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Relevance, Reliability, and the Earnings Quality Debate

Gary M. Entwistle and Fred Phillips

ABSTRACT: These instructional materials are designed to elicit debate about the primary accounting qualities of relevance and reliability, and to encourage you to consider how these qualities are linked to the debate over earnings quality. The case material comprises two narrative essays, which elicit divergent views about relevance and reliability, and several discussion questions. You will use these essays and discussion questions as the foundation for a discussion and building a deeper understanding of earnings quality, through extensive inquiry of fundamental financial accounting concepts.

ACCOUNTING LOSES FOCUS ON REALITY

The Future of Accounting and Disclosure in an Evolving World: The Need for Dramatic Change

—Wallman (1995)

The Day Has Come to Put Brand Equities on Our Balance Sheets

—Ambler (1999)

Is the Balance Sheet Outdated?

—Batchelor (1999)

Have Financial Statements Lost Their Relevance?

—Francis and Schipper (1999)

Brainpower on the Balance Sheet

—Aston (2002)

These are ominous titles to be sure. But what are their underlying messages? That the world has changed, but accounting has stood still! That it's high time to wake up and smell the intangibles!

There is little doubt the accounting profession is under constant fire, from all quarters, business and academic alike, for its seeming inability to remove its historical

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Gary M. Entwistle and Fred Phillips are Associate Professors at the University of Saskatchewan. Professor Phillips is currently on leave at The University of Texas at Austin.

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cost cloak and become relevant in a world where intangibles rule, where creating brand value is the business strategy of choice, where cutting back on R&D spending is not an option, and where human capital, and the need to invest in it, is patently obvious to all enlightened managers.

Who can argue? These are the characteristics of the business world in which we live. Coke and Nike *are* building brand equity, Microsoft and Cisco *are* spending billions of dollars on R&D, and Citigroup and McDonalds do see their employees as their most valuable assets. These things are quite clear. The question is whether accounting, at least in its present form, is of use in this business world. The answer, seemingly, is no—and the evidence is overwhelming.

Take for example a recent Interbrand survey,[1] which was released with great fanfare. According to Interbrand, Coke, the world's most valuable brand, is valued at approximately $72.5 billion; a value representing 51 percent of that company's market capitalization. Nike meanwhile has its brand value estimated at $8 billion; representing 71 percent of its market capitalization. Two other "Billion Dollar Brands," Hertz and Adidas, have brand values estimated at 110 percent and 151 percent of their respective market capitalizations. Meanwhile, a quick look at the accounting for these values. Nothing. The brand assets—invisible! And to be clear, neither a $100 billion valuation nor 200 percent of market capitalization will get the brand any closer to the balance sheet.

Next stop—R&D. In a recent year, Microsoft recorded approximately $3.8 billion as an R&D *expense*.[2] Cisco meanwhile showed a $2.7 billion R&D *expense*.[3] An expense—surely not! Their R&D is top shelf, and the resulting products are market leaders. These firms are the future for high tech. Surely if any two companies shouldn't be expensing their R&D, it would be these two. Clearly, their R&D expenditures are investments that create "future economic benefits." Sorry—rules are rules—accounting spares no one. There's just no room on the balance sheet for R&D.

Investing (or planning to invest) in human capital? What smarter way is there to ensure the success of a business? Indeed, people are the business. Take Citigroup, where the message from the Chairman's Office is that "Citigroup at its core is the people who work here every day," and that "We are investing in our employees' training, their potential and their futures."[4] Likewise, at McDonalds, the "People Promise"[5] remains strong, and the Chairman reminds us "Our people…are the foundation of our global success."[6] Indeed, the whole economy seems to have heard the message, as reports tell us that "creative workers" (e.g., engineers, computer scientists, entertainers) comprise an increasing proportion of all employees in the economy (Lev 2001). Enter Accounting—Stage Right. Expense those people costs! Keep those entertainers off the balance sheet!

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[1] This survey can be found at: http://www.brandchannel.com/interbrand/test/html/events/mvb_99_and_00.pdf.

[2] Microsoft's financial statements can be found at: http://www.microsoft.com.

[3] Cisco's financial statements can be found at: http://www.cisco.com.

