



Component depreciation in real estates

Will the burdens in practice only be leveled up by benefits in theory?

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Abstract

Seminar date: 2012-05-30

Course: BUSN69 Business Administration: Degree Project – Accounting and Auditing

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Five key words: Depreciation, component depreciation, K3, real estate and standard-setting.

Purpose: Our purpose with this thesis is to reveal the effects that component depreciation can have on Swedish non-listed real estate entities and why there is such great opposition among the preparers.

Methodology: We have done a qualitative study and our aim has been to approach our research questions and fulfil our purpose by using an inductive strategy. Literature in the frame of references has been used to analyse our empirical findings in order to draw conclusions.

Theoretical perspectives: We have used previous studies about the Swedish accounting development to give an explanatory value to how Swedish standard-setters are influenced by practitioners. Our starting point is to have a perspective that explains why practitioners are reacting to new standards by using studies about standards development and lobbying.

Empirical foundation: Exists of comment letters, interviews and illustrations on corporation's financial statements by using two component models. Comment letters from different organizations and companies regarding our study has been gathered. Suitable respondents to our study have been non-listed real estate's companies, organizations and an expert. Financial statements from non-listed real estate's companies have also been used as a basis for our calculations and illustrations.

Conclusions: There is no substitution to professional judgment when determine components in real estates and together with a recommendation derived from the business and regulation adjusted for ease the transition period the uncertainty in how to determine a component will be mitigated. Practical burdens have been successfully claimed when influencing Swedish standards-setters through history. We conclude that the reluctance seen in the real estate business is derived mainly from economic consequences when trying to influence the standard-setter instead of calming the practical hardship.

Preface

We would like to thank our advisor Kristina Artsberg for the time that she has spent reading our thesis and giving us advices which has helped us to increase the quality of our thesis. We would also like to thank Bo Nordlund who has giving us help with the choice of topic and also inspired us towards an interesting angle in our topic. Lars Andersson at The Swedish Property Federation has helped us to find relevant information so we were able to locate interesting respondents therefore we would also like to thank him. Last but not least we would like to state our appreciation towards the respondents whom has taking their time to talk to us and contribute to our thesis.

Lund 2012-05-24

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Abbreviations

IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IFRS	International Financial Reporting Standards
IFRS for SMEs	International Financial Reporting Standards for Small and Medium Sized Entities
PIAA (<i>FAR</i>)	Professional Institute for Authorized Accountants
SAAA (<i>ÅRL</i>)	Swedish Annual Accounts Act
SAPHC (<i>SABO</i>)	Swedish Association of Public Housing Companies
SASB (<i>BFN</i>)	Swedish Accounting Standards Board
SBA (<i>BFL</i>)	Swedish Bookkeeping Act
SFASC (<i>RR</i>)	Swedish Financial Accounting Standards Council

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Chapter 1 – Introduction

In this chapter we are introducing our research topic with a background to our problem which leads into a problem discussion that will help the readers to understand our research question and purpose. It also includes a limitation part where we argue for which restrictions we have done in our thesis. This chapter ends with a disposition where the reader gets an overview of our continuing process.

1.1 Background

In the beginning of the 21st century WorldCom one of the biggest telecom companies in the US filed for bankruptcy. Several shortcomings could be seen in their accounting behavior and some actions could even be seen as fraudulent. This accounting scandal was not based on a single decision or event but was a full scandal including some severe infractions in accounting and governance issues. What was stunning from an accounting perspective and one of the main reasons behind WorldCom's fall was the way they accounted for fixed assets and depreciation. Their accounting treatment of fixed assets was very aggressive when they capitalized expenses with no future benefits (Zekany et al 2004). In June 2002 it became impossible to hide the service and repair costs that WorldCom had for so long tried to postpone. In doing so they had overstated Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA) when huge amount of line costs was accounted for as new investments (Sadka 2006). This scandal reveals one of several valuation problems connected to depreciation and the effect it has on financial statements.

Fixed assets regulated in IAS 16 property, plant and equipment are important in many businesses and industries especially in transportation, energy, manufacture and mining where these assets are essential items on the balance sheet. Fixed assets are expected to be useful for more than one financial year and used in entities ongoing production and business (Marton et al 2010 pp 166-167). Assessment connected to fixed assets is mainly about how they shall be accounted for at the acquisition date and how subsequently valuation shall be conducted. Depreciation is required in subsequent valuation and is a way to allocate costs over the fixed assets useful life (Lind & Hellström 2011 p 11). IAS 16 states that this allocation shall be made on a component level, which means that the fixed asset is divided in parts. This applies only for parts with costs that can be identified and is significant to the total cost of the asset (FAR SRS 2010a IAS 16 §43). A common cited example is depreciation of airplanes where the engines should be separated from the airframe and depreciated according to their individual useful life (FAR SRS 2010a IAS 16 §44). A probable explanation for why this has been practice in the airline industries is because there are strict regulation to replace the engines at a specific time frame (Lind & Hellström 2011 p 37). This accounting treatment of depreciation has already been introduced for listed companies in Sweden due to adoption of IFRS in 2005 on a consolidated level. There is a new proposal from the Swedish Accounting Standard Board that suggest a strict implementation of component depreciation regarding

non-listed entities. This proposal that soon can be reality are anticipated to raise much controversies and debate especially applied on properties (Drefeldt 2012)

1.2 Problem discussion

The Swedish Accounting Standard Board has since 2004 been involved in a project where new standards are established to better suit different types of entities. It is called the K-project due to different companies shall be divided in different categories. The starting point for how entities shall be divided is the Bookkeeping Act and the project exists of four categories called K1, K2, K3 and K4. Entities are divided according to which report they are required to establish at the end of their financial year. Entities belonging to the K3 category need to be non-listed and present an annual report. Also they need to fulfill at least two of three criteria in having an average of 50 employees, 40 million SEC in balance sheet total or 80 million SEC in net sales (Lundqvist 2011). The aim of the project is to establish relevant standards that will not generate additional costs or burdens for entities. K1 and K2 have been established and exist of nearly the same valuation and measurement rules. K3 will have a different valuation and measurement approach due to it is based on IFRS for SME and SASB is still processing these standards (SASB 2009). There are already today accounting standards in Sweden that regulates component depreciation. SASB:s standard (FAR SRS 2010a BFNAR 2001:3 §6:3) and SFASC:s standard (FAR SRS 2010c RR 12 §24) do both required component depreciation, but they expresses a vague wording that is only encouraging. The wording in the K3 draft is stronger and states that properties shall be divided in components if there is a significant difference in consumption patterns for different parts in the total asset. Accordingly, this will lead to a compulsory use of component depreciation due to standards can no longer be interpreted only as advice (Hellman 2011).

A compulsory use of component depreciation will lead to a change in accounting treatment for tangible assets. Entities belonging to K3 that carrying huge amount of tangible assets in their balance sheet will be heavy exposed to this new standard and in the real estate business there can be seen a great reluctance from their representatives and organizations. Why the real estate business has critical views in this matter is because they obviously having huge amounts of tangible assets and buildings can be separated in many different components, which requires a lot of work (Lundqvist 2011). There is a view that tangible assets in the real estate business do not need a more comprehensive depreciation approach because the important information that should be disclosed about the property are more regarding fair value and cash flow. Comparing to industries that uses their buildings for production and has equipment and machines this approach can be more legitimate. Properties in the real estate business have another purpose and depreciation can be regarded as relatively incurious. Companies are reacting negative as they see increased costs due to implementation and administrative burdens and entities have put pressure to erase this standard or at least make it optional (Lundqvist 2011). Standard-setters in Sweden have a history of listening to practitioners concerns which makes the practical reasoning an important factor when introducing new standards (Jönsson 1991). It will therefore be interesting to see if the reluctance in the real estate business are using practical burdens and limitations as arguments

when they expressing their concerns to the standard-setter. Nobes (1992) have identified different parties involved when a new standard are produced and tries to explain their behavior and reactions. Several parties and factors are recognized like corporations, governments, auditors, international influences and users of financial statements. These parties are involved in a standard setting procedure were an explanation to management reluctance to a new standard are derived from reducing income and increase standardization (Nobes 1992). The introduction of component depreciation has economic consequences especially for real estate companies and it will be interesting to see if the impact on financial statements can explain their reluctance or if they use the practical burdens and complexity as argumentation when influencing the standard-setter.

There is a technical difficulty embedded in component depreciation that needs to be considered (Hellman 2011). Component depreciation is a complex matter to implement in real estate entities because it forces them to create new routines for depreciation, to update the plant register and to conclude how to define and value different components. According to K3 draft this approach should be implemented retroactive which do not ease the valuation problem because the acquisition cost will be hard to confirm for many components in old buildings. Instead a replacement cost has to be established and from there try to assess the components useful life to get the right depreciation rate (Nordlund 2004). The principle nature of the standard has received critical comments because no guidance and details are given to the entities about how to implement an already complex matter (Hellman 2011). A more ruled-based standard could have advantages in giving more comparability, easier to see infractions, reduce opportunity for earning management through judgments and intentions can be communicated more clearly. But the disadvantages in a ruled-based standard are too much detail can give higher complexity and the possibility to structure transactions. By following a principle-based standard professional judgment are essential and the implementation and adoption of the standards is left to the entities (Nobes 2005). Therefore is will be interesting to see how the companies in the real estate business are interpreting this standard and how they are anticipating the impact of a strict adoption of component depreciation.

1.3 Research questions

- What are the anticipated effects of applying component depreciation and why is there reluctance in the real estate business to implement it?
- What determines how real estate entities are recognizing components?

1.4 Purpose

Our purpose with this thesis is to reveal the effects that component depreciation can have on Swedish non-listed real estate entities and why there is such great opposition among the preparers. We want to contribute to the debate of possible impacts derived from K3 project when this thesis aims to show both disadvantages and advantages of a more comprehensive reporting of depreciation.

1.5 Scope

In our thesis we have restricted us and analyzed corporations that are included in the K3 category. Therefore has our focus been on investigating Swedish non-listed entities that have a requirement of producing an annual statement. We have also limited us and used real estate corporations as our investigation area because these entities have high booked values of tangible assets in their balance sheet and therefore we believe that this regulation will have an impact on them.

1.6 Disposition

Chapter 2 – Method

In this chapter we are explaining our thesis approach and how we have answered our purpose. The reader will get an increased understanding regarding our works process and choices made.

Chapter 3 – Frame of references

We have decided to divide this chapter into two parts namely; Standards and Theoretical perspectives. In the first part relevant accounting standards are described and thereafter a focus on explaining depreciation and component depreciation ends this part. In the second part, theoretical perspectives, we are describing an explanation model which we are using with the purpose to explain why individuals or organizations are reacting as they do when accounting changes is made

Chapter 4 – Empirical findings

We have used three different sources contributing to our empirical findings. The first part includes a broader investigation of the comment letters received by the SASB, regarding implementation of the component depreciation approach included in the K3-regulation. To be able to analyze our research questions in a deeper manner we have interviewed three of these organizations that have delivered comment letters to the SASB. Interviews have also been done with two real estate corporations who are in the process of implementing a component approach and also an expert in this area. This part starts with a presentation of the respondents. The last part consist of an short illustration made on two real estate corporations showing if the component approach could have an impact on their income statement, by using two different component models.

Chapter 5 – Analysis

In this chapter we are analyzing the empirical findings with help of our frame of references to be able to answer our research questions. This part is divided into two sections where each section is analyzing one research questions.

Chapter 6 – Conclusion

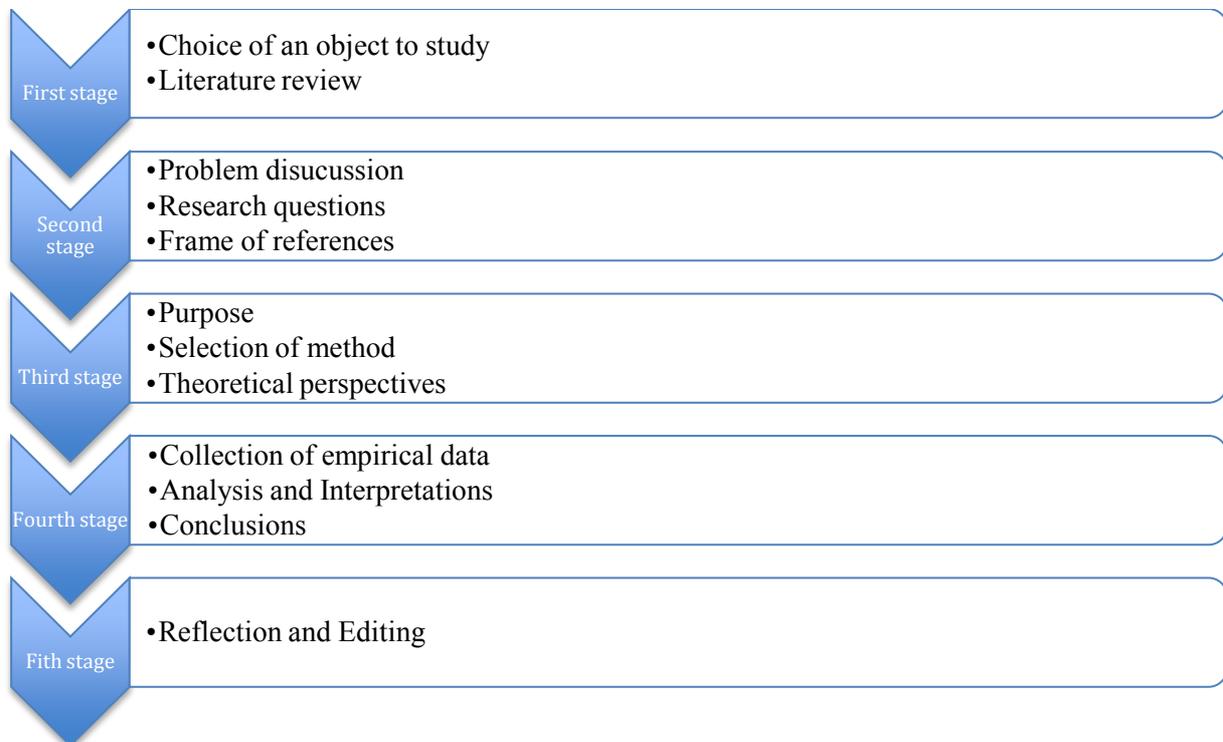
In this chapter we are answering our two research questions with conclusions derived from our analysis

Chapter 2 – Methodology

In this chapter we are explaining our thesis approach and how we have answered our purpose. The reader will get an increased understanding regarding our works process and choices made.

2.1 Progress

We began our thesis with a selection of an object to study and decided quite early in our progress to study component depreciation. We contacted Bo Nordlund a recognized experts with many published articles and books in the area to see if he could help us getting an interesting angel to debate of implementing component depreciation. He was willing to share some of his thoughts about component depreciation, which helped us in our progress. There are limitations in surveys done by non-academic bodies like professional groups or state owned institutions that miss some significant aspects of academic research (Bryman 2005 p 17). Consultants' gives contributions to practice without necessarily give any emphasis to theory. Academic researchers have to consider theory to a greater extent and there is a linkage between theory and research that cannot be overlooked (Bryman 2003 p 5) This were limitations we had in mind before taken in advice from experts so early in our process and to make sure that possible approaches would be feasible in the frame of academic research and not too comprehensive. The table below outlines our progress and we have divided it into five stages were each stages includes different procedures. Each procedure signals a crucial moment in every step that we have taken and have been our chart in our work of progress.



