Universal Journal of Accounting and Finance 11(1): 1-8, 2023 http://www.hrpub.org
DOI: 10.13189/ujaf.2023.110101

The Dilemma: Push-Down Accounting and the Conceptual Framework of Financial Accounting: A Case of Contradictions between Relevance and Reliability

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Received July 16, 2022; Revised October 19, 2022; Accepted November 14, 2022

Cite This Paper in the Following Citation Styles

(a): *[1] Khalid Al-Adeem , "The Dilemma: Push-Down Accounting and the Conceptual Framework of Financial Accounting: A Case of Contradictions between Relevance and Reliability," Universal Journal of Accounting and Finance, Vol. 11, No. 1, pp. 1- 8, 2023. DOI: 10.13189/ujaf.2023.110101.*

(b): *Khalid Al-Adeem (2023). The Dilemma: Push-Down Accounting and the Conceptual Framework of Financial Accounting: A Case of Contradictions between Relevance and Reliability. Universal Journal of Accounting and Finance, 11(1), 1 - 8. DOI: 10.13189/ujaf.2023.110101.*

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Abstract While some accountants are against using push-down accounting to prepare separate financial statements, others argue that it provides a suitable measurement. Authorities in the United States have issued rules and statements specifying where this practice could be applied. The opponents argue that, first, financial statements using push-down accounting could mislead some users due to the changes in the bases for valuation of the assets and liabilities of the acquired company. Second, the comparability property of the financial statements is lost. Third, the entity assumption is violated. On the other hand, the proponents state that push-down accounting allows providing relevant information to the stakeholders. That is, financial statements are based on current prices reflecting the real financial standing of the subsidiary. To them, an acquisition is a complete transaction and therefore, its impact must be reflected in the financial statements. Finally, they state that push-down accounting is a welcomed practice in many countries except in the United States. This article presents arguments to address some of these concerns. The variation of bases that occurs when push-down accounting is applied, additional information based on the historical cost model can be disclosed with the published financial statements to assist the stakeholders in making their decisions. The argument regarding the violation of the entity assumption is valid when accounting for a business combination is pushed down in corporate reporting. Additionally, since the external party's valuation is deemed to be evidence of the new value of the proportion of the acquired assets and liabilities, the parent company when applying push-down accounting provides a new value to a significant portion of the subsidiary. Using push-down accounting breaches the conceptual framework, which operates as the constitution of financial accounting for business enterprises, which weighs reliability more than relevance of information characteristics. While combining 'reliability' and 'relevance' is impossible, a tradeoff between them must be found.

Keywords Push-Down Accounting, Conceptual Framework, Corporate Reporting, Measurement, Relevance, Reliability

1. Introduction

A company owned by a single controlling shareholder must prepare separate financial statements in certain situations. The Securities and Exchange Commission (SEC) has directed subsidiaries with securities held by the public to file separate financial statements [1]. There are two ways for subsidiaries to publish these statements. First, subsidiaries can revaluate their assets and assumed liabilities using the price paid by the parent, in other words, they apply push-down accounting. In a business

combination, the separate financial statements of the acquiree are prepared using the accounting valuation criteria of the acquiring company [2]. As Baluch et al. [3] illustrated :

> *"Instead of recording the investment in the subsidiary on the parent's books and allocating the purchase price of identifiable assets, liabilities and goodwill through working paper adjusting entries, the allocation of the purchase price may be recorded in the subsidiary's accounts, thereby pushing the purchase price down into the subsidiary's records. The financial statements of the subsidiary report the cost incurred by the parent company in buying the subsidiary instead of the subsidiary's historical costs" (p.6)."*

The push-down accounting term was created because the acquiring purchase cost is pushed down onto the acquired firm's financial statements [4]. The second alternative is to keep producing financial statements using the pre-acquisition valuation, in other words, producing financial statements is based on the historical cost model.