[4] These comments are contained in the Message from the Office of the Chairman in Citigroup's 1999 Annual Report.

[5] This discussion can be found at: http://www.mcdonalds.com/corporate/promise/people/people.html.

[6] These comments are contained in the Chairman's letter to the shareholders in McDonalds' 1999 Annual Report, available at: http://www.mcdonalds.com/corporate/investor/financialinfo/annual/archive/1999/index.html.

The underlying theme is that accountants have lost their way; that is, as firms invest, accountants expense. And the saddest part of all is that it didn't have to be this way. In accounting we define assets as "future economic benefits," a definition that brands, investments in R&D, and human capital surely fit. Interbrand tells us that by simply being true to our own definitions, we could instantly add $912 billion to the balance sheets of 75 brand-conscious firms. One can't even begin to envision the billions (or trillions) of dollars more we could add for R&D and human capital. And these three items represent only the tip of the intangible iceberg. Imagine if the whole iceberg were placed on the balance sheet—such things as pricing power, distribution channels, political connections, strategic locations, community involvement, and a reputation for quality. The outcome would be a set of financial statements, rich in intangible assets and true to accounting's own definitions, which contribute to improved investment decisions and to a full and healthy recovery for the accounting profession.

Well, what about it? Why not a quick Marlboro brand on accounting's backside? Why not the line item "Dr. Smith's genome insights"? Why not Dr. Smith himself? Surely accounting isn't that hung up on reliability. It's this obsession with ensuring that "information is reasonably free from error and bias and faithfully represents what it purports to represent" (FASB 1980) that got accounting into this mess in the first place, and that is keeping real assets off the balance sheet. Come on people, it's time to show a little faith! It's a new world out there. Just a few minutes of web surfing will inform you that the Boston Consulting Group has "developed a robust system for measuring the value of a brand,"[7] that Interbrand's "Brand Valuation" is "a unique tool that quantifies the economic value of a brand,"[8] and that KPMG values intangibles. Further, these measurement tools can incorporate "*everything* that contributes to the purchasing decision and shapes the ownership experience"[9] (emphasis added). Sure, some subjectivity is involved, but accountants already have plenty of experience with estimation. Besides, desperate times call for desperate actions. Let's do accounting a huge favor and get rid of this reliability obsession.

[7] See http://www.bcg.com.
[8] See http://www.interbrand.com.
[9] See http://www.bcg.com.

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ACCOUNTING REMAINS PATIENT

No one can reasonably argue against the business case for developing brand value, investing in R&D, and training employees, or that these, and myriad other intangibles, will likely result in "future economic benefits" for the firm. Hence, according to our current definitions, it appears these intangibles may be "assets." The critical questions for accounting, however, are *when* should these "assets" be recorded on the balance sheet? And, has accounting truly lost its way?

Let's deal with the second question first. It is becoming increasingly common to hear that the market-to-book value ratios of companies have been steadily growing, indicating increasingly incomplete and uninformative financial statements (e.g., Lev 2001). Outdated accounting is the primary suspect; in particular, the finger points to balance sheets void of increasingly important intangible assets. Such evidence, however, seems to suggest that the holy grail of accounting would be a set of financial statements that at all times mirrors the stock price, and where zero discrepancy exists between accounting reports and market values. Does evidence that suggests accounting is moving farther from this grail imply that accounting has lost its way? Panic stations everyone? We say no, for two reasons.

First, as pointed out in the conceptual framework, "Financial accounting is *not* designed to measure directly the value of a business enterprise" (FASB 1978) (emphasis added). In other words, a market-to-book-value ratio of 1, or a recording on the balance sheet of all "assets" the market deems to have value for the firm, neither is, nor should be, the goal of accounting. To think otherwise, to deem accounting and valuation as synonymous, would surely set accounting adrift in a sea of hopeful guesstimates of borderless and potentially volatile assets, completely unable to attest as to whether a firm's financial statement is "reasonably free from error and bias and faithfully represents what it purports to represent" (FASB 1980).