2.2 Qualitative method

Our selection of method was done in the middle of our work of process and was depending on our research questions and purpose. Methods in business research are often divided in a quantitative and qualitative distinction and the selection is crucial because it will conclude how well the research questions are answered. A qualitative method is selected in this study because it is most suitable to approach our objective and purpose. This method has more intent to emphasize words than collection of quantitative data that should be tested. This distinction that quantitative method uses data for measurement and qualitative focus on words and reasoning is a common simplification of the difference between them (Bryman 2003 pp 25-26). Our research questions are based on possible affects because component depreciation regarding non-listed corporations exists only as a draft and is not compulsory to use. There is a high complexity to apply component depreciation and there are different views on if and how it should be implemented into Swedish accounting standards. These factors suits a qualitative method were interpretation and examination of participants in a social environment is in focus and their views and interactions are significant (Bryman 2003 pp 280-283). Our purpose of our study is to give more insight in how a more comprehensive accounting of tangible asset will affect the real estate business. Accordingly, the characteristics in a qualitative method such as contextual understanding, close involvement with participants, unstructured approach and riche ambiguous data were depending factors when selecting method (Bryman 2003 pp 302-303).

Interviews are an approach used in a qualitative method and exist of relevant subjects chosen, based on the general research question. Focus groups such as real estate companies, business organizations and accounting experts are being seen as relevant subjects in our study. Our empirical data consist of comment letters, interviews and illustrations of how component depreciation can affect financial statements using two different component models. These calculations serve as examples and cannot be used for generalizations and therefore we have chosen to present them in our appendix.

2.3 Research and theory

There is a connection between empirical data and theory that is not easily outlined but needs to be considered in data collection. Theory can be used to guide and influence the collection of data when using a deductive strategy or it can be the end product derived from data collection when using an inductive strategy. Researchers do not always accept dividing the linkage between theory and research because deductive and inductive strategies shall not be viewed as clear distinctions. Instead they shall be viewed as tendencies influencing each other. But there is certainly a point of choosing an approach because it will affect the way data is collected. In the context of using data as a basis for generating theories and the lack of theories to test this study can be viewed as having an inductive strategy. An inductive strategy is usually connected to a qualitative method but this does not necessarily mean that theories are only being formed as an end product. In many studies with this approach theories is also used as a background when collecting and analyzing data which is also the case for our study (Bryman 2003 pp 9-13).

2.4 Literature review

Our literature review began with an article search about component depreciation to grasp what current researchers are focusing on. Most of the articles that were collected were not as up to date as we hoped and it became quite clear to us that it would be hard to create a database existing only of clear cut research articles about component depreciation. We therefore decided to broaden our search setting up a database existing of depreciation articles with not necessarily findings about component depreciation as an objective. Recognized journals in accounting were searched through with key words in an attempt to gather as much relevant material as possible. We primarily used two databases Google Scholar and Lunds University's database Summon. Material was gathered from journals like *Abacus*, *The Accounting review*, *Accounting Horizons* and *Journal of Accounting Research*. Key words used in our search were mainly component depreciation and depreciation. We also used the Swedish accounting journal *Balans* to follow the ongoing discussion about K3 and component depreciation.

Our frame of references is divided into two parts with significant content but with a common purpose to create a better understanding of our research questions and analysis of empirical data. We start our frame of reference with current standards to give a fundamental explanation about methods and concepts connected to depreciation. In the subsequent part we have constructed an explanation model that could help the understanding why real estate companies are reacting as they are doing to this new standard. We have created an extensive frame of reference to increase the understanding about this phenomenon, which made our subsequent writing, and analyzing about component depreciation on a detailed level easier to grasp. Introducing a more comprehensive depreciation system especially in real estate business does not only exist of technical difficulties but also difficulties in making this view understandable and accepted. Therefore we wanted to present both sides in our framework.

2.5 Data collection

2.5.1 Respondents

Respondents in our study exist of real estate companies, business organizations and an expert in the real estate business. Our collection of comment letters used in our empirical findings helped use getting in contact with relevant respondents that we thought could contribute to our study. The three business organizations that we selected had left comments to the K3 draft. During our interviews with the organizations and our expert we were recommended real estate companies that had to some extent already implemented component depreciation, which allowed us to approach the problem from a detailed level to increase our understanding. All companies were initially contacted through mail to see if there were any interested to participate in a deeper discussion about K3 and the stricter demands on component depreciation. Two real estate companies Botkyrka Real Estates and Telge Real Estates was willing to participate in an interview. Our preferences in selecting real estate companies were that they should have reasonable knowledge about the component depreciation proposal in K3 and willing to participate in a more extensive interview. A respondent needs to be carefully selected because the quality of the interview will be reflected

in our empirical findings. A qualitative interview takes time and can be a demanding task therefore dedication and a desire for having a good discussion is a condition when gathering relevant data for subsequent analysis (Holme et al 1997 pp 100-101). The reason for interviewing business organizations is because they have high expertise in their organization and can give a more unified view about their members concerns. We wanted our empirical data to reflect an extensive discussion that allowed use to approach the problem in detail and therefore real estate companies with a detailed knowledge about component depreciation was contacted. We also followed up our contact with Bo Nordlund because we wanted to include an interview with an expert with a more theoretical approach and not bound to represent members.

2.5.2 Interview process

In qualitative research the term qualitative interview is often used to express the flexibility and unstructured technique that is significant in gathering information. Every interview stands in context to each other and the aim is to receive exhaustive answers with much details. There are two approaches that can be selected when performing a qualitative interview. An unstructured approach that is similar to a normal conversation with only a few open questions followed up by subsequent questions in areas that are interesting for the researcher. The other approach is referred to as a semi-structured interviews and more bound to specific topics with a list of questions that should be answered through the interview (Bryman 2003 pp 340-343). Our interviews had a semi-structured approach because we wanted to address specific issues. Component deprecation is done on a very detailed level in real estate companies and it has a complexity that cannot be answered through a general impression. Even if we wanted to have answers on specific issues our questions was structured as open as possible with room for subsequent questions. The process of the interview is crucial for how detailed the analysis can be so we wanted to have a flexibility in our discussion with our respondents which allowed us to follow up leads and clearing up inconsistencies (Bryman 2003 p 349). After our respondents agreed to anticipated in our study we sent our questions by mail including a briefly explanation about the issues we wanted to discuss. Some respondents answered our questions through mail before our phone interview which allowed us to have subsequent questions ready on their views. This qualitative approach on interviews allows us to gather more information and bring clarity to some question in a subsequent interview. Therefore we ended every interview with asking if there was a possibility of a callback, to straighten out any inconsistencies (Holme et al 1997 p 100). Because our selection of respondents does not only exist of real estate companies we were forced to adapt our questions depending on respondent. None of our respondents were located in a distance that allowed us to have personal interviews. Therefore all of our interviews were carried out through the phone and recorded to capture the respondents own terms and allowed us to be more focused on the discussion.

2.5.3 Financial statement

Information has been gathered from two financial statements and we used the Swedish Housing Federations members list to find two suitable real estate companies. We selected

Ernst Rosen and Graflunds Real Estates because we considered that they had the best disclosure about tangible assets. The financial statements are for 2010 and downloaded from the companies' webpage's, and thereafter printed out to easier get an overview of its intent. Our purpose of selecting and testing these financial statements is to give some indications about how component depreciation can affect the depreciation rate of the companies' properties. We used two models on how a building can be divided in components one for residences and one for offices. Every component in the model had an appreciated life and expected cost of the total building, which allowed us to draw some conclusion about how these companies' depreciation costs could be for the financial year 2010. It must be stressed that these calculations are simplifications of reality and the comprehensiveness of the numbers shall not be overestimated and the result serves more as illustrations. The component model for residence was received from SAPHC and the component model for offices from the study made by Lind and Hellström (2011) and both can be found in appendix (1 and 2) with our calculations.

2.6 Reliability and validity

Our research method is not structured to maximize reliability and validity of certain key concepts. When using a qualitative method we distance our self from the natural scientific model and measurement of data and its reliability. Instead we are trying to increase our understanding by getting more involved in certain individuals, groups and organizations reality. The concept reliability loses some of its meaning if there is no statistic representativeness in the data and becomes harder to apply on experience and awareness (Holme 1997 p 94). Reliability is concerned with the possibility to make the study repeatable and it becomes harder to achieve high reliability when using semi-structured interviews with subsequently interpretation that can be done differently depending on researcher (Bryman 2003 p 33). Our effort in increasing reliability of our study has been in chosen relevant respondents to interview and a suitable amount of respondents with different perspectives. Validity is concerned with the possibility for the study to have integrity of the conclusions that is generated through the empirical data. During our interviews we have tried to be as objective as possible because it is easy to take sides when discussing component depreciation. Practitioners believe that component depreciation is only good on a higher theoretical level while theorists believe it will be beneficial to implement in practice. The pressure on respondents to give certain answers and the researchers experience and interpretation of the situation can be factors that can mitigate the validity when performing a qualitative research (Holme 1997 pp 94-95). To strengthen our validity in our research we have tried to build a relaxed atmosphere when performing our interviews and not chasing answers from our respondents. We have also tried to be well prepared before our interviews reading background facts about our respondents and performed our interviews in a later stage of our process when we believed that we had reasonable knowledge to have a deeper discussion.

2.7 Generalization

Our study is based on comment letters, interviews from six respondents and information gathered from two financial statements. This is in line with how we chosen our research

design and method to answer our research questions. Our aim is not to have findings that can be generalized and our respondents' views cannot be representative for all non-listed companies in the real estate business. Besides, this population can be hard to recite if considering all non-listed real estate companies as a population. When using a qualitative method the aim is not to generalize to populations instead the focus is to generalize to theory. Naturally the absence of statistical criteria and with a small number of respondents makes it hard to draw conclusion that can be generalized to others. Although generalization can be made when using a qualitative method but the aim is the quality in how empirical data can generate theories and the strength in theoretical conclusions (Bryman 2003 p 300).

Chapter 3 – Frame of references

We have decided to divide this chapter into two parts namely; Standards and Theoretical perspectives. In the first part relevant accounting standards are described and thereafter a focus on explaining depreciation and component depreciation ends this part. In the second part, theoretical perspectives, we are describing an explanation model which we are using with the purpose to explain why individuals or organizations are reacting as they do when accounting changes is made.

3.1 Standards

3.1.1 IFRS for Small and Medium sized entities

IASB published in 2009 IFRS for SMEs with the purpose to ease the burden for non public interest entities that published financial statements for external users. Even if these standards are named small and medium sized entities the size is not primary when considering compliance. The key point is that entities do not have any public interest or manage important social activities such as banking or insurance. IFRS for SME has 230 pages compared to a full IFRS with 2800 pages and is a heavy condensed version. Reasons for giving non-listed entities this simplified version of IFRS was because a full IFRS is considered to be too complex for small and medium sized companies, which brings more costs than benefits. Even if there is a lack of public interest in those entities there is still a need to have standards that increase comparability because there is no limitation for small and medium sized entities to operate international (Nobes 2010 pp 339-340). Much of the complexity is mitigated through elimination for certain standards and alternatives and where standards are not eliminated they are simplified. IFRS for SMEs do not give as many options as a full IFRS and the solutions that are given is the easiest ones to apply. For example IAS 16 contains two alternatives for subsequent valuation of fixed assets. Only the cost model alternative is given in IFRS for SMEs due to simplification (Miller 2010). These simplifications do not necessarily exist of only deleting alternatives there are also standards in IFRS for SMEs that have stricter requirements if a certain valuation model shall be used. IAS 40 states that an entity can choose between using a fair value or a cost model as its accounting policy after initial recognition (IASB 2010a IAS 40 §30). In IFRS for SMEs it is stated that a fair value are only allowed if measurement can be made reliably without exaggerated costs or effort. If this cannot be upheld by the entities a cost model referred to in section 17 about property plant and equipment shall be used (IASB 2009 IFRS for SME section 16 §7). Component depreciation that is stated in IAS 16 has nearly the same meaning in IFRS for SMEs and the intent of this paragraph is still the same. It is stated that major components shall be recognized and items that has a significantly different consumption pattern with economic benefits shall be separate from the asset (IASB 2009 IFRS for SME section 17 §16).

3.1.2 K3 Project

Swedish Accounting Standards Board (SASB) changed their approach in 2004 and started to work on introducing different accounting standards according to different needs. Prior they had tried in vain to implement one standard that should fit all organization regardless characteristic, excluding those publicly listed entities (Engström 2007). The base for the K-project is the regulations in the Swedish Bookkeeping Act, where it is stated that corporations has obligations to establish either:

- Simplified annual closing (K1)
- Annual closing (K2)
- Annual report (K3)
- Annual report according to IAS/IFRS (K4)

SASB introduced four different categories of corporations based on the Swedish Bookkeeping Act. The purpose is that each corporation should use an accounting standard developed to inhabit all relevant rules and principles needed, and not being forced to use an extensive standard difficult to implement (SASB 2009). K1 includes sole proprietorships, partnerships and non-profit institutions that establish simplified annual closing. Regulations included in this standard shall be easy to apply but still meet the requirements; book value should also be consistent with the tax value. K2 primarily targets limited corporations and co-operative entities and prudence and historical cost valuation is strong characteristics (Overud 2009). K4 includes publicly listed corporations and therefore fully applies IAS/IFRS.

In June 2010 SASB released an exposure draft on a new accounting framework for K3 which consist of non listed limited corporations that establish annual reports. A corporation also needs to fulfill at least two of the following criterion; Average number of 50 employees, 40 million Swedish crowns in balance sheet total and 80 million Swedish crowns in net sales (SASB 2010a). The basis for K3 is IFRS for SMEs, and therefore the main structure of the chapters in these two standards is equal. The language in the K3 standard is directly translated from IFRS with only minor changes to make it easier for the reader. Regulations included in IFRS are not fully convertible with Swedish legislation (Annual Account Act) and therefore some accounting choices have been reduced or restricted.

Included in the K3 regulation is a strict requirement for corporations of applying a component depreciation approach. If a tangible assets consists of parts that has substantial differences in their useful life, these components shall be individually depreciated and accounted for separately (SASB 2010, 17.13§). In this regulation no amendments has been added regarding which properties that should be depreciated according to this approach, this means that a retroactive approach is considered. Therefore all properties included in a corporation's property portfolio will need to be revaluated, components identified and separately depreciated. When a component is being substituted it shall no longer be presented in the balance sheet (SASB 2010, 17.17-18§a). Instead it will be transferred to the income statement as a profit or loss depending on the differences between the booked value and the residual value (SASB 2010, 17.19§).

3.1.3 Valuation of fixed assets

When a fixed asset is bought and subsequently sold there is a possibility to recognize an objective verifiable value, which is based upon these two external transactions. If the fixed asset is bought and sold during the same financial year there is no need to account for depreciation charges and no depreciation problems will arise. Although fixed assets are meant to benefit entities for a longer time period than one financial year. If the asset remains in the balance sheet during a longer time period there must be a value established at the end of each financial year. This value cannot be based directly upon external transaction and this is the basic problem when accounting for depreciation. Two approaches can be distinguished to this problem an accounting approach and an economic approach. The accounting approach is based on allocation incentives where the cost of the acquired fixed asset less residual value should be spread over the useful economic life of the asset. The economic approach is more based on valuations where the value of the asset should be based on the sum of discounted cash flow coming from future benefits (Wright 1964). These two approaches outline the two main theories of depreciation that was adopted in the 1960s when depreciation was heavily debated among researchers. One based on a matching principle where capital costs of each asset shall be matched with its revenues and one based on discounting expected revenues. Most of these theories discussed in the 1960s followed a normative approach considering how accounting for depreciation should be conducted. This normative approach is not used in the same extent today and can be considered a little out of date when today's researchers are more trying to explain what depreciation actually is and predict how preparers account for it instead of stating how they should account for it (Wright 2006).