With respect to push-down accounting, the accounting community is divided into two groups. The first group firmly believes that the practice is contrary to generally accepted accounting principles. In contrast, the other group believes that push-down accounting is a good measurement for the acquired company. The Financial Accounting Standard Board's (FASB) conceptual framework does not help resolve this debate because it is an unfinished work with conflicting guidance. This article serves as a critique of the FASB's Conceptual Framework project which aims to establish the fundamentals of the financial accounting practices. The article argues that there should be no contradiction in these fundamentals even in cases where a tradeoff is required such as the dilemma in the application of push-down accounting introduced above.

The rest of the article is organized as follows. Section 2 presents the conceptual framework of FASB as the constitution of financial accounting at the present time. Section 3 demonstrates that the conceptual framework is an unfinished work. Section 4 briefly illustrates the background of push-down accounting. Section 5 presents the view that uses the conceptual framework to argue against push-down accounting. Section 6 discusses the counterview. In order to benefit from the opposing arguments, section 7 evaluates the debate, laying a foundation for deducing a conclusion which is presented in Section 8. This section also suggests a direction for future research by evaluating push-down accounting in light of the IASB conceptual framework.

2. The Conceptual Framework of Financial Accounting: What is it?

As in other professions, accounting has procedures and methods that are applied and practiced with a theoretical foundation [5]. While a profession should be grounded on a theory, contemporary accounting is not guided by a single theory of its own [6-28]. Nevertheless, accounting has always been characterized by structured thinking [23].

Accounting has never been practiced simply without a conceptual basis [16]. A conceptual construction for practiced accounting has been structured and is in place. The FASB's Conceptual Framework project serves as a structure of reference accountants rely upon while practicing accounting [1]. The Conceptual Framework of financial accounting has a role in legitimizing and developing the accounting profession [20] and establishing accountants' power [29]. Without a framework, the conceptualized body of knowledge becomes fragmented [30,31].

The constitutionally accepted Conceptual Framework acts as a metatheoretical structure for deriving accounting standards to normalize accounting practices [32-34]. While the conceptual framework is accepted to legitimize the standard-setting procedure, it cannot be considered as "an actual theory" embodied in the document [34]. Until a theory of accounting gains wide acceptance, the conceptual framework is, for the time being, the basis for standardizing accounting practices, but not as a permanent substitution for accounting theory [35].

The conceptual framework is probably best defined as "a coherent system of interrelated objectives, and fundamentals that are expected to lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and reporting" [36]. The Conceptual Framework of FASB comprises of eight concept statements, five of which are superseded[2] [37-39].

3. Unfinished Conceptual Framework for Financial Accounting

The FASB's Conceptual Framework project is the most protracted and most expensive accounting project [40,41] and it is not completed yet. The discourse about its elements still exists. For example, a discussion about the FASB's amendment to its conceptual framework to eliminate "reliability" as a fundamental accounting property [42] has motivated several accounting researchers to comment on Ramanna's study [43-47]. In addition, SFAC No. 2 issued by the FASB [48] contained contradictions such as mandating relevance and reliability

[1] On the idea of a conceptual framework for financial reporting, see Power [72]. For analysis and discussion of the conceptual framework, see Storey and Storey [73]. On the methodology of constructing a conceptual framework for financial accounting, see Archer [40]. Zeff [74] deemed Macve "a close student of the FASB's conceptual framework" (see for example, Merce, [75,76]. For a textbook illustration of the conceptual framework, consult with Kieso et al. [77]; Nikolai et al., [78].

[2] Retrieved https://fasb.org/page/PageContent?pageId=/standards/concepts-statements.html last visit 5/23/2022) see also [22]. These five suspended concept statements are SFAC No. 1 [79]; SFAC No. 2 [80]; SFAC No. 3 [81]; SFAC No. 4 [82]; SFAC No. 6 [83]

in the information to be contained in corporate reports for general use [12], leading others to criticize it [48,49].