Second, any attempt to use the stock market to judge accounting's usefulness rests on accepting the unswerving accuracy and sanctity of stock prices—and at all times! As Warren Buffett noted, "When the price of a stock can be influenced by a 'herd' on Wall Street with prices set at the margin by the most emotional person, or the greediest person, or the most depressed person, it is hard to argue that the market always prices rationally. In fact, market prices are frequently nonsensical" (Hagstrom 1999). Accounting, we suggest, would be wise to question the calls for change emanating from this market value fixation.

What then, about the first question. *When* should these (intangible) assets be recorded in the financial statements? The answer, not surprisingly, is when we have a *reliable* measure of them—one "reasonably free from error and bias." Interestingly, what this leads to is that we will never directly place the intangible asset itself onto the balance sheet. Instead, only the resulting "economic benefits" are recorded. And this is only logical. You see, Coke isn't actually in the "business" of building its brand equity; Microsoft isn't in the "business" of building its R&D infrastructure; and McDonalds isn't in the "business" of enhancing its human capital. They are, respectively, in the business of selling soft drinks, selling software solutions, and selling hamburgers, and their intangible assets simply help them to do this. When, then, does accounting have a reliable measure of the firm's intangibles? When are they recorded as assets? When they are revealed in the sale of a Coke, the sale of a Windows operating system, or in the sale of a Big

Mac. This is what accounting does, what reliability leads us to do. It requires, indeed it demands, that we be patient and wait for the signal, the unequivocal and unambiguous measure (Ijiri 1975), which reliably confirms the (intangible) asset truly exists.

So, in accounting, two things happen. First, we typically expense the investments firms make in brands, R&D, human capital, and numerous other "intangible" areas of the business. Second, we wait for a reliable signal to emerge before we record the value of these expenditures (i.e., these assets) into the financial statements. In other words, the asset is guilty (does not exist) until proven innocent (it exists) beyond reasonable doubt, until, to use Littleton (1953), a "transactional experience" takes place. Will all the firm's (real) "intangible assets" eventually find their way into the financial statements? Will all the firm's (real) "future economic benefits" eventually be recorded? Will accounting ever truly portray the (real) "value" of the firm? Yes, when accounting has proof.

So, can accounting continue to remain patient? Can it live with market-to-book-value ratios of 6, or 10, or 200? Should it continue supporting the primacy of reliability? We would suggest this remains our best option for external financial reporting. The price of losing patience would be far too high, and accounting should not risk divorcing itself from that quality of information that "permits users of data to depend upon it with confidence as representative of what it purports to represent" (AAA 1977, 16). We believe that accounting has not lost its way.

Information is all around us; it is given to us for free; it is sometimes even forced upon us. "Reliable" information, however, is a rare commodity. It is worth waiting for.

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DISCUSSION QUESTIONS

Prepare to discuss the assigned essay(s) within the context of the following discussion questions and the arguments expressed in the Statement of Financial Accounting Concepts (SFACs) referenced below in parentheses.

1. What are the objectives of financial reporting? (SFAC No. 1, FASB 1978)
2. What are the primary qualities of useful information? (SFAC No. 2, FASB 1980)
3. What constitutes the resources (and claims on resources) of an enterprise? (SFAC No. 6, FASB 1985)
4. When should these resources (and claims on resources) be recognized? (SFAC No. 5, FASB 1984)
5. How do the preceding questions relate to earnings and earnings quality? (SFAC No. 6, FASB 1985)

DISCUSSION QUESTION REFERENCES

Financial Accounting Standards Board (FASB). 1978. *Objectives of Financial Reporting by Business Enterprises*. Statement of Financial Accounting Concepts No. 1. Stamford, CT: FASB.

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CASE LEARNING OBJECTIVES AND IMPLEMENTATION GUIDANCE

Objectives

The primary objective of these instructional materials is to illustrate how the debate over earnings quality is fundamentally a debate between the primary accounting qualities of relevance and reliability. A second and related objective is to weave this debate within the context of FASB's conceptual framework, thereby providing instructors an alternate means for discussing critical accounting concepts.[10] We believe the writing style used in the essays and the basic discussion questions posed make these materials appropriate for any financial accounting class in which the qualitative characteristics of accounting information are discussed.