3.1.4 Depreciation

If an asset has a limited lifetime, this asset should be depreciated over its useful life. The purpose of depreciation is to delegate the costs of assets over the time that the assets are producing profits for the corporation. The majority of all assets are obsolescing over time and therefore it is important to consider depreciation for these assets. One exception from depreciation is land which means that if you buy a property you should exclude the land value from the depreciable unit (Marton et al 2010 p 177). The depreciation unit is the amount that is going to be depreciated and consists of the difference between the historical cost and the residual value, the residual value is excluded due to future cash flow expected by the corporation. Residual value is the value that the asset has when the useful life has been expired. It could either consist of expected future sale price or a salvage value. The main issue for corporate management is to determine if an asset has a residual value and how to evaluate it. The difficulties are referred to problems with estimation of future values and therefore

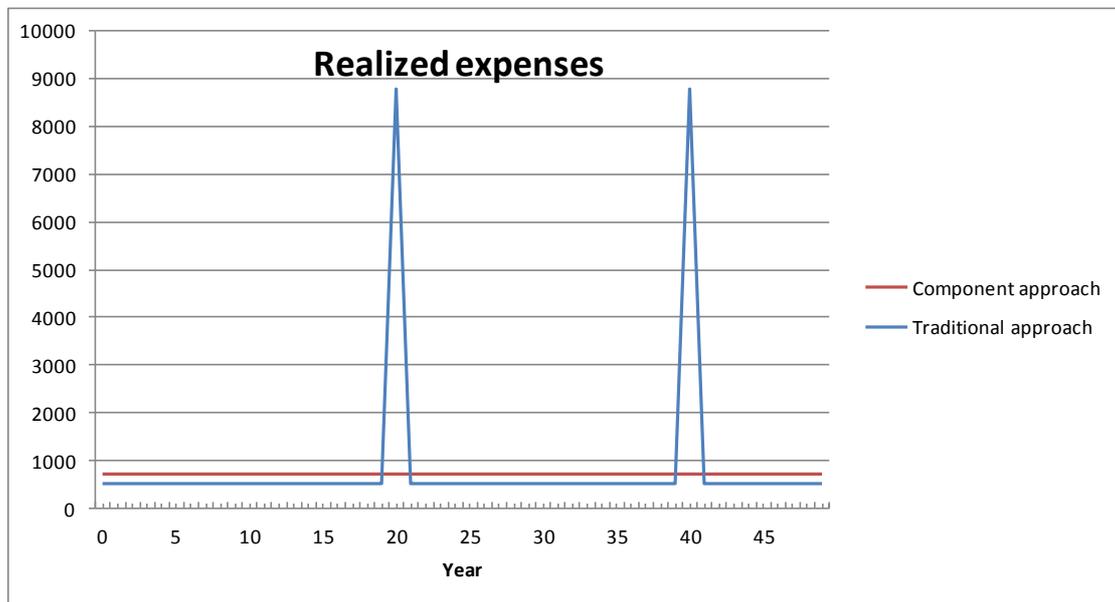
3.1.5 Component depreciation

The main objective with this approach is to divide an asset into different components that has a different useful life, and account each component individually. To determine each component's value an ideal approach would be to calculate its historical cost but this could be difficult and in cases where it is impossible you instead could calculate the replacement cost

for the specific component. When a component is being changed the residual value of the prior component will be expensed (Nordlund 2004).

When using component depreciation, investment is considered in a broader view while the maintenance charge category is narrower. This means that in this approach capitalization of costs is the prime focus. When a component is in need of maintenance or replacement, this approach will regard it as an investment if it raises the future economic benefits for the corporation (Lind and Hellström 2011, p 10). When capitalizing almost all costs it will lead to a smoothing of the corporations income over time compared to the traditional approach that suffers from big differences in costs from year to year due to more focus on maintenance costs. Lind and Hellström (2011) introduced an example where a corporation has invested in a property and according to the component approach it will have a depreciation of 730 \$ each year. Considering the traditional approach it will lead to a depreciation on 500 \$ each year, the difference is explained as the component approach is focusing on capitalizing more costs which equal a smooth but higher annual expense. In this example investments is needed twice during this assets useful life which is equal to a cost of 8300 \$ at each occasion. According to the component approach this will not be regarded as an expense that year instead it will be capitalized and depreciated over its useful life. Compare this to the traditional approach that consider this investment as a maintenance cost and therefore see the cost as an expense these two years as they occur, in the diagram below (figure 3.1:Realized expenses) it shows how these two different approaches will have impact on the income statement.

Figure. 3.1: Realized expenses

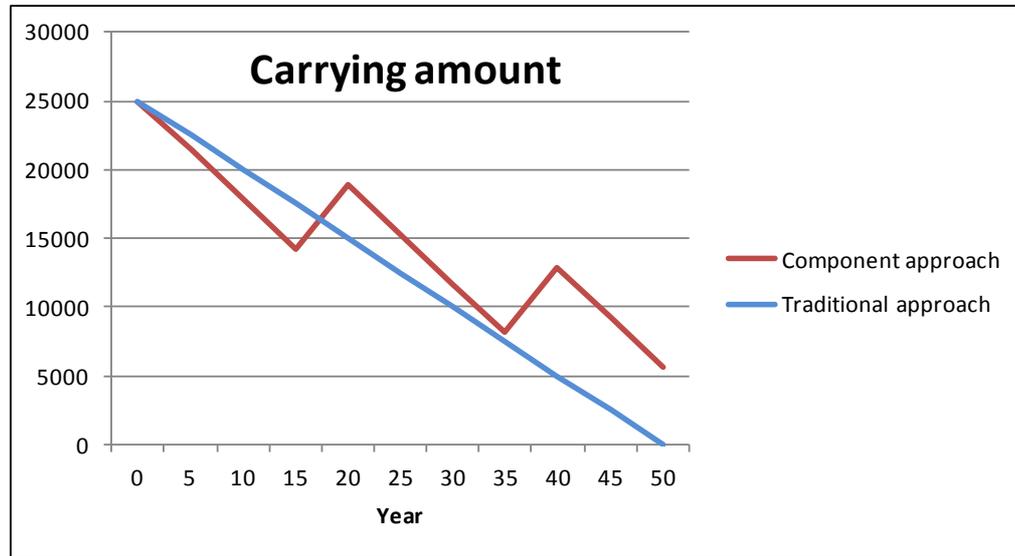


Source: Lind and Hellström 2011, p 15

This investment of 8300\$ in reality also enforces the properties standard and therefore also its market value. A property that has more investment in it should have a higher demand than an asset with no investment. According to the component approach this will be visible in the

balance sheet because the investment is capitalized and therefore gives a higher value to the assets value. While the traditional approach regard it as an immediate expense it will not be shown in the balance sheet and the fair presentation could be questioned. The diagram below (figure 3.2: Carrying amount) presents how the balance sheet is affected differently depending on which approach is used.

Figure. 3.2: Carrying amount



Source: Lind and Hellström 2011, p 19

Companies can make different judgments about what they believe should be a component because there is no distinct way to classify a component. There are two basic principles discussed in the area about how component shall be recognized. The first principle states that the economic value is of importance if any component shall be recognized. The value of the component needs to be significant comparing to the asset, which it should be separated from. The second principle does not try to define a component according to its economic value instead the frequency of replacement is in focus. Accordingly, recognition shall be made from anticipated replacements of different parts so if the floor is replaced at one specific time period and the roof is replaced subsequently it makes sense that these should be recognized as different components. There is a point in recognizing components due to anticipated replacements because high maintenance costs from certain parts of the building will be capitalized and depreciated which can help companies that face high maintenance costs and has not the ability to take the cost directly to the income statement (Lind & Hellström 2011 pp 36-39). Regardless of how companies chooses to divide their assets in components new routines and systems needs to be established to be able to follow the pattern of a component. Updates of the land registry and assessments in how allocation of costs to different components shall be done are difficulties when trying to establish a component depreciation system. Determining a useful life of a component can also create difficulties and the fact that much discretion are given in how components shall be recognized makes it difficult to compare depreciation rates between companies (Lind & Hellström 2011 pp 43-46).

3.2 Theoretical perspectives

3.2.1 Accounting development in Sweden

Classification of accounting systems has a useful purpose to explain today's accounting developments and predict future developments. The classification of Anglo-Saxon accounting and identification of a group is only relevant when it is put in context to other accounting systems. A Continental accounting system and an Anglo-Saxon accounting system are recognized on an international level and countries are grouped after their characteristics in accounting practice. Not every researcher believes that countries can be divided after a Continental system or an Anglo-Saxon system and some even think the Anglo-Saxon accounting system is a myth. But there are differences both in conceptual approaches and accounting practice depending on country and separating countries into these two groups clearly help the understanding of these differences. An Anglo-Saxon accounting system is oriented to decision-making and investor focus, prudence is not a significant principle, it is more willing to cross superficial legal form and it takes no consideration to accounting as a measurement for taxation. Viewing these characteristics as a package it is reasonable to conclude that this is a fair picture of the accounting system in countries like the US and the UK comparing to Continental countries like Germany and France (Nobes 2003). Sweden has had a history with close relationship to Germany both on a politically and economically level and a well developed and sophisticated German accounting system has influenced Swedish accounting during the end of the 19th century and the beginning of the 20th century. Therefore Swedish accounting has inherited much of a Continental accounting system with a close linkage between tax and accounting, historical cost as the basis for valuation and prudence as a significant principle. The German accounting system was used as guidance when setting the first Swedish national accounting legislation (the limited companies act of 1910). Few specific rules were included instead the focus was on more general guidelines, and therefore complementation from practice inside industries was vital. The legislation also included vague criteria when it came to valuation and the focus was on following a "good accounting practice". In 1909 the first Swedish higher education in economics was implemented in Stockholm. At this school the students learned accounting according to German theory and practice. They also learnt how to best take advantage of the legislation in showing the wanted profits in a firm, this phenomenon is called "valuation policy" (*bokslutspolitik*) and decisions regarding depreciation were highly included (Artsberg 2010, pp. 191-196)

Although Swedish accounting practice has been influenced by a strong Continental accounting system development towards a more Anglo-Saxon approach started in the 1960s with American influences both in practice and in standard-setting. The prudence principle, which had influenced accounting practice started to be replaced by the matching principle and to disclose more information became important. The building of secreted reserves significant in a Continental accounting system and inherent by German practice was influenced by these changes and the Swedish profession invented a technique where more information about these reserves was disclosed both in the balance-sheet and the income statement. Several Swedish companies with business abroad and listed in American Markets brought home new practice

based on the Anglo-Saxon accounting system. However much of these new ideas were only recommending to group accounts because they are not used as a basis for taxable income and there is still a strong connection between accounting and taxation in Sweden (Artsberg 2010, pp. 198-200).

A demand for harmonized international accounting standards has been created due to globalization and the foundation of a European Union with a unified market. A major issue according to increased harmonization is that economic, social and cultural contexts in different accounting systems can clash against each other. Having FASB and IASB as the main players in international standard-setting harmonization has been criticized to copy an Anglo-Saxon system of accounting (Nobes 1995). The implementation of the K3 act will give a more Anglo-Saxon approach to the financial statements in Swedish non-listed companies due to its basis are IFRS for SME:s (Hellman 2011). Companies following K1 and K2 are going to have a more transaction-based accounting with prudence and realization principle as cornerstones. Introducing these two acts has not created any major issues because much of its characteristics and valuation measurements have been recognized in the Swedish accounting system for a long time. But introducing the K3 act will be more controversial because the Anglo-Saxon influence that have been seen in the group level for Swedish listed entities will now have an impact on national standards for non-listed entities as well. A more value-based accounting will be introduced for the K3 entities and there will be more room for professional judgment due to it is more principle based. The international influences of Continental accounting and Anglo-Saxon accounting have shaped the accounting system in Sweden. Together with preparers and their concerns, which historically have been taken into consideration has created a mixture of different ways of looking at accounting implemented into Swedish standards (Artsberg 2010, pp. 208-212).

3.2.2 Practical arguments and its impact on Swedish accounting

Accounting changes is not costless, it often requires an increase of disclosure or change of accounting methods which result in a higher administrative and bookkeeping costs. Therefore changes that has a higher cost compared to its benefits will be opposed by the management (Watts and Zimmerman 1978). This could be related to the theory made by Sutton (1984) that means that individuals is participating in a “due process” if they could gain something from it, the organizations that is taking the main burden is the ones who will receive the highest benefits from it. One example of controversies in adaptation of a new accounting principle which could be referred back to our case is the debate raised in the U.K. regarding accounting for goodwill. During the 80’s corporation in U.K had an option to account goodwill as either an asset that is depreciated or carried permanent as an asset, a third option was also allowed to write off goodwill against reserves. The choice of method was often corporate specific and related to which principle that best supported their profit goals. The standard setters argued that reducing the choice to one, capitalization with depreciation over time, would increase the accountability and also the comparability internationally, because American corporations used this single approach already. This meet resistance from corporations and this could be referred to that different managers prefer different options, to exclude options could lead to

disadvantages for some corporations and therefore this proposal was unattractive. This proposal would have had a negative impact on the income statement due to a higher level of depreciation which was not favorable at the management level. The users of financial statements argued that this would increase the economic reality and comparability in the financial statement, and after a few years of debate the amendments went through and became a part of Great Britain's accounting legislation (Nobes 1992). The standard setter needs to listen to its environment and mirror their opinion when implementing a new standard, because they are in a high need of receiving the right to represent the market in accounting issues, in this case the standard setters listen to the users of financial statements. To be able to legitimize its role as an appropriate body they need to exhibit openness for debate and opinions from different actors (Jönsson 1991).

Discourses could appear between different actors on the market that has different views regarding accounting issues. Discourses are related to different knowledge ideologies and objectives that prevail in both political and economic areas, it is present during any given time in different corporations, organizations, state agencies and universities etc. Discourses point out which areas that is of importance to analyze and which areas that are of minor interests (Robson 1991). In the accounting area it has been regarded that the main discourse on accounting regulation are related to mainly practical arguments, where practical experience and practical expediency has been the most important influences on new regulations. In certain accounting areas the theoretical arguments has been the main underlying factor for changes, for example inflation accounting and currency translation, but in those cases regulations has failed to be implemented (Jönsson 1991). The persuasive power is higher if arguments are based on practical experience compared to experience referring from theoretical approaches.

One explanation to the phenomena that practical discourses has a higher level of power compared with theoretical arguments can be related to Argyris (1977) and his theory regarding single loop and double loop learning. Single loop learning is explained as a process where learning in essence consists of adjusting an inaccuracy in a preset standard. The main feature of this approach is that changes arises from areas that are not questioned, the problems related to this approach arises when the technique needed could not be effectively implemented and at the same time if the underlying objectives are questioned by different actors on the market. Double loop learning consists of a change of standards after a requirement of examination, where the preset standard is highly questioned (Argyris 1977). If a change of accounting standards is being implemented this will require a double loop learning to be effective. Changing an accounting principle is therefore a far-reaching process that could be speeded up if circumstances arises where people questions the regulations (as in the case of goodwill accounting in the U.K) or for example because of an accounting scandal (Jönsson 1991). Regarding component depreciation the main practical users has not regarded the depreciation area to be a problem area needed adjustment, while individuals with an theoretical background is regarding this accounting area in an high need of adjustments. This

is making the implementation of component depreciation difficult, because it will end up as a single loop learning process.