Despite its limitations, the FASB's conceptual framework is needed to develop the accounting profession and solve issues faced by the practitioners [49]. Professional accounting bodies around the world, recognizing the need for the conceptualization of practiced accounting, have more or less adopted the FASB's Conceptual Framework, e.g. the Saudi Organization for Chartered and Professional Accountants (SOCPA)[3] [35], the Gulf Cooperation Council Accounting and Auditing Organization (GCCAAO) [11] and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)[4] [12]. A verbatim adoption of the Conceptual Framework may not meet the needs of the societies and users that was intended to serve. This is because accounting is based on responding to its environment, which varies by civilization and society [85,86]. The cultural values of a society determine the accounting system that best serves the members of such a society [13,87,88]. For example, according to Shahatah [51], Islamic accounting practice requires that assets be valued at their current market values and not historical costs. Valuation at the current market value is crucial for the calculation of zakat – a form of levy in Islam. Similar to the definition in the Conceptual Framework, paragraph 4.25, issued by the International Accounting Standards Board (IASB), the definition of income in Islam includes gains and revenues for zakat purposes. In terms of zakat, selling goods entails income that is already realized by the possession of the goods. The act of selling does not generate income or gain. Instead, holding valued and appreciated goods generates income (particularly gains). Thus, zakat is calculated on the appreciation, that is, appraisal and increased value of goods held for one fiscal year. Using historical cost measurement to calculate zakat is not acceptable. The practice of valuing ending inventory as per "the lower of cost or market value" principle as an alternative to the historical cost principle is not appropriate except when the market value is lower than the cost.

AlSultan [52] states that calculating zakat on inventories that are valued at cost value neglects a proportion of unrealized gains from holding the inventories. Moreover, conservatism does not help in calculating zakat when the cost is lower. In this case, conservatism leads to a lower calculation of zakat dues.

In general, accounting practices may have dilemmas when guided by such conceptual frameworks. The accounting treatment of push-down accounting is one of them [53].

4. A Brief Background on Push-Down Accounting

Consolidating financial statements for corporate purposes is a longstanding accounting topic that is mostly standardized. Push-down accounting is a deeply rooted accounting method that emerged in the United States in the 1970s and was revived in 2014 [2]. Regulatory and professional bodies in the United States have paid much attention to the dilemma described above since the inception of this practice. However, much work should still be done. In 1972, the SEC presented an unpublished draft in which it required companies to establish a new basis for recording assets and liabilities using the purchase price to reflect the transaction. It is the same case when the net assets of a subsidiary are valuated using the fair market values as the net assets are sold. In 1976, the FASB brought up the question of whether a new basis should be used for financial statements of a business combination and any individual company. In 1979, the Accounting Standard Executive Committee (AcSEC) published a paper on "push-down accounting"[5] [89]. The key point of the paper was the percentage of the shares owned by the parent in a business combination. The paper stated that the parent should own at least 90% of the shares to apply push-down accounting. Push-down accounting was not an acceptable practice when AcSEC published the paper. In addition, Staff Accounting Bulletin (SAB) No. 54, November 1983, indicated that in a business combination in which all of the shares of the subsidiary are sold to the parent company or only a portion of the shares are sold and the subsidiary remains in existence, the same basis of accounting should be used for assets and liabilities.

The percentage used for the application of the push-down calculation is disputed. Baluch et al. [3] articulate that a divergence in the threshold where push-down accounting should be applied exists in the literature and detail that,

> *"The available authoritative guidance favors the use of push-down accounting if a subsidiary is owned 90% or more, prohibits its use for less than 50% ownership, and is silent if ownership is in the 50% to 90% range. An argument can be made that once an ownership of more than 50% exists, the non-controlling shareholders are no longer owners, per se, but resemble investors instead; suggesting the use of push-down accounting be used when ownership exceeds 50%."(Colley & Volkan, 1988 as cited Baluch et al. 2010: 8; Beams, et al, 2009 as cited in Baluch et al. 2010: 8)."*

[3] https://www.socpa.org.sa/Socpa/About-Socpa/About-us.aspx
4 See https://aaoifi.com/?lang=en

5 It was reproduced in 1985 as appendix B in Goodman & Lorensen [1985).

As a rule, Jeter and Chaney [54] proposed that "The SEC requires push-down accounting when the ownership change is greater than 95% and objects push-down accounting when the ownership change is less than 80%." Baluch et al.[3] conclude that "a general lack of authoritative literature exists as to how push-down allocations should be done when less than a 100% ownership exists."