Earnings Quality

A quarter of a century ago, Siegel (1977, 315) noted that "[i]t is evident…that the term 'quality of earnings' does not admit to simple definition." Today, there continues to be a number of definitions of earnings quality (Beneish 2001). In this paper we define earnings quality as the ability of earnings to meet the primary objective of financial reporting, which is to provide to investors and creditors, and other users, information that is useful for evaluating the cash flow prospects of an enterprise. This perspective is consistent with Siegel's (1977, 277) original observations that any appraisal of quality can only "be formed in terms of favorable or unfavorable *characteristics* in earnings" (emphasis added), and with more recent writings (e.g., AICPA 2000; Jonas and Blanchet 2000; McDaniel et al. 2002; SEC 1999; Turner 2000) emphasizing the critical trade-off between relevance and reliability when assessing earnings quality.

Narrative Essays

The case materials comprise two purposely provocative and contrasting narrative essays about the relevance and reliability of accounting information where firms possess significant internally generated intangible assets. In this setting, critics suggest (e.g., Lev 2000, 2001) the existing financial accounting model[11] most dramatically degrades the quality of such information. The first essay, entitled "Accounting Loses Focus on Reality," criticizes financial accounting for failing to produce *relevant* information, while the second essay, entitled "Accounting Remains Patient," argues the merits of producing *reliable* information. The essays are framed in terms of relevance and reliability because these characteristics are ultimately at the heart of discussions of earnings quality.

Instructors will note that although the topic of earnings quality is an important part of these instructional materials, the essays make no specific mention of

[10] The objective of weaving the earnings quality debate within FASB's conceptual framework responds to calls made by Michael Crooch, FASB Board Member, and Lynn Turner, former SEC Chief Accountant, for finding new ways of centering discussions of contemporary accounting issues on the conceptual framework (Crooch 2002; Turner 2002).

[11] The existing model of financial accounting referred to is represented by the U.S. accounting standards currently being used in practice. This multiattribute model, which uses transaction-based historical cost as the predominant measure for intangible assets, essentially represents the decisions that have been made when operationalizing the SFACs.

earnings or earnings quality. This is deliberate for two reasons. First, much of the criticism of accounting, at least within the popular press (e.g., Aston 2002; Gross 2001; Stewart 2001), takes place at the "asset" level—in questioning whether recording or not recording nontraditional assets in a firm's financial statements makes accounting more or less relevant or reliable. To be consistent, the essays are written at this same level. Second, and more importantly, by excluding earnings and earnings quality, the essays set the stage for the series of conceptual questions that encourage students to discover for themselves how a firm's earnings, and the quality of its earnings, flow from the same decision whether to record a firm's assets in its financial statements. This approach requires that instructors be patient when discussing the essays, in the sense that the discussion questions do not rush to the topic of earnings quality. Instead, the questions unfold in a logical and cascading progression, with each question building on the previous one, never mentioning earnings quality until the final question. It is at this culminating point that students should experience the "a-ha," when they realize that the topic of earnings quality is inextricably linked to the fundamental relevance/reliability trade-off.

Instructors will also note that the essays take certain liberties, such as ignoring that some firms' R&D expenditures can be recorded as assets, that the definition of assets goes beyond "future economic benefits," or that the terms "historical cost" and "value" are not clearly defined or contrasted. These liberties also are taken for two reasons. First, they provide instructors with opportunities to deepen students' understanding of the pertinent issues through subsequent discussion (more fully described in the Teaching Notes). Second, we believe these liberties heighten the contrast between the positions advocated in the two essays, thereby increasing the likelihood the essays will elicit divergent views that will engage students and spark discussion.

Implementation Guidance

Our recommended approach for using the case materials involves three steps: (1) spark an initial classroom discussion, (2) require a written critique of the narrative essays, and (3) engage in a subsequent classroom discussion. This approach requires approximately 25 minutes of classroom time in each of two successive class meetings. An alternative approach, upon which we do not elaborate, is to combine the initial and subsequent discussions into a single 50-minute class meeting and to assign the written critique as a post-class exercise.