3.2.3 Principle-based versus ruled-based accounting

K3 is based on IFRS for SMEs and these standards consist with underlying principles and if accepting a “black and white” view about principle-based or ruled-based accounting standards the K3 regulation can at a first glance be defined as principle-based (Miller & Bahnson 2010). It is common to divide standards into these two camps and we usually find FASB and IASB at each side. FASB produced standards are viewed as ruled-based having the characteristics of detailed implementation guidance, numerous test and exceptions. IASB produced standards are viewed as principle-based having the characteristics that practitioner shall follow the intent of the standards rather than the letter and demanding more professional judgment. However, when having a closer look and comparing FASB standards with IASB standards it can be stated that this is not a meaningful description of standards and serves only a purpose in relative terms. IASB standards are not pure principle-based because if this were true there would only be a need for a conceptual framework to follow. The fact that there are standards proves that there is a need for rules to clarify what is stated in the conceptual framework. FASB standards are not created ad hoc and can therefore not be viewed as pure ruled-based standards. Those standards are like IASB standards derived from a conceptual framework and based on principles. What is meaningful when trying to explain what differs these two sets of standards is to see to what extent standards are referring back to qualitative characteristics in the framework and how much professional judgments that is required by these standards. Referring back to comparability and consistency and having an absence of general reference to professional judgment will increase the demand of having detailed rules. IASB acknowledge relevance as a significant principle and moves away from a checklist mentality by relying on professional judgment. Accordingly, it makes better sense to referring to judgments based standards instead of principle-based standards in this discussion (Bennet 2006).

Following the controversies about ruled-based or principle-based standards, which have gained new fuel because of the convergence project between FASB and IASB, it is often stressed that ruled-based standards are inferior and demands only a short-sight mind with a checkbox mentality. As stated above about the simplification in differentiate ruled-based from principle-based it is also a simplification to think that principle-based standards is a solution to all questions. It does not exist such a simple answer in the context were accounting standards should apply to satisfy all needs (Miller & Bahnson 2010). There is a point in having the economic substance over form to guide financial reporting and that principle-based standards is the best way to satisfy this approach. Also the fact that too much rules gives opportunities to structure transaction only meeting the minimum requirements of the standard is a shortcoming that have been voiced in this discussion. There is no rule that can be applied on every possible circumstance and there is neither any substitute for having a professional judgment. However, the ruled-based approach is something that has been demand-driven when principle-based standards has an absence of details and guidance (Manies 2003).

Theorists will prefer broad principles instead of having to reason about implementation of standards on a detailed level and misses certain aspects from a practitioner's point of view (Miller & Bahnson 2010).

3.2.4 Earnings management

Accounting literature gives many examples of earning management and in its meaning lies one of the most fundamental issue for professional accountants. That is the importance and influences of accounting accruals and how it will lead to a summary of measure of the entities underlying economic performance. Schipper (1989) define earning management as "*purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain*" and this intervention is based on manager's intent, which makes it difficult to detect that earnings have been managed when only relying on external financial reporting. Common in many earning management studies is assumptions about contracts between management and the entities owners. Also assumptions about a feasible reporting set are a predetermine assumption included in studies about earning management. These assumptions used in analytical models are often criticized for being simplistic and gives an unrealistic view about human behavior. However these assumptions give incentives for why earning management may occur and how the institutional environment gives a feature that makes it possible (Schipper 1989). The agency theory is connected to earning management due to predictions that earnings are managed to give higher compensation, avoiding triggering debt covenants and not be exposed to political scrutiny. Also the effort of keeping up with financial analysts' predictions or outperforming them is another example of a theory that is strong connected to earning management (Wolk 2003 pp 399-403).

There are many incentives behind earning management and theories are constructed to give explanation about whether and when reported performances are not showing the right underlying economic transactions. Many studies have given contributions to those incentives but according to Nelson (2002) more evidence should be provided on how accounting standards and the precision of rules will influence attempts to earning management. Precise accounting standards with specific guidance and details gives more scope to structure transactions in an attempt to earning management. An unspecific standard makes the outcome more unpredictable and this uncertainty makes practitioners more responsive to follow the standards intent. There is a significant connection between structured transactions and precise standards and an indication that this interaction affects management and auditors decisions (Nelson 2002). The purpose of having standards no matter if they are specific or unspecific is to provide management with credible means to provide information about the entities performance. When reporting the most acquired information about the entities performance standards most give management the scope to exercise judgment to choose the best accounting method, estimations and disclosure that gives a true picture about the firm's performance. This will increase management discretion and subsequently create an opportunity to earning management. Therefore, standard-setters most frequently asked themselves the question about how much judgment would be exercised when complying with the standards. Earning management exist in several accounting areas and the hardship for

standard-setters is to distinguish between those standards that helps management to report relevant and reliable information and those standards that gives opportunities to earning management (Healy 1999).

3.2.4 Lobbying an economic consequences

One of SASB main objective in their work is to restrict the accounting choices included in the SAAA (Askenmalm 2010, p. 52). This is a difficult process because they need to consider different impacts on different stakeholders and also different opinions on the market, it is though impossible to satisfy each stakeholder and comply with every opinion (Macdonald 2004). At the end standard-setters often will land in regulations and norms that are of a more general nature and the process is not mainly driven by economical and rational reasons instead adjustment will be made to be able to fit the regulations closer to the stakeholder's opinion (Sharp 2005). The rule makers are balancing the different opinions from interested stakeholders, and take them in to consideration when implementing a new standard. If the stakeholders believe that there is a high chance of possible impact on standard-setters and that they are open for new suggestions, the greater pressure stakeholders excise over the rule-makers (Sutton 1984). If a stakeholder would receive benefits from changes or abolishment of proposed legislation they will use different tactics in their tries to intervene in the standard-setting process. This phenomenon is called lobbying and it does include writing comment letters towards accounting bodies, where stakeholders disclose their unsatisfactory aspects with the new proposed amendments (Nobes 2010, p. 248). Lobbying is regarded as an process where stakeholders is trying to force rule makers to implement regulations that has benefits for the corporation, and it could lead to abolishment of principles and rules by standard-setters (Sutton 1984).

In an historical context influence from a stakeholder in the standard-setting process has been of awareness of standard-setting bodies in the US since the early 60's. Individuals that earlier had not been involved in this process started to put pressure on the standard-setters and arguments others than the traditional approach that changes could decrease the level of fair presentation was introduced and named "economic consequences" (Zeff 1978). Earlier standard-setting was believed to be neutral in its effect on the financial statements, but it had now showed that economic consequences had become the main issue in this process. Different stakeholders therefore started to intrude in the standard-setting process when a new standard had economic consequences for their corporation. It was showed that managers despised changes of their accounting principles in order to satisfy regulations. The Financial Accounting Foundation, the father of FASB in U.S., concluded that standard-setters should not be directly affected by economic consequences in their process of adopting new standards but they should anyhow consider both the costs and benefits for a corporation related to new principles. In the middle of the 70's FASB confessed that the board needs to add economic consequences in their decision-making process (Zeff 1978).

Sutton (1984) is using Downs (1957) model regarding which factors lays behind an individual's reason for voting in a national election, to explain why and when a stakeholder is using lobbying. According to Downs study a rational person will choose to vote if that person

feels that; (a) the benefits that this person will receive by voting exceeds the costs of voting and (b) that his vote could lead to a difference in the voting process. Sutton (1984) argues that this model could be used in the process behind lobbying as well and that this phenomena will occur when the benefits is higher than the cost. If the benefits are consider to be increasingly higher than the cost the corporation will be able to us expense a high amount in order to achieve their objective (Sutton 1984). The lobbying activity increases when the rule-makers are trying to decrease the accounting choices in standards and if the standards-setters are interrupting the efficiency to enforce compliance with standards. When the proposed regulations include criteria that are directly decreasing the level of earnings earned or if it makes future earnings more volatile, lobbying increases as well (Nobes 2010, pp. 248-249). According to Burgstahler (1997) positive earnings are a common objective in corporations and he states that references to a desire of high profits is made frequently in corporation's annual reports and news releases. It is also more common that corporation's shows small increases in profits compared to small decreases in their profits (Burgstahler 1997). Stakeholders historically have used the argument that they question if new amendments would lead to an increased level of fair presentation but instead they were concerned with its economic consequences (Zeff 1978).

The producer of financial statements is according to Kenny and Larson (1995) the stakeholder that could reach the most benefits by using lobbying. Users of financial statement are not involved in this process to the same extent as producers. This could be based on the fact that corporations are receiving their profits from one source, namely their corporation while users are receiving their income from many sources (Sutton 1985). This means that corporations are to a higher extent exposed to economic consequences related to new accounting regulation and is the stakeholder who will receive the most disadvantages of negative effects. Lobbying is also diversified in an industry where minor corporations does not have the same possibilities to be involved in the process due to extensive costs and time that is demanded (Askenmalm 2010, p. 29). Therefore minor companies included in the K3 regulation might not have the same chance to participate. Other reasons for not participating in the lobbying process are that stakeholders are agreeing with the proposal and that they believe that their opinions would not lead to any differences (Schalow 1995).

In conclusion stakeholders that are receiving benefits from lobbying will apply this approach and an increase of lobbying is present in the case where the proposed regulations have an immediate negative effect on a corporations earnings.

Chapter 4 – Empirical Findings

We have used three different sources contributing to our empirical findings. The first part includes an investigation of the comment letters received by the SASB, regarding implementation of the component depreciation approach included in the K3-regulation. To be able to analyze our research questions in a deeper manner we have interviewed three of these organizations that have delivered comment letters to the SASB. Interviews have also been done with two real estate corporations who are in the process of implementing a component approach and also an expert in this area. The last part consist of an illustration made on two real estate corporations showing if the component approach could have an impact on their financial statement, by using two different component models.

4.1 Comment letters

4.1.1 Administrative costs and abolishment of the strict requirement

According to the comment letters sent to SASB many has regarded the increase of administrative costs as the main disadvantage with the component depreciation approach. Corporations that own properties will be affected with this proposal and it will demand a higher administrative burden (SASB 2012; Swedish Property Federation, FAR, SAPHC, Swedish Real Estates, The Confederation of Swedish Enterprises). The administrative costs are related to the massive amount of components that the corporations need to administrate (SASB 2012; Swedish Real Estates) and also an increase of costs in continuously applying this approach over several years (SASB 2012, FAR, The Swedish Construction Federation, Castellum). These costs are questioned by several organizations and many believe that the costs will be higher than the benefits (SASB 2012, FAR, Swedish Property Federation, SAPHC, and Swedish Real Estates). They also questions if the level of fair presentation actually will be increased. In a property several components are included and therefore organizations believe that it will not be feasible to use this approach, the administrative costs will be too high (SASB 2012; The Swedish Construction Federation, Castellum). Castellum goes further in their comment letter by giving an example of what can happen if this approach is being implemented; *“Assume that a corporation has a property portfolio of 600 properties and each property consists of 10 components. Investments are made 5 times on all components each year, this would lead to 30 000 different depreciation schedules and estimations, and therefore we conclude that the benefit of this proposal is absent”*.

Many organizations are very critical that a strict requirement of component depreciation is included in the K3 proposal (SASB 2012; Castellum, Swedish Real Estates, SAPHC, the Association of Swedish Accounting Consultants, and The Swedish Union of Tenants). These five organizations are united in their view that the strict requirement needs to be abolished and changed into a possibility for corporations and therefore maintain a possibility to estimate the depreciation rate according to the traditional method.

4.1.2 Need of transitional rules and abolishment of the retroactive approach

The proposal has excluded transitional rules of how a corporation should account for their properties at the transition day. Should the component approach be regarded only on new investments or on all properties? (SASB 2012; The Swedish Construction Federation, SAPHC, Swedish Real Estates). If these rules are not implemented a retroactive approach will be required on all properties and it will lead to a difficult process for corporations to be able to implement this new approach (SASB 2012; The Confederation of Swedish Enterprises). To find the accurate values for each component without these rules will be a challenge (SASB 2012; Swedish Union of Tenants, Swedish Real Estates). Several corporations are suggesting that the retroactive approach should be abolished (SASB 2012; FAR, The Confederation of Swedish Enterprises, Castellum). This approach is in practice difficult or impossible to implement for many corporations (SASB 2012; The Confederation of Swedish Enterprises) due to complex and active property portfolio (SASB 2012; Castellum). FAR suggest that if the component depreciation approach should be implemented then the focus should be on new investments and therefore no retroactive approach. The table below (figure 4.1 summarizing arguments from comment letters) shows a summary of the overall comments of component depreciation that SASB received on their draft.

Figure 4.1 Summarizing arguments from comment letters

	Castellum	FAR	Swedish Property Federation	The Swedish Union of Tenants	Swedish Association of Public Housing Companies	Swedish Real Estates	The Confederation of Swedish Enterprises	The Federation of Swedish Farmers	The Swedish Construction Federation	Sten-Eric Lingblad and Pernilla Lundqvist	The association of Swedish Accounting consultants
Administrative costs	X	X	X		X	X	X		X		
Need of transitional rules				X	X	X	X		X	X	X
Abolish the strict requirement	X			X	X	X		X			
Abolish the retroactive approach	X	X					X				
Standards include vague criteria	X				X						X
Allow the fair value option	X		X		X						
Exclude minor corporations		X									X
Need of guidance from branch organisations		X			X						
Could lead to increase of rental				X							
No listed companies uses it					X						
What is an component?					X	X					
Where is the boundary between investment and maintenance					X						

4.2 Presentation of respondents

4.2.1 Swedish Association of Public Housing Companies (SAPHC)

Swedish Association of Public Housing Companies (*“Sveriges allmännyttiga bostadsorganisation”*) is an organization that helps and guide municipality owned real estate corporations in Sweden. SAPHC has around 300 different real estate corporations that they assist. These corporations are active in cities all across Sweden and include entities with major differences in size. Altogether SAPHC assists corporations that together owns 730 000 properties, and has a net turnover of 43 billion Swedish Crowns (SAPHC 2012a). Their main objective is to offer guidance, support and service through consultation, information and educations, so that these corporations can be able to be effectively in a long-term perspective and be competitive on the market. SAPHC also has the responsibility to follow the real estate industry internationally to be able to understand trends and aspects that can increase the efficiency for their corporations at an early point (SAPHC 2012b). We interviewed Peter Wallberg who is an economist at SAPHC he is also responsible for this organizations accounting guidance and for their accounting committee.

4.2.2 Swedish Property Federation

Swedish Property Federation (*“Fastighetsägarna”*) is a business organization and represents approximately 17 000 members. These members owns about 80 000 properties and 80 % of all commercial properties. Their purpose is to help their member organizations to make their voice heard in questions that they have towards the Swedish parliament and the government. They are also working on a local level and assist their member organizations in their daily work, Swedish Property Federation also have collaborations with other organizations in Europe to be able to influence decisions made in EU. This organization gives guidance in economical and technical issues that corporations might have, and also gives them the opportunity to receive help in the rental negotiation process (Swedish Property Federation 2012). We interviewed Ulla Werkel and she is a tax lawyer at the Swedish Property Federation but she also works with accounting and finance in their organization.