5. Using the Conceptual Framework to Argue against Push-Down Accounting

The argument against push-down accounting is supported by different aspects. First of all, push-down accounting is not aligned with the historical cost principle [53,3]. Users of corporate reports may be unaware of the changed basis. As Allison and Paula [1] pointed out, they may not realize the management decision and look at the subsidiary's financial statements as an "autonomous" entity. Some users may deal with subsidiaries as separate enterprises. As a result, those users do not put in their accounts that what is included in the financial statements is affected by the price paid by the parent.

Second, comparing financial statements based on different bases might be challenging to users and limit the intended benefits of corporate reporting under push-down accounting [55]. Creditors rely on comparing financial statements between accounting periods, so adoption of a new basis — push-down accounting, making the evaluation challenging [4]. Attributing the differences might become difficult with the new basis. The comparable property of accounting information is eliminated as the new basis is applied. The historical concept gives financial statements the comparability property. Inconsistency in the bases of accounting measurement [55] results in losing the benefits of financial statements based on Generally Accepted Accounting Principles (GAAP) [56]. GAAP stands for the truth in accounting [6,57].

Third, using the push-down accounting basis breaches the entity assumption. Even though the transaction takes place, a closer look must be given to the two parties involved in this transaction. They are the acquiring company on one side and part of the acquired company's stockholders on the other side. Hence, the acquired entity does not get involved in that transaction at all. Clearly, "transactions of the entity's shareholders are not transactions of the entity and should not affect the entity's accounting" [3]. The application of push-down accounting violates the entity concept because the transaction was carried out between the shareholders of the acquired company, but not between the acquired company, and the acquiring company [3,53,54]. Shareholders' actions and activities should not be recorded in the acquired company's book and, therefore, should not affect its financial reports.

6. Arguing for Push-Down Accounting

Push-down accounting is executed by using current prices, leading to producing financial statements that virtually reflect economic reality. "The push-down accounting reflects the financial condition and results of operations on the subsidiary's books as reflected when the subsidiary's financial statements are consolidated with the parent's" [4]. When a considerable transformation in ownership takes place, the amount paid for an entity can indeed be almost the most relevant base for appraising the subsidiary's assets, liabilities, and outcomes of its operations from the viewpoint of the owners [59]. The historical cost in such a case breaches the relevance and representational faithfulness of information [3].

In addition, users of financial statements can decide effectively based on the economic impacts of the previous executive management's decisions. Even though some users demand financial statements based on the historical cost for comparing purposes, they still demand relevant financial reports prepared using the purchase price to determine how successful the new management is.

Using the fair value measurement to record the noncontrolling interest is acceptable in many countries except the United States [56]. However, there is no guarantee that this practice in the other countries is correct. Assuming that accounting practices used elsewhere in the world are appropriate, they are only appropriate for the places where they are implemented. This does not imply that the same practices are applicable in the United States as well. As mentioned earlier, accounting is social knowledge that is influenced by the society in which it is applied [12,60-62], the needs of the people and the businesses in that society [14,23,61,63-67] and the culture [13].