Initial Classroom Discussion

We suggest instructors begin by splitting the class into two groups. One group is assigned to read, prior to class, the relevance essay entitled "Accounting Loses Focus on Reality," and the other group is assigned to read the reliability essay entitled "Accounting Remains Patient." Both groups are assigned the five discussion questions to consider in advance of class.[12] To encourage comprehension of the arguments in the assigned essay, we also advise assigning students the task of preparing a bullet-point summary of the main arguments embedded in the narrative essay that they have been asked to read. When these tasks are assigned,

[12] Because most students require just ten minutes to read one of the essays, the readings and questions could be distributed at the beginning of class.

students should be reminded that "financial accounting"—a term used throughout the essays—often is used as an abbreviation for "general purpose external financial reporting by business enterprises" (FASB 1978).

To encourage the initial classroom discussion, we suggest asking students: "Should financial accounting favor the relevance or reliability of information for decision making, and why?" We have found that this normative question elicits many of the divergent views expressed in the essays, and results in a spirited debate.[13] If the trade-off between relevance and reliability is not explicitly raised during the discussion, instructors should ask the question: "Is there an ideal level of relevance and reliability for financial information to be useful?" This question presents opportunities to acknowledge specifically that a trade-off exists and to recognize that the relative importance attached to relevance and reliability will likely differ for different kinds of decisions and for different groups of users. Whereas the earlier normative question sparks divergence in opinions, this trade-off question moves student opinions toward convergence.

After the main arguments from the essays have been raised and the relevance/reliability trade-off has been highlighted, instructors should then pair each student who was assigned the *relevance* essay with a student who was assigned the *reliability* essay. The pairs should be asked to share their bullet-point summaries with one another, to again highlight the pertinent arguments, and to further reinforce the inevitability of a relevance/reliability trade-off.

Written Critique

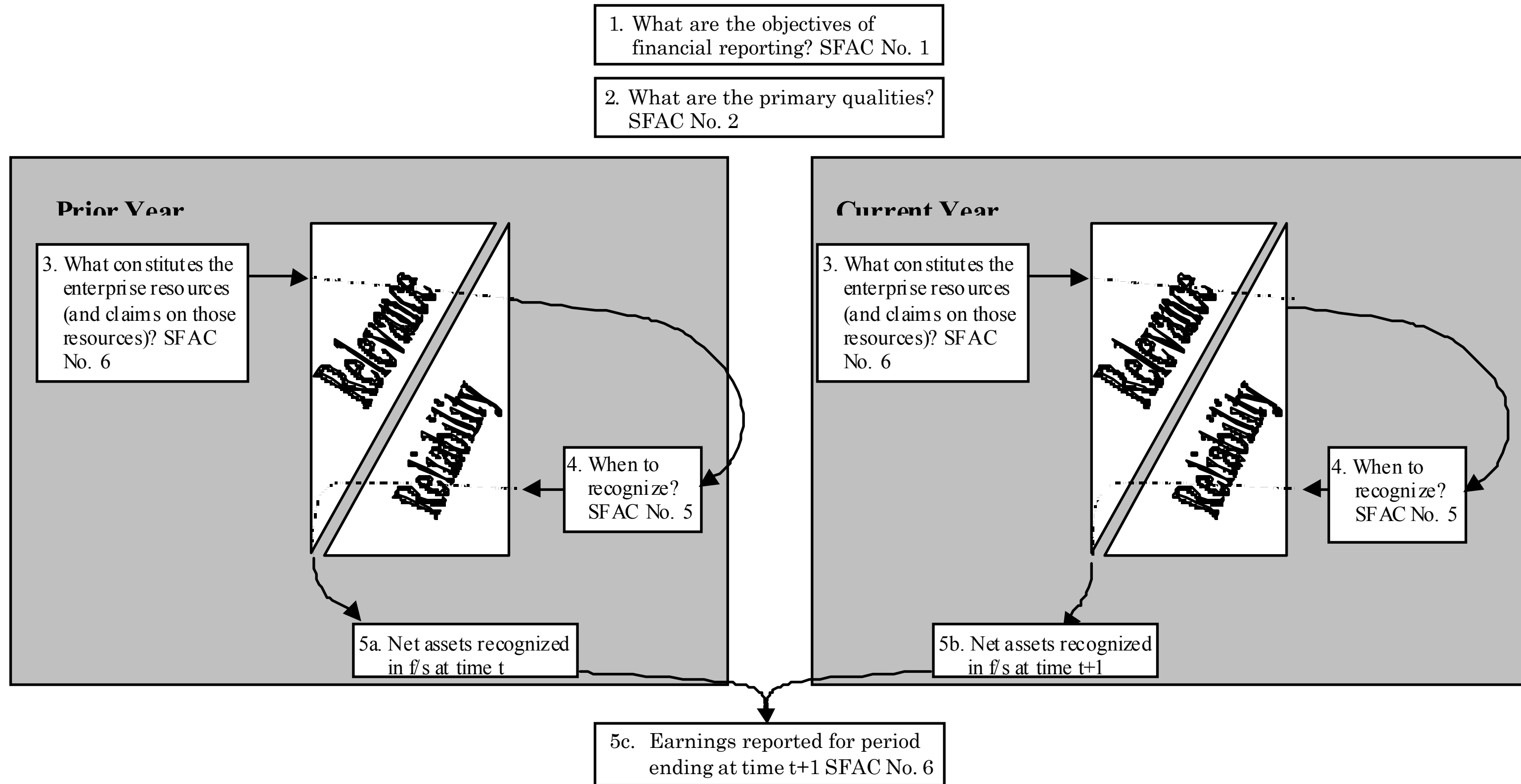
The pairs should then be assigned a task of preparing, for the following class, a written critique of the two narrative essays. The main objective in the critique is to critically evaluate the arguments contained in the two essays. To aid in preparing the critique, we advise students to reread the essay assigned to them in class, along with the essay assigned to their partner. We also recommend providing each pair with the five discussion questions. Finally, in considering the discussion questions, we recommend that instructors encourage their students to reference the FASB Concepts Statements. This latter recommendation should enable students to prepare more informed written critiques.