4.2.3 The Swedish Union of Tenants

The Swedish Union of Tenants (*“Hyresgästföreningen”*) represents 525 000 households and their objective is to attain a high standard on residents across Sweden for a reasonable price. At the local level the organization is working in, behalf of their members, towards the landlord regarding important questions including the maintenance of the properties. At the municipal level they are negotiating the rental levels with municipal real estate corporations and also represent their members in other questions as well. The Swedish Union of Tenants is creating an increased standard of real estate's for tenants according to their website (Swedish Union of Tenants 2012). Stig Josefsson accounting manager and Karin Larsson real estate economist was interviewed in behalf of the Swedish Union of Tenants.

4.2.4 Telge Real Estates

Telge Real Estates is a real estate corporation that was founded in 1948 and they are Södertäljes largest real estate corporation, who owns and administrate 10 000 residences.

They are supplying residences with high technical standards in Södertälje and its surrounding area. Their mission is to create good residences to a reasonable price and they are focusing on a high level of standard and services for their clients. Their main objective is to contribute to the development of Södertälje and raise the attractiveness of the city (Telge Real Estates 2012). At the end of 2010 Telge Real Estates had a profit of 170 million Swedish crowns and assets including land in their balance sheet at a value of 8,5 billion Swedish crowns (Telge Real Estates 2010, pp. 6-7). Telge bostäder will be regarded as a K3 corporation and will therefore be affected by the component depreciation approach if implemented. Cecilia Löfquist was Telge Real Estates respondents and she works as Chief Financial Manager in their organization.

4.2.5 Botkyrka Real Estates

Botkyrka Real Estates is the largest real estate corporation in Botkyrka and they owns 12 000 residences. It is owned by Botkyrka municipal and is therefore a non-profit making corporation. Their main objective is to offer residences that are affordable and key words are safety, quality and professional service so that a high growth is possible (Botkyrka Real Estates 2012a). Their basic values are that they want to have a close relation with their clients and states that they are regarded to be reliable and engaged in the local environment (Botkyrka Real Estates 2012b). At the end of 2010 Botkyrka Real Estates had a profit of 20 million Swedish crowns and properties including land at a value of 2.2 billion Swedish crowns (Botkyrka Real Estates 2010, pp. 15-16). Botkyrka Real Estates will be regarded as a K3 corporation and will therefore be affected by the component depreciation approach if implemented. We had our interview with their Chief Financial Manager Jan Karlsson.

4.2.6 Bo Nordlund

Bo Nordlund is a technical doctor and accounting specialist in the valuation of real estate area, he is also a member of FAR. Bo has earlier been working in the auditing firm KPMG and been an qualified teacher at the Royal Institute of Technology (KTH) in Stockholm. Today he is working in his own firm Bo Nordlund Real Estate Consulting AB (BREC) where he offers consultancy and education in the real estate area (BREC 2012). Over the years Bo has published many articles in for example Balans, where the component depreciation approach has been the main focus.

4.3 Interviews

4.3.1 Swedish Association of Public Housing Companies (SAPHC)

Peter believes that the component depreciation approach is in practice feasible because nothing is impossible, but he adds that there are more disadvantages than advantages. Implementing this approach will demand a substantial increase in administrative time and resources. It will lead to increased costs and Peter also questions its relevance because this approach might not increase the level of fair presentation or comparability in the financial statements. *“I don't believe in the component depreciation approach even though in theory it looks attractive that every corporation is going to follow the same principle and estimate the*

depreciation equal, because it includes too many barriers such as extensive costs”, Peter states.

According to K3, capitalization will only occur when the corporation would receive a future economic surplus value from the costs laid on assets, and if this is the reality it would end up like it is today and no drastic changes will occur. But if you could capitalize all maintenance costs this approach might in the future lead to an increased level of accounting quality. This approach would though lead to an increased level of capitalization in the corporations and it could lead to a higher level of economic reality in the financial statement. Peter states that a regular problem that appeared when he started in this business was that regular maintenance costs was directly expensed in the income statement the year that they occurred. These maintenance costs, even though you only restore the property to the original standard, would lead to an increased standard on the property in the long-term, because the corporation is now able to lend this real estate to their clients for an increased limit of time. And by capitalizing these costs you would achieve a balance sheet that has a higher level of economic reality, and this is an advantage with the component depreciation approach. Other advantages are that the corporations are forced to implement well judged maintenance plans, which lead to an improved future planning. Regardless of these advantages it could still be questioned if this increased level of accounting quality is so great that it could legitimate all the increased costs that the corporations receive.

The strict requirement for component depreciation included in the K3 proposal has to be abolished and instead regarded on a voluntarily basis, Peter states. In Swedish accounting today it is voluntarily and if you analyze the real estate corporations accounting there is no one that uses component depreciation, due to implementation barriers. And at the same time no publicly listed corporations is using this approach either, because of the possibility in IAS 40 to use the fair value accounting, and this option will never be included in the K3 proposal due to discrimination of the Swedish Annual Accounting Act. He believe that a retroactive approach is not going to be implemented instead the component depreciation will probably be implemented only on new investment.

One big issue with this approach is how to define what a component is and how to estimate it's useful life. Little or no research has been done in this area, should you account as few components as possible or should you try to be as realistic as possible it depends on which one you talk with. Some persons says that if this approach will be implemented than you should try to only use three different components categories, keep it simple. But when Swedish Real Estates implemented component depreciation in the end of the 90's they used a model included 25 components, after analyzing the consequences of this implementation it showed that this model was too extensive and included too many components. This lead to a substantial increase of their costs and in the end they switched back to the traditional model, estimating an asset as a single unit. Peter believes that it is important for the industry to meet up and discuss and implement an internal guidance, together with experts and see what is in practice feasible and conclude some kind of definition for what a component is. One approach could be to categorize components into 3 to 4 groups with different estimated useful life and

by this determine each group's depreciation rate. There is also an obvious risk that different corporation makes different estimation of what a component is and which useful life that should be used, the risk is that subjective judgment increases with this new approach. The corporations will probably not be reluctant to the increased possibility of subjective judgment, but it all depends on how the auditors will review the corporations accounting for fixed assets. The reason behind the increased subjective judgment is not the vague criteria included in the K3 proposal instead Peter argues that economic incentives is the main reason. Valuation of assets is an everyday question for the real estate corporations, how too account maintenance costs according to the standards but at the same time fulfill their interest as well. The vague criteria included in the K3 proposal are unsatisfactory and the different paragraphs is not sometimes synched with each other. At one place it is stated that maintenance costs that does not bring any future economic benefits for the corporation cannot be capitalized (§17.7) while in 17.13-17.19 it states that reparation costs shall always be expensed, regardless if they bring future economic benefits to the corporation. One issue with component depreciation is how to calculate the component substitution cost and Peter believes that corporations might look into the income statement to see how much the entity is able to handle as a cost. This will lead to extensive subjective judgment where some corporations might regard component substitution in 20 % of the apartments as a cost that should be capitalized while other corporations might regard a higher percentage level of substitution before they regard it as an asset on the balance sheet. This is related to the reasoning that some corporations afford to expense more, without reducing their profit into undesirable levels, in the financial statement.

Big part of the maintenance costs today is going to be capitalized with this approach, you should also activate components even though it exceed the market value on the property this will lead to an demand for impairment, then the value on the property will increase at the same time as the yearly result will decrease due to increased depreciation. At the same time the maintenance costs will decrease which leads to an overall profit smoothing. In big parts of the country you have booked value that is equal to market value and corporations located in these areas do not have any possibility to use this method because they need to use impairment directly. This method will work in a market where you have a possibility to activate these costs without considering impairments such as in bigger cities while it will be more difficult in minor cities. Peter states that properties today can have a depreciation rate of 2 %, while with this new component depreciation approach it would be more difficult to motivate it and could lead to a higher depreciation rate. Because of a higher annual depreciation percentage the annual costs will increase, which could have impact on some of the corporations.

4.3.2 Swedish Property Federation

Ulla has a negative attitude towards the component depreciation approach and believes that it will probably not increase the fair presentation of the financial statement. It will be difficult to implement this new approach, due to high administrative costs and it demands for extensive work. Everything is possible but the question is if it actually enhances the level of fair presentation and how much work it will take to implement. It also depends on how this

approach will be implemented, at which level the categorization of components should be done, more component categories equals an higher level of administrative work and costs. A to extensive level of component categories will lead to administration and supervision difficulties over the properties, because of too many different underlying accounts. The administrative costs will also increase if a retroactive approach is going to be implemented; it is going to be very difficult, *“I mean some corporations have plenty of old properties and it is almost impossible to estimate each component in those buildings, an retroactive approach is not an good idea”*, Ulla states. Problems might also arise when corporations are defining what a component is and what to include, also problems with the useful life estimation of each component is an disadvantage with this approach. Ulla has some difficulties to find any advantages with this approach and her negative beliefs and thoughts have increased after several consultations with auditors in the real estate industry who also claims to have difficulties with understanding the benefits that this approach will have. It could have advantages on a higher theoretical level but in practice Ulla still believes that it would not increase the accounting value; *“I find it difficult to see any advantages at all”*. Not even analysts will receive a better picture of the corporations and they do not demand this approach.

It is important not to distinguish component categories to wide, groups in the region of 20 is not manageable. *“A limited amount of groups with perhaps a 5 years interval could be a system that might be workable”*, she says. These things are difficult to discuss because we have not yet seen SASB last proposal and when we have done that we at the Swedish Property Federation will issue guidance for corporations, which would help them in their work of how to in an effective manner define what a component is. Each year we release guidelines to corporations on how to interpret different accounting principles, and if implemented the component depreciation is an important part to inhabit in this guidance. She does not believe that SASB will release any guidance regarding component definitions and therefore clearly states the importance of their work together with other organizations, for example SAPHC, to help corporations with this issue; *“I believe that this process will work out well for all involved parties and resolve some of the problems”*. Some kind of component depreciation approach will be implemented in the future but clearly pronounces that even though it is possible to categorize an property into an extensive amount of different components it's important to focus on just a few groups; *“we need to do as little harm as possible”*, she says. It is impossible to internally in an organization have a discussion about every small part included in a property and discuss individually its useful life; a broader view is critically needed. The corporations will have many technical issues to solve when implementing this approach, it will demand an extensive correction of their plant register and many underlying accounts for each property have to be developed. Ulla believes that this will change corporations accounting materially and increase the level of costs.

When you are forced to divide a property into several components it equals increased levels of estimation because you need to consider each parts useful life. This increased estimation possibility might lead to a higher level of subjective judgment; this is even more possible if

the industry lacks a clear guidance regarding how to define and categorize components. If this guidance does not exist and praxis in the industry fails to be implemented, it will lead to corporations making estimation internally and therefore lose the comparability between entities accounting. As the K3 proposal looks today the problem area that they have identified at Swedish Property Federation is the component depreciation approach, which includes vague criteria in some aspects. But otherwise, except from some minor mistakes, she believes that this proposal is a good effort from SASB towards a better accounting. Subjective judgments can be derived from both vague criteria included in the proposed standard but also from internal economic incentives. Most of the corporations are following the praxis of an industry, but if an opportunity of judgment is there some corporations that might have financial problems will probably use it for their advantage. There might be some problems for corporations in the implementation phase with the standards and norms but in the long term the issue will be a more technical problem, *“It would be a big issue if the regulations are so unclear that it leads to insecurity in the industry”*, Ulla says.

Today the industry uses an annual depreciation rate that often lands between 2 and 1 percentage, but with this new approach where you divide the property into components that often has a lower useful life it would lead to an increased rate of depreciation. But Ulla also believes that this will not occur in every entity, in some corporations differences will probably not be visible to the same extent. But clearly there is a risk that the yearly costs will increase if the corporations need to use depreciation according to this model and in that case it will have a negative impact on their result. These negative aspects could lead to problems for some corporations which cannot handle minor changes in their costs. Some entities might use depreciation to balance their results and for them this strict requirement could lead to financial problems. She explains that there is an anxiety in the real estate industry today regarding this component depreciation approach. Corporations are worried about increased costs and they cannot relate to its benefits. They are contacting us and want explanations and guidance of how this approach will have impact on their corporation, and it is because of them that we sent in a comment letter to SASB and explained our worries regarding this approach.

4.3.3 The Swedish Union of Tenants

A component depreciation approach will lead to increased administrative costs at the corporate level and it is somehow difficult to estimate if this new approach is in practice something that is possible to implement, due to its high costs, Stig says. These costs are highly related to the requirement of a retroactive approach, included in the K3 proposal. This approach will be difficult to implement for especially those corporations that own old properties, where transactions has been made historically which leads to an hurdle for corporations to estimate each components value retroactive, Karin says. *“Therefore if a component approach will be implemented, we support a method where you start the valuation on new investments not retroactive”*. Stig continues; *“The Swedish Union of Tenants will not receive any direct benefits from this new approach”*. Their organization does not support the strict requirement included in the standard, their organization works in the nonprofit sector and have tried to enforce SASB to implement a special K3 regulation suited for this sector

that could include an opportunity of component depreciation instead of a strict requirement, but without success. At a theoretical level they could see some advantages of this new approach; it could lead to a better and more relevant valuation of assets by depreciating each component individually. This is the only advantage that Karin could point out and she states that; *“in a corporate perspective and all disadvantages that are including in this method is the reason for us to not support this approach”*.

They believe that if a component approach is implemented it is important not to focus on too small parts and too many different component groups, the focus should be at the properties major parts and therefore as less components as possible should be the praxis. Karin adds that an idea could be to have some kind of system where you use different appropriate levels of useful life and categorize each components in one of these categories, so that few groups includes several parts with almost the same useful life's. It is difficult to estimate how many components that is appropriate and feasible to use in an organization. Swedish Real Estates that used approximately around 25 categories is a system that is too extensive according to Stig. To answer this question you need a good insight in a properties different components and their useful life, but components above 10, he regard as too many; *“The fewer the better”*, Stig States.

Subjective judgment could be increased due to a valuation on each component individually, and Karin states that; *“If one corporation is estimating that their elevator has a useful life of 30 years and another corporation has the exact same type of elevator but estimate it to have a useful life of 40 years, subjective judgment has occurred”*. This subjective judgment could be referred to both economic incentives and vague standards, it depends on which corporation you analyze; but a corporation that has profit maximizing as their main purpose is probably going to have some kind of economic incentives included in their decisions. Corporations do though mainly look into the demand on the market when they estimate a property's value, and therefore does not use economic incentives as their main objective. The K3 proposals include vague criteria when it comes to the definitions of components and when asking SASB for guidance the answer have been that it is not their task according to Stig and he continues; *“SASB is letting each industry determine this definition and that is not good enough, stricter guidelines are needed”*. Even though the Swedish Union of Tenants respondents believes that this new approach could lead to an higher level of subjective judgment, they also thinks that this method could lead to an increased level of fair presentation and comparability between corporations. The fair presentation will probably be higher in the bigger cities of Sweden, where the accounting competence already today exists, while smaller cities will probably need a longer implementation phase before they reach the same level, Karin says.

This approach will have impact on corporations financial situation, it will lead to a higher annual depreciation cost that has negative impact on the income statement; key ratios will also be affected in the same direction. The result will though become smoothed over time because of a decrease of yearly maintenance that otherwise could have severe impact on the result, these will instead be capitalized and depreciated. This approach will also have impacts on the

depreciation rate on assets, it will probably land on somewhere near a useful life of 50 years, maybe less according to Karin.