7. Evaluating the Debate

Some of the arguments that have been made against the push-down accounting technique in reporting a business combination's financial standing can be addressed. Concerning the variation of underlying bases that occurs when push-down accounting is applied, additional information based on the historical cost model can be disclosed with the published financial statements. However, the decision to disclose additional information or not depends on the cost/benefit criterion, which is part of the conceptual framework. Expected benefits from providing certain information via general-purpose corporate reporting should be more than its cost. Thus, the preparation of financial statements on the basis of push-down accounting and the disclosure on the basis of historical cost could therefore be an uneconomic solution. The historical cost concept is not only essential for the comparability property, but it is also necessary for accounting for minority interests. Cunningham [4] warns

that a minority has not sold its portion yet. Thus, its portion in equity and depreciation and other costs should be recorded only in the historical cost model [4].

Disclosure might partially solve some of the issues brought to corporate reporting due to the application of push-down accounting. But the breaching of the entity assumption cannot be addressed when accounting for a business combination is pushed down in corporate reporting. Apparently, with push-down accounting, a subsidiary as an entity does not have a transaction. Although part of the equity changes, the shareholders have done that between themselves. This has nothing to do with the subsidiary. Therefore, from the subsidiary's point of view, the definition of the transaction cannot be applied to this change in equity, and the subsidiary does not have any transaction to be measured. Instead, the subsidiary needs to continue using the previous valuation.

Under push-down accounting, the external party's valuation is deemed evidence of the new value of the proportion of the acquired corporation's net assets. As a participant in the market, the parent company provides a new value to a significant proportion of the subsidiary. In fact, “the exchange values are determined in an arms-length transaction among market participants resulting in evidence that has the highest degree of credibility” [3]. The new value is the market value of the part of the acquired subsidiary if the acquisition is less than 100%. Not to do so means not to communicate to the market the new value of the subsidiary. Historically, this was the main reason for prohibiting a pooling of interests.

8. Conclusions

This article presents critical evaluation on a debate between the opponents and the proponents of push-down accounting. The article clarifies that the opponents and the proponents of push-down accounting view the issue of pushing the price paid by the parent down to the subsidiary's corporate reports as extremely important to fulfill the corporate reporting obligations. While the opponent group pays much attention to GAAP, the proponent group advocates that the financial statements reflect the economic reality of the acquired company.

From a fundamental point of view, the attitude of the opposing group is probably appropriate, because the work of accountants and the development of the accounting profession must arguably take place within the accounting framework, and not violate its frame of reference. Accounting is the body of knowledge that has no postulates or axioms, as is the case in mathematics and physics [68]. It is built on four assumptions, one of which is the entity assumption, and other principles and concepts such as the historical cost concept. All of these together form the framework of accounting. Failure to follow this framework will lead to further contradictions in the profession.

Another criticism of push-down accounting is that disclosing additional information based on the cost concept does not always pass the cost-benefit test. For example, if producing additional information based on historical costs is greater than the expected benefits, that information will not be disclosed. Therefore, parties who have agreements with a company before the push-down accounting is performed face troubles in their evaluation and decisions.

The FASB and other authoritative bodies should oppose push-down accounting and discontinue the practice if they value reliability over relevance. On the other hand, push-down accounting should be an option for companies to provide relevant information when there is a significant change in ownership. Combining "reliability" and "relevance" is impossible. A compromise between them must be found [84].

Accounting is still evolving. Its theoretical structure is constantly changing [69]. Attitudes toward an accounting subject may change. Thirty years after the publication of his monograph co-authored with Professor Littleton in 1940 [70], Professor Paton [71] regretted promoting historical cost as the accounting measurement basis for corporations. He also wished the monograph had been out of print[6].

A possible extension for this article is to evaluate push-down accounting in light of the IASB's conceptual framework. Such an assessment will provide more clarity to the debate presented in this article.

Acknowledgment

I thank Dr. Abdulmalik Al-Hogail for reviewing and commenting on an earlier version of this manuscript. I thank the three anonymous reviewers for their comments. I am indebted to Case Western Reserve University for granting me access to their resources through the KSL Alumni Online Library, which made the completion of this article possible. All remaining errors are my own.

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