Subsequent Classroom Discussion

In the following classroom meeting, the organizing framework in Figure 1 should be presented to students. When presenting this framework, instructors should acknowledge that it is constructed from the SFACs. The framework begins (in Box 1) with identifying the objectives of financial reporting (Discussion Question 1), which SFAC No. 1 (FASB 1978, paragraph 32) defines as presenting useful information, broadly defined. The second discussion question (Box 2) then introduces the primary qualities of useful information of relevance and reliability that are discussed in SFAC No. 2 (FASB 1980, paragraph 33). We use triangles in Figure 1 to depict: (1) the inevitable trade-off between relevance and reliability, and (2) the varying weight given to relevance and reliability as one focuses on each subsequent stage of the financial reporting decision process. Relevance appears to be weighted more heavily when SFAC No. 6 (FASB 1985, para. 25)

[13] As an alternative approach, instructors might wish to create a formal debate of the resolution that "financial accounting should favor relevance over the reliability of information for decision making."

FIGURE 1
Organizing Framework



This figure illustrates that relevance and reliability are the primary qualities of earnings and other accounting information that aims to meet the objectives of financial reporting. Presenting relevant accounting information is the primary concern when identifying what constitutes the enterprise resources (and claims on those resources). However, before these resources (and claims on resources) are recognized in the financial statements, there is a need to cycle-back and evaluate more closely the reliability of the accounting measures. Upon demonstrating adequate relevance and reliability, net assets (i.e., enterprise resources and claims on resources) are recognized in the balance sheet. Earnings reported for the period t+1 then "fall out" from changes in the net assets of the firm between time t and t+1. Hence, the quality of earnings is dependent on the quality of recognized net assets, which ultimately depends on decisions involving relevance and reliability.

responds with a broad and flexible definition to the question (Box 3): "What constitutes the resources (and claims on resources) of an enterprise?" In contrast, as one approaches questions about recognition (Box 4), which are addressed in SFAC No. 5 (FASB 1984, paragraph 63), the relevance/reliability trade-off places greater emphasis on reliability concerns.