4.3.4 Telge Real Estates

Telge Real Estates uses a component depreciation approach for their assets. As Cecilia states; *“When Telge Real Estates have done restorations, we have during the last three years used a component approach, separating the building into approximately 21 different components”*. They have implemented this approach, prior to the anticipated requirement included in the K3, because it sometimes has been difficult for them to expense the total amount of restoration in the income statement. Another reason is that it also creates a better arrangement and overview of our assets. Prior praxis for Telge Real Estates has been to capitalize some parts of for example a foundation while some amounts have been regarded as an immediate expense. Today they have a better control and a well working system for when and how to account for a substitution of an old component from the balance sheet; this has led to a higher level of fair presentation, according to Cecilia. It is important to start the implementation at an early stage which is another reason for them to be an early adopter, because this new K3 proposal is anticipated. The main difficulties to implement this approach for Telge Real Estates have been to organize a plant register, and figure out how to manage the substitution of components. This has led to a high level of administrative costs. Another disadvantage with this approach is that in the long-term it is difficult to estimate how much depreciation Telge Real Estates actually is going to have, which equals difficulties to estimate future depreciation rates. The depreciation rate has been changed to some extent, but they anticipate that more distinct changes will be visible after full implementation according to Cecilia. Telge Real Estates have only used this approach during the last three years and therefore have not been able to use full implementation on all of their assets, only focusing on new investments. Cecilia points out that if full implementation is required it will lead to a depreciation time of approximately 40 years. The retroactive approach should not be considered due to its extreme administrative costs, *“it is possible but it will demand to much administrative work”*, Cecilia states.

The last K3 proposal did not include any guidance on how to implement the component depreciation approach at the transition date. It is also stated that K3 corporations should be required to implement the approach directly without including a possible transition period. This will lead to a high level of administrative costs at the transition date. Component depreciation will also lead to an increased depreciation rate for the fixed assets, but according to Cecilia *“you could capitalize more and it will lead to higher comparability in-between corporations because you know how much that has been capitalized, which today could be difficult to understand because it differs too much in-between different corporations”*. It will also lead to a balance sheet that will become more accurate, compared with today’s accounting where values are accounted for at wrong places.

Telge Real Estates have chosen to define components as big parts such as, foundation, elevator etc. Cecilia does not believe that taking it down on to small details is possible, *“this is our definition of what a component are but you could always regard it differently”*. The

reason for them to choose 21 different component categories is that their plant register is working well and they also receives the wideness and because of that achieve a fair presentation. Cecilia believes that it is always difficult to categorize components in fewer groups, because each component has a specific useful life. It is also difficult in an administrative way, if for example they do a substitution of the elevator and if it is categorized with something else then it is not practicable to determine the residual value. When they implemented an component depreciation approach on new buildings, Cecilia consulted with their technical chief regarding guidance of different components useful life; *“me as an economist, could never be able to handle it by myself I needed help from an engineer”*, Cecilia said. After this discussion they needed to consult with their auditing firm and receive an approval of their model, including approval of their substitution model and their assets different components useful life. The useful life is based on their prior experience that exists internally in Telge Real Estates. After implementation of this new approach, Cecilia understood that a useful life of 100 year for a property is difficult to argument for.

Cecilia does not believe that the proposed K3 regulation is that difficult to implement and understand. The criteria are fairly well interpreted and that even though some parts are vague, praxis in the business will be adopted in the long-term. This new component depreciation approach can lead to an increased level of subjective judgment, because they need to estimate more components. Historically real estate corporations have used a low depreciation rate and useful life estimation around 100 year, which Cecilia believes is very difficult to motivate. Corporations are in the process of understanding how important fair presentation is for their stakeholders, and we will go towards shorter depreciation periods which equals an increased economic reality, Cecilia says. Subjective judgment could be referred back to unclear and vague standards, and not mainly to internal economic incentives.

4.3.5 Botkyrka Real Estates

Botkyrka Real Estates is working on implementing the component depreciation approach and their main objective is to get the new system in action at September 2013. Jan states that the advantages of implementing this approach are related to their near future which consists of a high need of maintenance of their property portfolio. Their traditional approach of dealing with fixed assets has been to when capitalizing a cost all costs will be accounted for at the same account and depreciated as an whole unit with an depreciation rate of 2 %. Jan believes that this system is not accurate; *“some components has an useful life that is lower than 2 percentage while other components such as the foundation has an higher useful life, our balance sheet is therefore not in line with the expression fair presentation”*. Implementing this approach will lead to a more correct matching with the components actual technical life and therefore a more accurate depreciation rate. Another advantage for this corporation is that because of an strong demand of maintenance in the near future by capitalizing these cost and depreciate it over its useful life this approach would increase their profit compared to the traditional approach were most of the costs have been expensed directly. Botkyrka Real Estates is also positive towards the retroactive approach and consider it too be fully implementable; *“when we are going to analyze our old properties we will probably find that*

90 % of the booked value is related to the foundation while the other components has already been depreciated, our aim is to have one plant register based on an component approach for all our properties”, Jan states. The main disadvantage is the increased level of administration needed to implement in their new system and this cost is mainly related to the early stages of the process where a new plant register is needed and many hours of work would be demanded. Many employees will be involved in this process according to Jan and continues; “three employees from our financial department, approximately two employees from our technical department and also consultants will be used for their expertise in this implementation process”. Jan still believes that the advantages is greater; “When the implementation phase is over we at Botkyrka Real Estates will have an new way of dealing with our fixed assets and it will equals an improved system with an higher control of our properties, that also increases the level of fair presentation”.

A component should be an easily distinguishable property parts for example the roof or an elevator according to Jan. One important aspect is that their plant register that will be implemented have to be practically feasible and therefore a focus on too many different components might be difficult. In their process of implementing this component system discussion has been raised regarding how many components that should be used. Jan states that; *“discussions with our technical department is mainly related to the properties differences and we have talked about using in-between 10-15 different component groups”*. But during their discussions Jan states that as closer their proposal goes towards the financial department the amount of components decreases while the technical department does not regard it as something complex to recognize components.

Botkyrka Real Estates believes that by implementing a far too extensive system with several small component groups included it could lead to administration costs that is too big and also they might lose control over the properties. Jan believes that it is too early for them to discuss exactly how their plant register system will be established and so far there have only been some calculations and discussions made regarding this approach and therefore they do not know where it will land. Botkyrka Real Estates has started to analyze their plant register and financial system to see if they can in an effective manner use this approach, and Jan states that; *“we are going to have a project module that is catching all investments and thereafter locate it to the correct account”*.

Jan believes that the proposed K3 regulation is sufficient and that it is all depended on how the regulation should be perceived; as a standard or as a definition handbook. He continues: *“I believe that it should be regarded as a framework for accounting and therefore not needed to include guidelines for how to define a component, instead let the business organizations or praxis deal with that task”*. It would be practical if guidance would be released, guidance that corporations could relate to when estimating components. There is also important that this guidance is business specific because each segment has specific components that are of importance. Jan brings up an example of hospitals that is one segment that is special and where components is highly focused on their most important parts that they need to be able to continue with their work and have an high level of security, for example elevators that is

especially important in this area. Subjective judgment could be included in this approach based on how an corporation is defining an component and it can vary in different corporations, but he clearly states that after this process the subjective judgment will not be increased instead he says; *“It will lead to an more open accounting towards auditors instead of using one depreciation rate for the total properties, the level of fair presentation will be increased”*.

The depreciation rate will increase after the implementation of a component depreciation approach. Botkyrka Real Estates have only done some low advanced calculations and studies and have found that the annual depreciation amount will get increased to some extent, but Jan adds that it is still too early to estimate how big this difference will be. Their profit will be increased after this implementation because they are going to capitalize more costs than they are doing today; this is going to occur even though the depreciation cost will be increased. The benefits for their result is higher due to a lower level of expensed costs in the income statement compared with their increased depreciation cost, Jan states. Corporations included in the K3 category is big entities and therefore should probably not have problems dealing with implementation of this approach. It could though have impacts on the need of impairments in some entities and this demand will be increased when the booked value is higher than the market value.

4.3.6 Bo Nordlund

The clear advantages with this approach are that it will show a more correct result over time and there will also be a better capital accounting when you capitalize costs that fits the definition of assets in the balance sheet. The matching between costs and future benefits will increase when capitalization is enhanced. The disadvantages with this approach is that the administrative costs and burden will increase due to a higher level of work needed, where the costs will be at the highest point during the implementation phase. Bo also believes that the business organizations are going to play a vital role and that they need to release guidelines for the industry regarding what a component is. If the corporation should be able to solve the technical issues related to the component approach they need strict and valid guidelines from business organizations and a high level of education considering the changes that this approach will lead to. The management needs to be able to analyze each new acquisition and understand what kind of component it should be related to, Bo says. The guidelines hopefully issued should help corporations in the process with their implementation of a new accounting distribution system that this new approach will demand. Another technical issue is the routine for how to substitute a component accurately, this do also need to be clarified. Today, in most cases, this cost is still included in the assets even though it is being replaced, according to Bo.

It is possible to implement a component approach but it demands that corporations need to change their working principles, the possibilities of implementation also depends on which level an component will be defined, higher level of detail leads to an increased complexity to implement it. One thing that needs correction in the proposed regulation is that the retroactive approach must be simplified, *“I believe that you have to accept that corporations has done different historically estimations and that the book value at transition date should be used and*

divided up on different components". The disadvantage with this could be that corporations have used a different level of investments that has been capitalized compared to maintenance cost which has been expensed. This will lead to some consequences, a few corporations will have more long-lived components in their balance sheet while other has also short-lived components included, and therefore it could be difficult to get it right according to Bo. The employees inside organizations will also need to be relearned and really understand this approach so it will be done accurate directly. It is important that the employees understand the new register needed for this approach and be aware of the accounting distribution system, so that each expense is ended up at the right account.

Bo wants to define a component as a material expense which has a material departed useful life compared to the main asset. He believes that individuals in the industry has a quite good idea of what a component is; *"If you look into a corporations maintenance scheme, they already there have separated some parts as for example; foundation, roof, facade, balcony and windows etc. Then this is a natural limit of what a component truly is"*. It is possible to divide an asset into a very detailed level, but it is important that you find a level that will work in practice. The K3 proposal includes good guidelines when they refer to concepts such as material expenses and material separately useful life's. This is of importance when you have to locate component categories that are based on different material level of useful lives and as I believe categories between 10-15 is a reasonable level. But the most important aspect is to locate the major parts with a useful life between 30-50 years, for residential buildings, because it is here that the main costs can be allocated and have the highest impacts if they are expensed on the income statement. For office buildings centrally located in strong markets the need for replacement of significant components could be expected to have shorter intervals (time ranges).

Subjective judgment can be increased with this approach but he also claims that the benefits with this system will still be higher than the disadvantages. The traditional method that is used for depreciation of properties today is not that appropriate according to Bo and gives an extreme example of a case that might occur; *"If you compare two corporations with each other, the first might have a really high yearly profit and therefore is able to expense all its costs in the income statement. The other corporation has a low profit margin and therefore searches for every opportunity possible to capitalize the costs to avoid a direct impact on their result"*. This could lead to an extreme case were one corporation is capitalizing its foundation when the other is taking it directly to the income statement; this is a problem with today's system it does not present a fair presentation of corporations accounting of assets. The new system is going to have management judgment included in the process of component substitutions, how much is it worth at that point is a question that could be difficult for corporations to answer due to the lack of a transaction based accounting. Subjective judgment will also occur at the acquisition date, where a corporation may need to estimate which component the cost is related to. Bo states, although the advantages with this system will still be higher than the disadvantages.

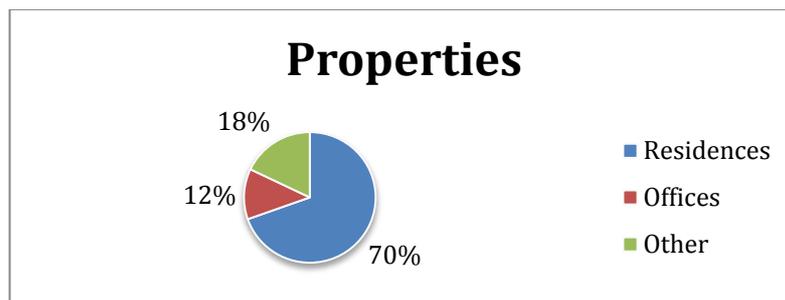
He does not really understand the criticism that has been raised towards the K3 regulation regarding their vague criteria, *“The K3 regulation is principle based and it is supposed to be applicable in every industry and therefore it is impossible for SASB to define what a component should be, this is a task for business organizations”*. If these organizations are taking their responsibility than the K3 regulation is well acceptable. The K3 regulations are dealing with stricter impairments requirements, which are going to prevent corporations to overvalue their assets. Raised needs for impairments might have impacts on the industry but Bo believes that this is just a book-keeping issue, because maintenance costs taken directly to the income statement or impairment costs due capitalizing maintenance will both effect the income statement but with different signal value. Some corporations might feel threaten to show impairments due to its signal effect; *“High maintenance costs could signal that the corporation is doing investments to increase the standard on their real estates, while impairment costs signals that they have done weak investment decisions”*, Bo states.

The income statement will be affected by this new approach, the depreciation rate will increase which will have a negative yearly impact on the result. At the same time the maintenance costs will decrease and therefore lead to a profit smoothing where the corporations will avoid big periodical costs in the income statement and instead capitalize them. The balance sheet impact will differ from one corporation to another due to some entities is already today capitalizing at an high level and therefore will not see any significant differences, while others that has expensed major parts of their costs will get an increased level of assets. These effects on the financial statements could lead to some hurdle in corporations with low profit margins, but in a long-term it should be quit equal because of a decrease in the maintenance costs, Bo states. Some corporations might have used a high level of capitalization but still use a depreciation rate of 1 %. These corporations might feel threaten of the component depreciation approach which will directly decrease their profits and not improve their profit smoothing, due to an already high level of capitalization, Bo states.

4.4 Financial statement analyzes

4.4.1 Ernst Rosén AB

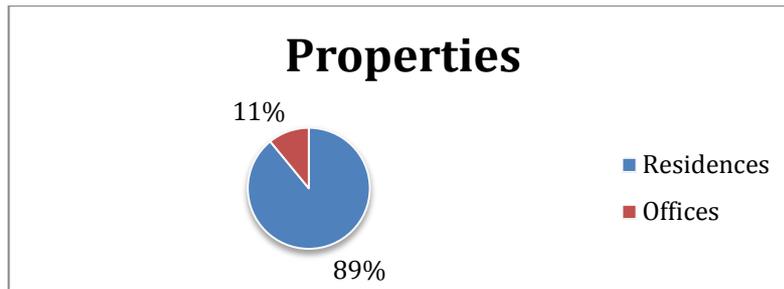
Ernst Rosén AB owns and administrates around 100 properties in Gothenburg, Alingsås and Lerum. Their main objective is to reach a high level of long term-returns and have content clients. The corporation has been in this business for 60 years and is a family owned entity now at the fourth generation (Ernst Rosén 2012). In the financial statement of 2010 it is stated that Ernst Rosén AB owns 240 000 sq m of properties. This is divided at residences (167 000 sq m), offices (30 000 sq m) and the remaining as an own category called other (43 000 sq m), see diagram below (Ernst Rosén 2010, p. 11).



