounts proved inconclusive in terms of relevance to the models, although this was not expected in this preliminary study. The findings did suggest a majority of firms were not offering complete transparency, however, and leads one to questioning the reasons for this. It is also an additional area that will need to face compliance in the post-2005 era of IAS.

Legitimacy theory was the most easily identifiable theory in the observations of interviewees. This theory helped to explain the behaviour of companies disclosing revenue recognition policies prior to the ASB's November 2003 amendment to FRS 5 and Exposure Draft issued in 2001. The observations of interviewees were in agreement that companies disclose policies both as a means of attaining legitimacy and in order to discharge corporate accountability. Companies are more likely to disclose accounting policies in the absence of a standard when their market performance is adversely affected by the absence of a disclosure, because of the formation of a legitimacy gap. Property companies were broadly split in half within the sample in their adoption of a stated policy. This division appears particularly strange within the theory, since disclosure prior to adoption by peers should follow only in cases where this action enhances a company's corporate image in the hope of extracting some benefit from the enhanced image. Further research will follow in order to interview property companies and obtain the reasoning for reporting decisions.

The interviewees agreed that economic consequences and politicisation are applicable in describing the behaviour of companies and tend to occur together. In the political process of setting accounting policies, interested parties use the arguments of economic consequences to promote their submissions. It is also true that in cases where economic consequences arise, these issues gain political importance. The interviewees observed that, in practice, when an issue becomes topical and the subject of political importance, this is normally as a result of economic consequences surrounding the issue. The most commonly mentioned example of this among interviewees was, predictably, Enron. Further research

will endeavour to discover whether property companies perceive these issues in the same way.

This research aimed to discover whether revenue recognition is a problem in the UK in general, and for property companies in particular. The result is a qualified affirmative. While all respondents agreed that there were inconsistencies, there were differing opinions about the manner in which those concerns have been addressed. Accounting respondents also doubted the independent interests of the property sector, while the analysis of the accounts showed widespread variation. Further research will follow to analyse the viewpoints of property companies, and to explain their positioning within the models developed here.

APPENDIX: COMPANY ACCOUNTS ANALYSED

AGIV Real Estate
Ashtenne Holdings plc
Brixton plc
Canary Wharf Group plc
Capital & Regional plc
CLS Holdings plc
Daejan Holdings plc
DTZ Holdings plc
Freeport plc
Grainger Trust plc
Great Portland Estates plc
Halladale Group plc
Helical Bar plc
Land Securities Group plc
London Merchant Securities plc
NHP plc
Pillar Property plc
Quintain Estates & Developments plc
Rugby Estates plc
Savills plc
Shaftsbury plc
Slough Estates plc
The British Land Company plc
Warner Estate Holdings plc
Workspace Group plc

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Notes

1. The authors have discussed the relevance of this standard in other papers, see for example Holt and Eccles (2001).
2. This is an issue that the authors will review in a later paper.
3. Accounting for Pension Scheme Liabilities released in November 2000 — a controversial policy which forced companies to disclose the extent of their pension liabilities on the balance sheet.

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