Figure 1 consequently allows students to visualize the fundamental trade-off between relevance and reliability, and to understand at which stage of analysis relevance and reliability become more/less prominent within the existing financial accounting model. In essence, we suggest that relevance and reliability be viewed as "quality filters" through which all financial reporting decisions pass, and which ultimately affect the quality of a firm's reported earnings (Boxes 5a to 5c). We elaborate on this point (and on points related to all of the discussion questions) in the Teaching Notes, which helps to operationalize the framework in Figure 1. To aid in this elaboration, the Teaching Notes also contain a table that organizes points of discussion around the five discussion questions and the two narrative essays. Instructors can use this table as a guide when prompting key points of discussion, and they can use it as a basis for judging the depth with which students critiqued the narrative essays.

Empirical Validation

We conducted an experiment with senior undergraduate accounting students[14] in which two groups were created—one that read the relevance essay before the reliability essay, and another that read these essays in reverse order. We asked students to indicate their beliefs about the relative importance of the primary accounting qualities of relevance and reliability at three different stages of the experiment: (1) before reading either essay (to assess baseline beliefs), (2) after the first reading, and (3) after the second reading. By creating these two groups and by measuring their beliefs before and after they read each essay, we could obtain preliminary evidence that their views about the relevance/reliability trade-off diverged after reading the first essay (i.e., a desirable condition for provoking debate), and then converged after reading the second (contrasting) essay (i.e., a desirable condition for achieving a balanced debate).

Results of repeated-measures analyses of variance showed that students in the two groups held similar views before the first reading, then diverged significantly after the first reading, and converged after the second reading. We interpret the divergence of views as evidence that the essays are effective in provoking contrasting views, and the convergence of views as evidence that the essays help students to appreciate the inevitable trade-off between relevance and reliability. An additional correlation analysis indicated that students' views about relevance and reliability did not depend on whether they were evaluating the importance of these two qualities for accounting information, in general, or for earnings, in particular. These results are consistent with students recognizing the link between earnings quality and accounting information quality in general.[15] Finally, as

[14] Participants included 40 accounting seniors who completed the experiment in one class session during the last week of their final term—a point at which the participants had largely completed the entire accounting curriculum.

[15] Details about experimental procedures, data, analyses, and limitations are available from the authors upon request.

additional preliminary evidence of the essays' effectiveness, we observed lively student debate of the main arguments raised in the essays during the remainder of the class session in which the experiment was conducted.

CONCLUDING COMMENTS

Some critics argue that accounting has lost its relevance, primarily because it fails to recognize internally generated intangible assets. Others are questioning the quality of firms' reported earnings. The instructional material in this manuscript responds to both criticisms, and thereby makes three contributions. First, the material can be used to help students see that any changes that might be made to enhance the relevance of accounting, for example by recognizing internally generated intangible assets, will have a corresponding effect on earnings. Given the inherent trade-off between relevance and reliability, changes that sacrifice reliability to enhance the relevance of asset reporting also will sacrifice the reliability component of earnings quality. Second, the material implies that when viewed from the opposite direction, criticisms about earnings quality are fundamentally criticisms about the failure to recognize the net assets of a firm. Instructors can use this perspective to demonstrate that to improve the quality of earnings, standard setters will need to improve standards pertaining to the recognition of assets (and liabilities). Third, the instructional material can be used to assist students in understanding that a relevance/reliability trade-off is at the center of both of these important topics.

Finally, there exists speculation that antagonism between accounting standard setters and corporate executives arises because the former group focuses on the recognition of assets (and liabilities) whereas the latter group focuses directly on earnings. An interesting issue for future investigation is to determine the extent to which these groups differ in their focus and whether this difference actually translates into different perceptions and concerns regarding the quality of earnings.[16] For now, these instructional materials can be used to suggest to the standard setters and corporate executives of tomorrow that, regardless of their focus, the quality of earnings ultimately depends on decisions involving relevance and reliability.

TEACHING NOTES

Teaching Notes are available through the American Accounting Association's new electronic publications system at http://aaahq.org/ic/browse.htm. Full members can use their personalized usernames and passwords for entry into the system where the Teaching Notes can be reviewed and printed.

If you are a full member of AAA and have any trouble accessing this material please contact the AAA headquarters office at office@aaahq.org or (941) 921-7747.

[16] We are grateful to the special editor for suggesting this possibility.

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