Ernst Rosén AB owns properties and land at a book value of around 2.3 billion Swedish crowns (SEC), in their opening balance of 2010 (Ernst Rosén 2010, p. 52). Their property is assessed to be 70.8% of the total amount. The offices are assessed to be 12% of their property and residences are assessed to be 70% of their property. According to our model (see Appendix 1.1) the depreciation costs for offices would approximately be 8 million SEC and with a rate of 4.0%. The actual depreciation rate for Ernst Rosén was disclosed in their financial statement and they had a linear depreciation rate of, 1 % used as an overall for their properties (Ernst Rosén 2010, p. 59). This means that this year's depreciation will be 2 million SEC, comparing with our model this will result in a difference of 6 million SEC, regarding offices. Continuing with the calculations for residences, according to our model (see Appendix 1.2) the depreciation rate will be approximately 2 % compared to the used depreciation rate of 1 %, which results in an increased depreciation cost of 11 million. Ernst Rosen profit for the year 2010 ended up at 97 million SEC but if considering our models regarding component depreciation in offices and residences the profit would be reduced with 17 million SEC to 80 million SEC (Ernst Rosén 2010, p. 51).

4.4.2 Graflunds Real Estates

Graflunds Real Estates owns and administrate 14 500 residences and 80 000 sq m commercial properties in for example Strängnäs, Mariefred and Eskilstuna (Graflunds Real Estates 2012a). Their business idea is to offer and develop residences to each individual that wants to rent instead of buying an apartment (Graflunds Real Estates 2012b). Residences is 89.1% out of Graflund AB property portfolio and 10.9 is commercial properties, see diagram below (Graflund Real Estates 2010, p. 7).



Graflunds Real Estates owns properties with a book value of 1.2 billion Swedish Crowns (SEC), in their opening balance of 2010 (Graflunds Real Estates 2010, p.34). In their financial statements Graflunds Real Estates is using a category of commercial properties as everything else besides residences. In our calculations we have used the commercial properties and considered it to be offices. Offices are therefore assessed to be 10.9 % percentage of this amount. According to our model (see Appendix 2.1) the depreciation costs for offices would approximately be 5 million SEC and with a rate of 4.0%. The actual depreciation rate for Graflunds Real Estates was disclosed in their financial statement and they had a linear depreciation rate of 1 % used as an overall for their properties (Graflunds Real Estates 2010, p. 31). This means that this year's depreciation will be 1.3 million SEC, comparing with our model this will result in a difference of 3.7 million SEC, regarding offices. Continuing with the calculations for residences, according to our model (see Appendix 2.2) the depreciation rate will be approximately 2 % compared to the used depreciation rate of 1 %, which results in an increased depreciation cost of 10.5 million. Graflunds Real Estates profit for the year 2010 ended up at 116 million SEC but if considering our models regarding component depreciation in offices and residences the profit would be reduced with 14.2 million SEC and therefore decrease the profit to 101.8 million SEC (Graflunds Real Estates 2010, p.27).

Chapter 5 – Analysis

In this chapter we are analyzing the empirical findings with our frame of references to be able to answer our research questions. This part is divided into two sections according to our research questions.

5.1 What are the anticipated effects of applying component depreciation and why is there reluctance in the real estate business to implement it?

Our empirical findings show that all of our respondents had a common view about the anticipated effect on financial statements. It was commonly cited by all that more maintenance cost would be capitalized and depreciated when introducing component depreciation. But if this will generate better information to users and if there is a demand of a more comprehensive and transparent accounting of depreciation is there different opinions on. The Swedish Union of Tenants agreed upon the reasoning of coming closer to a fair value when dividing the properties in components to assess their individual depreciation rate but was more doubtful to if this approach will generate a more true and fair view of an entities property. The Swedish Association of Public Housing Companies also questioned if the financial statements will give a better true and fair view meaning that this is only applicable in theory when entities are using the same components.

The real estate companies that has a more detailed knowledge about components in properties is of the impression that subjective judgments in connection to depreciation will not increase as an effect of this implementation. It is normal that technicians are assessing the components in properties and then together with the financial department reduce components to a feasible level because a property can be separated in innumerable parts. The fact that buildings have different construction and functions makes it obvious that different judgments about components will be recognized and valued. A usually cited and simple illustration of an component in properties are elevators but naturally it makes sense that not all buildings have elevators and the useful life varies according to material and usage. Therefore the experience and knowledge to use own assessments are important which also is in line with a principle-based standard. Component depreciation has only a reallocation effect were more cost taken directly to the income statement are being capitalized and depreciated over time. But there can be different economic consequences of this if companies are put in a context regarding how they have used the traditional method. Real estate companies like Botkyrka Real Estates that faces huge maintenance cost are welcoming this approach because more can be capitalized and their view is that the anticipated effect will be positive on the income statement. Comparing this with a real estate company that has capitalized much maintenance cost already and used a general depreciation rate of 1% the effect on the income statement becomes negative. As we have tried to illustrate in our own calculations the depreciation rate of 1% used as a general rate to depreciate buildings will be hard to defend when separating the buildings in components. Accordingly a higher depreciation rate will generate higher depreciation costs. Both companies will face these higher depreciation cost but depending on situation the economic consequences of this can be different. There is also a downside in

capitalizing more maintenance costs if the properties book values will exceed the market values. This will force the real estate companies to perform more impairment. The signal value of having an impairment cost in the income statement is more inconvenient than having maintenance costs that signals that the companies have an interest in preserving their properties. These situations are more likely to occur in minor cities and districts where the book value of the properties is more in line with the market value. These negative economic impacts on the financial statements give an alternative explanation to why there is a great reluctance in the real estate business to implement component depreciation and this is not based on the increased administrative costs or practical issues that are usually voiced in this discussion.

It is fully clear that the traditional depreciation system has shortages and the main anticipated advantages related to this implementation are that an increased level of fair presentation in accounting will occur. As Cecilia Löfquist, Telge Real Estates, states that earlier their corporation has been able to capitalize some parts of for example the foundation while some parts are seen as an immediate expense. There is a scope to use discretion about what companies shall take as cost or capitalize depending on the financial muscles in the company. Real estate companies that have low liquidity are trying as far as possible to capitalize and recognize maintenance as standard improvements when companies with a stronger liquidity can take all costs over the income statement. Bo Nordlund is of the impression that real estate companies have done differently in this matter and this has to be taken into consideration. Jan Karlsson at, Botkyrka Real Estates, is agreeing on this opinion and states that their balance sheet is not in line with fair presentation when using the traditional approach, because all costs will be depreciated with the same rate even though some components have a higher or lower useful life's. Both of our real estate companies are of the impression that a better true and fair view will be reflected in the financial statements. The general accepted depreciation rate at 1% used in the real estate business is inadequate when for instance the foundation has an expected life three times longer than the ventilation system. According to the traditional method used today it is hard to see if maintenance are capitalized or taken directly to the income statements as a cost. Our expert in this area, Bo Nordlund, states that another advantage with this approach is that it will lead to an increased level of capital accounting and matching of costs and future benefits will enhance. Botkyrka Real Estates is agreeing that this is a positive aspect of the implementation. There will also be easier for corporations to administrate their properties after implementation and it will lead to a better overview of their maintenance plans. As Peter Wallberg says; *"corporations are forced to implement well judged maintenance plans which lead to an improved forward planning"*.

In our interview process we have been able to analyze all objection arguments found in the comment letters in a deeper manner and therefore more easily understand the component depreciation approach disadvantages. All our respondents believe that the increase of administrative costs is the main burden with the component approach and Stig Josefsson, at the Swedish Union of Tenants, goes even further and states that due to these costs it is difficult to estimate if this approach is even possible to implement. Our two real estate's

corporation respondents are in different phases of implementing the component approach. Telge Real Estates have already implemented this approach to some extent and therefore has by now experienced the increased administrative burden. Cecilia Löfquist, Chief Financial Manager at Telge Real Estates, states that the increased level of administrative costs is related to the demand of implementing a new plant register and to the process of establishing an effective system regarding substitution of their components. Botkyrka Real Estates has just started with evaluating how this approach is going to be implemented in their organization with an objective of full implementation in 2013. Jan Karlsson, Chief Financial Manager at Botkyrka Real Estates, is agreeing with Cecilia that the main costs can be related to an need of implementing a plant register and adds that the costs is mainly related to the early phase where many hours work will be demanded. Both our respondents Swedish Union of Tenants and the Swedish Property Federation is arguing that the requirement of an retroactive approach is the principle that is going to, if implemented, lead to the highest costs for corporations. Ulla Werkel states that because of properties that in many cases are very old it can be difficult to assess the useful life of the buildings components.

All the respondents are reluctant towards a retroactive approach, except Jan Karlsson Botkyrka Real Estates, and they means that it needs to either be abolished or simplified. If this will not occur the administrative costs will become too extensive for the corporations and therefore makes it even more difficult to implement this system. Jan Karlsson states that their objective is though to land at one plant register for all of their assets and therefore approves this requirement and believes that it is feasible because the main parts of their properties are today regarded to be the foundation while the other parts has been depreciated.

One interesting point of view that organizations used in their comment letters was that 5 out of 11 respondents argues that reluctance towards the K3 proposal is related to the strict requirement of implementing the component depreciation approach that is included in the K3 regulation. They believe that it should be regarded instead as a possibility to use this approach but still be able to use the old traditional model where depreciation is made on the total unit. Peter Wallberg, at SAPHC, is also agreeing on this opinion and means that this requirement should be abolished and refers to the possibility for listed corporations to use a fair value model for their investment properties. According to Nobes (2010) lobbying activities is increased if the proposed standard is abolishing an accounting choice. Referring back to the situation in the U.K. during the 80's when a debate was raised when standard-setters aim was to reduce choices in the English goodwill accounting. This was related to management disapproving that accounting choices was reduced due to corporations can draw benefits in diverse situation from different choices (Nobes 1992). This behavior is occurring regarding the strict requirement of a component depreciation approach as well, due to a desire of abolishing the strict requirement but still leave it as a possibility for corporations.

During our interviews with our respondents it is made clear that there is some kind of a clash between theoretical- and practical arguments present in this debate. As Ulla Werkel believes that this approach could be to advantages for corporations in a higher theoretical level but in practice it is not feasible and therefore is reluctant to it. Other respondents are agreeing with

these thoughts such as Peter Wallberg (SAPHC) who adds that it is related to many barriers and extensive costs, also Karin at Swedish Union of Tenants is discussing in these terms. According to Bo Nordlund this system is implementable but corporations need to reconsider their working principles. What is more interesting is that both Telge Real Estates and Botkyrka Real Estates, which are regarded to be practitioners in our study, are considering the approach to be regarded as fully implementable and even leads to an increased level of overview of their assets. It seems like arguments that this approach has only advantages on a theoretical level could be questioned when real estate corporations that has or are about to implement this approach are seeing many advantages with it. Jan Karlsson, Botkyrka Real Estates, states that they do understand that this approach leads to increased level of costs but he means that it is mainly related to the early stages of implementation and continues; *“Botkyrka Real Estates will have an new way of dealing with our fixed assets and it will equals an improved system with an higher control of our properties, that also increases the level of fair presentation”*. Swedish standard-setters are influenced by practical argumentations, which have had a strong impact on Swedish accounting standards. In cases of a higher level of theoretical arguments behind new accounting implementation, success has been absent. Swedish standard-setters has a history of listening to practitioners and therefore having more concern of producing standards with a sound practical approach than settle matters of principles (Jönsson 1991). Our empirical findings give a divide picture over the practical hardships of implementing this approach were business organizations are seeing many difficulties and even question if it is possible when having a retroactive approach. Although our real estate companies that has a better detail knowledge about components has a different view and the changes in working principles and updating their plant register is not regarded as a practical boundary.

According to Nobes (2010) organizations that write comment letters to standard-setting bodies such as SASB are using lobbying. Sutton (1984) continues and states that if a stakeholder believes that they would receive benefits from this approach and believes that they might have impact on the standard-setters, they will try to force their rule-makers into their direction. When SASB released their proposed K3 regulation they received 28 comment letters from different corporations and 11 of those were discussing their reluctance towards the component depreciation approach. The reasoning from the business organizations was based on the practical hardship of implementing this comprehensive way of depreciation and even if the information in the financial statements are becoming more relevant the element of judgment and uncertainty of what a component really is makes it questionable if the true and fair view will be improved. Even though the practical arguments are included in the reluctance the main source is connected to economic consequences. The main reluctance was that administrative costs will be extensively increased due to this implementation and therefore would be to disadvantage for the corporations. Additionally our empirical findings show that this standard will have economic consequences with a negative impact depending on how real estate corporations have used the traditional method. Nobes (2010) states that lobbying will increase if a proposed standard is having a negative effect on corporate earnings and as we could see in our case this argument could be confirmed.

5.2 What determines how real estate entities are recognizing components?

Dividing buildings in different components are a complex matter and both our real estate corporations agreed upon the complexity and the difficulties for their Financial Departments to manage this by itself. Buildings have a significant value and components can vary from building to building due its age, construction and material. Valuation of an asset includes assessments of its residual value and the useful life. Making this valuation on a component level regarding properties estimated to several billions and were different components varies from building to building gives an apprehension about the difficulties. The Technical Department in both our real estate companies was involved in dividing their buildings in components because requirements of a deeper knowledge about their buildings were needed. Bo Nordlund is of the impression that the initial recognition of components is a crucial moment and much time and effort needs to be invested. The hardship of going back for corrections and revaluation after the component model is in place can be avoided by being precise and accurate in the beginning. Botkyrka Real Estates has created a project group existing of three persons from the financial department, two persons from the technical department and an external consultant. Their auditor and auditing firm cannot participate in the project but were included as an external reference point. Telge Real Estates used personal from their Technical Department but their project was smaller comparing to Botkyrka Real Estates because their aim was only to divide new investments in components. Both companies agreed on that too many components could make the flow of information inconceivable and components cannot be recognized on a smaller detailed level. Although there was a discrepancy in how many components they had chosen to recognize. Botkyrka Real Estates was aiming at recognizing between 10 or 15 components and Telge Real Estates had already recognized 21 components and mainly used their plant register as a basis. The Swedish Federation of properties believes that components shall be separated in a few categories to do as little harm as possible. Stig at The Union of Tenants believes that components categories above 10 is too many and continues; *“the fewer the better”*. Although our business organizations agree on that only major component shall be recognized we can see a difference when implemented in the real estate entities.

The standard in the K3 draft do not give any further guidance about how many components that is feasible to recognize. Instead every company can chose for themselves and as it is today there is no praxis or guidance from the business organizations that creates a common starting point. The introduction of K3 that is based on IFRS for SME will bring a more Anglo-Saxon perspective into Swedish accounting. Therefore a more value-based attitude is expected with an investor focus and a balance sheet approach expressing the value of the company. This is in line with introducing components depreciation because more relevant information will be disclosed in the balance sheet and there will be more efforts in matching the assets costs with its benefits over time. But the increase in relevance will influence comparability and consistency between the real estate companies. Even if today's accounting for depreciation do not disclose a true and fair view about the consumption pattern of a building the fact that every company are using a general depreciation rate suits better the characteristic of comparability instead of assessing the depreciation rate for every component.

From our review of comment letters we have been able to see that there are questions raised about the absence of guidance in the K3 standard. A better definition is demanded because the current definition is giving little guidance, which creates uncertainty about how components shall be accounted for. K3 is a principle-based standard with professional judgment and referring back to principles as main characteristics. Principle-based standards are considered to be the best satisfying approach when the economic substance in transactions guides the financial reporting (Manies 2003). Bo Nordlund states that this standard should not only apply for the real estate business and cannot go into details about how to define a component. Buildings differ in many ways and there is no substitute for having a professional judgment and every company needs to consider in detail their properties before separating them in components. Telge Real Estate and Botkyrka Real Estates see the definition as sufficient and are both of the impression that a checklist of components should not be stated in an accounting standard. The business organizations are skeptical to the definition and are of the impression that it needs improvement. There is a common view in the organizations that a common praxis needs to be established in the business to get a unified view about component depreciation. According to Miller and Bahnson (2010) standard-setters are having a more theoretical approach when implementing new standards and neglect certain aspects from a practitioner's point of view. The alternative is to create a standard that do not rely on professional judgment to the same extent and gives more detailed guidance in numerous examples. Ruled-based accounting can be based on principles but subsequently changed due to demand-driven practitioners that request more guidance to mitigate their uncertainty (Manies 2003). As our empirics shows there is no intention for SASB to give more guidance in this standard for ease the implementation in the real estate business. The Swedish Association of Public Housing Companies thinks that the whole business needs to assemble a group not only of accountants but also technicians to construct a better guidance as a status quo. Bo Nordlund see the transition period from a traditional depreciation method to a component depreciation method as a difficult matter. Besides an increased education in the companies he also thinks that some sort of starting point is required for the companies when separating their buildings in components. All our respondents said that components cannot be recognized on a too detailed level and agreed on that only major components should be recognized; examples like foundation, roof and elevators were frequently mentioned. All of our business organizations mentioned that a recommendation needs to be established within the business and they had the same fundamental view about what a component really are. This makes it possible that a recommendation can be established to create a starting point that may mitigate the uncertainty that can be seen in the business and makes it easier for the real estate corporations to determine components.

Principle-based accounting gives the opportunity of using a professional judgment which will increase the quality of the reporting information and mitigate the possibility to structure transactions. Standard-setters most always take into consideration that a judgment-based standards gives the management opportunity to choose the best accounting methods, estimations and disclosure that best reflect the underlying transaction. Although according to Nelson (2002) accounting standards and the precision of rules given or not can affect the

possibility to use earning management. Even if the intent of the standard is not as easily bent when relaying on principles there is a possibility that a judgment-based standard will provide management with discretion that subsequently will give management opportunity to disclose information with an underlying intent of a private gain. Bo Nordlund and our business organizations believe that the standard will increase the scope of management judgments in the real estate entities. According to the Swedish Property Federation it is natural according to the standard as it is today and when no recommendations are given that there will be different judgments regarding same components. That an increased discretion will be given in the context of earning management and this will affect how entities are recognizing and valuating components have none of our respondents agreed on. Fewer components will be lesser time consuming to handle and give lower administrative costs but there is a general view that entities are going to implement component depreciation as accurate as possible even if there is a possibility to recognize fewer components in order to ease their burdens and costs.

Chapter 6 - Conclusion

In this chapter we are answering our two research questions with conclusions derived from our analysis.

There is an increased complexity in introducing a component depreciation system in a building comparing to depreciate the building with a 1% depreciation rate and using maintenance cost for components that wears out and not lasting for a 100 years. Finding every components own useful life and depreciate it creates a difficulty in the real estate business with huge amounts of properties that can be a complicated asset to separate. Recognizing components and value them can be too difficult for a financial department to handle but having a technician assisting in this transition will make it more comprehensive. According to K3 only major components shall be recognized and real estate companies have already to some extent maintenance plans and a plant register to follow when locating these components. Having a retroactive approach will increase the complexity because acquisitions costs for components in old buildings can be difficult to confirm and companies have to use replacement costs. The extent of introducing this approach retroactively is not only complicated but also time consuming. There is a trade-off between more relevant information disclosed in the financial statements and consistency and comparability of companies when introducing this approach. When separating buildings into components it should be assumed that buildings varies to a great extent according to construction, material and age. It is difficult to believe that the company should not be able to make these assessments based on their own estimations even if it reduces comparability. We conclude that introducing a predetermine list in the standard is not a good substitute for having a professional judgment. This is the main point of introducing principle-based standards and due to the complexity and variety of determining buildings components there is no substitute for having a good professional judgment. Although the transition period between the traditional method and the component depreciation method needs to be considered to reduce some of the complexity and making this approach more accepted. It is made clear that principle-based standards such as K3 do not offer the guidance or details to mitigate the uncertainty seen in the business in how to determine a component. There is a need to establish a recommendation that can be used as a starting point for all real estate companies and together with professional judgment recognize and value components in properties.

The anticipated affects in introducing component depreciation in the real estate business exist of both advantages and disadvantages. If these disadvantages are leveled up by the advantages depends on respondent because there are both advocates and opponents in this discussion. The advantages when implementing this approach are derived from reflecting a better true and fair view in the financial statements. Costs will be better matched with the assets future benefits and subsequently reflect the assets usage more correct. Today's accounting treatment of properties regarding the scope of capitalizing maintenance or taken it directly to the income statement creates a difference between the real estate companies financial statements. Component depreciation will mitigate this scope of discretion because more maintenance

costs will be capitalized which creates a smoothing effect on the income statements over time. The plant registers in the real estate companies are going to be improved which will give a better overview over maintenance plans and a better control over the properties. In our study we have been able to conclude that there is not only a reallocation effects from capitalizing more maintenance costs but there can also be seen a direct economic consequence depending on how corporations has accounted for properties according to the current traditional method. Real estate corporations facing huge maintenance cost will welcome this approach because the burden and demand of liquidity of taking all costs to the income statements will be avoided. However, a company that has used the discretion in current standard and capitalized huge amount of maintenance costs as standard improvements will have a problem of seeing the benefit. The introduction of component depreciation will only generate a higher depreciation rate and bring forth an economic impact when the depreciation costs changes.

Opponents to component depreciation gives a troublesome view about to what extent the information in the financial statements are going to reflect a better true and fair view. There is a hardship in seeing the benefits in disclosing better information when component depreciation will lead to more judgments due to valuations and assessments on a component level. The view is that better information will only be disclosed in theory and not in practice were companies having different criteria's over what a component is and how to valuated their useful life, residual value and how to depreciate it. Having this view about depreciation on properties it is easy to argue that increased costs for implementing this approach are not leveled up by the benefits. The reluctance is built upon the argumentation that the gap between theory and practice will not make this approach feasible in the real estate business. We conclude that this perspective is misleading and we can see benefits both on an economic level and a practical level as we have included corporations in our study that has started to use this depreciation approach. We agree on that there is going to be a major change in how real estate companies are going to account for their properties. These changes are going to bring both disadvantages and advantages as anticipated effects but we do not support that there is a difference were disadvantages is only being seen in practice and advantages only in theory.

The reluctance that can be seen in the real estate business is according to our study mainly derived from higher anticipated costs. There are both implementation costs and increased administrative costs that need to be considered. Even if much of the implementation cost is a onetime cost the amount can be significant when hiring consultants and considered the effort from employees both in time and workforce. When the component model is in place there is a cost in maintaining and administrate the system. There will be an increased cost by following up each component and keeping track of them, which will be more time consuming, and difficult depending on the amount of components recognized. We can conclude that although practical argumentation has been voiced in this discussion about the hardship of implementing this approach and that benefits only will been seen in theory, there is a concern about the vast costs this standard will bring to the real estate companies. Especially as the standard is constructed today were a complete retroactive approach should be used which increase costs when forcing the companies to recognize and value components in all their

properties. The fact that the proposed standard is reducing the accounting choices when implementing this approach gives incentives to influence Swedish standard-setters to avoid higher costs. Practical argumentation has been successful when influencing Swedish standard-setters through history. The main reluctance in the real estate business seen in the comment letters and according to our respondents is derived from increased costs instead of practical burdens. Therefore we can conclude that the Swedish real estate business is not concentrated at the practical hardship when influencing standard-setters. Instead increased costs derived from implementing this new standard are the main reason for reluctance and an explanation to why an exposed business such as the real estate business want to maintain status quo in how to depreciate their properties.

Chapter 7 - Further research

The K3 project is going to be finished in a nearby future and a new set of standards is going to be released. It will be interesting to see if SASB has responded to the vast criticism they received when first publishing this draft and the standard about component depreciation. If they have respond it becomes interesting to see exactly to what criticism, for instance are this standard still going to be implemented retroactive and are there some transition rules established to ease the burdens for the companies? In context of whom and what influence Swedish standard-setters it will be interesting to evaluate especially when introducing a controversial standard like K3. After implementation it will be interesting to see if there still is reluctance in the real estate business and if a common praxis has been develop to determine how to recognize components in properties.

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Appendix

Appendix 1 Ernst Rosén Financial Statement 2010

1.1 Office building

Office building	Useful life	Percentage	Value	Depreciation	Depreciation %
Foundation	60	27%	54,740,862.99 kr	912,347.72 kr	1.7%
Facades, roof, wiring, Sanitary ware, NT	40	12%	24,329,272.44 kr	608,231.81 kr	2.5%
Windows, felt roof, pipes and distribution system, porcelain	30	19%	38,521,348.03 kr	1,284,044.93 kr	3.3%
Entrance, ventilation system, large-scale catering establishment, asphalt, etc	20	26%	52,713,423.62 kr	2,635,671.18 kr	5.0%
Control and regulator, lighting, intruder detector, etc	15	10%	20,274,393.70 kr	1,351,626.25 kr	6.7%
Passage control system, intruder detector, etc	10	6%	12,164,636.22 kr	1,216,463.62 kr	10.0%
			202,743,937.00 kr	8,008,385.51 kr	4.0%
Depreciation made			202,743,937.00 kr	2,027,439.37 kr	1.0%

1.2 Households

Households	Useful life	Percentage	Value	Depreciation	Depreciation %
Windows	50	2.6%	29,350,888.63 kr	587,017.77 kr	2.0%
Doors	50	1.4%	15,804,324.65 kr	316,086.49 kr	2.0%
Cabinet	40	1.1%	12,417,683.65 kr	310,442.09 kr	2.5%
Doorway and facades	50	0.8%	9,031,042.66 kr	180,620.85 kr	2.0%
Kitchen appliance	18	1.2%	13,546,563.98 kr	752,586.89 kr	5.6%
Washhouse	12	0.3%	3,386,641.00 kr	282,220.08 kr	8.3%
Painting	13	1.8%	20,319,845.98 kr	1,563,065.08 kr	7.7%
Floor	20	1.5%	16,933,204.98 kr	846,660.25 kr	5.0%
Tiling	40	0.7%	7,902,162.32 kr	197,554.06 kr	2.5%
Facing plaster	40	3.0%	33,866,409.96 kr	846,660.25 kr	2.5%
Balcony	40	1.2%	13,546,563.98 kr	338,664.10 kr	2.5%
Roof and plate work	40	1.0%	11,288,803.32 kr	282,220.08 kr	2.5%
Garbage facilities	15	0.3%	3,386,641.00 kr	225,776.07 kr	6.7%
Elevator part a	50	1.4%	15,804,324.65 kr	316,086.49 kr	2.0%
Elevator part b	25	1.4%	15,804,324.65 kr	632,172.99 kr	4.0%
Ventilation part a	50	1.0%	11,288,803.32 kr	225,776.07 kr	2.0%
Ventilation part b	25	1.5%	16,933,204.98 kr	677,328.20 kr	4.0%
Electricity part a	50	1.6%	18,062,085.31 kr	361,241.71 kr	2.0%
Electricity part b	15	1.6%	18,062,085.31 kr	1,204,139.02 kr	6.7%
Water, drain and heat part a	50	3.7%	41,768,572.28 kr	835,371.45 kr	2.0%
Water, drain and heat part b	25	0.3%	3,386,641.00 kr	135,465.64 kr	4.0%
Water, drain and heat part c	25	0.9%	10,159,922.99 kr	406,396.92 kr	4.0%
Water, drain and heat part d	10	0.9%	10,159,922.99 kr	1,015,992.30 kr	10.0%
Foundation	80	68.9%	777,798,548.75 kr	9,722,481.86 kr	1.3%
			1,128,880,332.00 kr	22,262,026.70 kr	2.0%
Depreciation made			1,128,880,332.00 kr	11,288,803.32 kr	1.0%

Appendix 2 Graflunds AB Financial Statement 2010

2.1 Office building

Office building	Useful life	Percentage	Value	Depreciation	Depreciation %
Foundation	60	27%	34,661,712.24 kr	577,695.20 kr	1.7%
Facades, roof, wiring, Sanity ware, NT	40	12%	15,405,205.44 kr	385,130.14 kr	2.5%
Windows, felt roof, pipes and distribution system, porcelain	30	19%	24,391,575.28 kr	813,052.51 kr	3.3%
Entrance, ventilation system, large-scale catering establishment, asphalt, etc	20	26%	33,377,945.12 kr	1,668,897.26 kr	5.0%
Control and regulator, lighting, intruder detector, etc	15	10%	12,837,671.20 kr	855,844.75 kr	6.7%
Passage control system, intruder detector, etc	10	6%	7,702,602.72 kr	770,260.27 kr	10.0%
			128,376,712.00 kr	5,070,880.12 kr	4.0%
Depreciation made			128,376,712.00 kr	1,283,767.12 kr	1.0%

2.2 Households

Households	Useful life	Percentage	Value	Depreciation	Depreciation %
Windows	50	2.6%	27,284,173.49 kr	545,683.47 kr	2.0%
Doors	50	1.4%	14,691,478.03 kr	293,829.56 kr	2.0%
Cabinet	40	1.1%	11,543,304.17 kr	288,582.60 kr	2.5%
Doorway and facades	50	0.8%	8,395,130.30 kr	167,902.61 kr	2.0%
Kitchen appliance	18	1.2%	12,592,695.46 kr	699,594.19 kr	5.6%
Washhouse	12	0.3%	3,148,173.86 kr	262,347.82 kr	8.3%
Painting	13	1.8%	18,889,043.18 kr	1,453,003.32 kr	7.7%
Floor	20	1.5%	15,740,869.32 kr	787,043.47 kr	5.0%
Tiling	40	0.7%	7,345,739.02 kr	183,643.48 kr	2.5%
Facing plaster	40	3.0%	31,481,738.64 kr	787,043.47 kr	2.5%
Balcony	40	1.2%	12,592,695.46 kr	314,817.39 kr	2.5%
Roof and plate work	40	1.0%	10,493,912.88 kr	262,347.82 kr	2.5%
Garbage facilities	15	0.3%	3,148,173.86 kr	209,878.26 kr	6.7%
Elevator part a	50	1.4%	14,691,478.03 kr	293,829.56 kr	2.0%
Elevator part b	25	1.4%	14,691,478.03 kr	587,659.12 kr	4.0%
Ventilation part a	50	1.0%	10,493,912.88 kr	209,878.26 kr	2.0%
Ventilation part b	25	1.5%	15,740,869.32 kr	629,634.77 kr	4.0%
Electricity part a	50	1.6%	16,790,260.61 kr	335,805.21 kr	2.0%
Electricity part b	15	1.6%	16,790,260.61 kr	1,119,350.71 kr	6.7%
Water, drain and heat part a	50	3.7%	38,827,477.66 kr	776,549.55 kr	2.0%
Water, drain and heat part b	25	0.3%	3,148,173.86 kr	125,926.95 kr	4.0%
Water, drain and heat part c	25	0.9%	9,444,521.59 kr	377,780.86 kr	4.0%
Water, drain and heat part d	10	0.9%	9,444,521.59 kr	944,452.16 kr	10.0%
Foundation	80	68.9%	723,030,597.43 kr	9,037,882.47 kr	1.3%
			1,049,391,288.00 kr	20,694,467.08 kr	2.0%
Depreciation made			1,049,391,288.00 kr	10,493,912.88 kr	1.0%