SSRG International Journal of Economics and Management Studies
ISSN: 2393–9125 / https://doi:10.14445/23939125/IJEMS-V10I4P102

Volume 10 Issue 4, 14-20, April 2023

Original Article

Damage to Company Assets : Method of Accounting for the Negative Event and any Insurance Compensation

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Received: 16 February 2023   Revised: 23 March 2023   Accepted: 04 April 2023   Published: 15 April 2023

Abstract - *The damage to the company's assets may concern products belonging to the company's inventories or multi-year tangible assets. Depending on the type of assets, the accounting recognition is profoundly different. As will be seen on the following pages, no particular problems arise concerning insurance compensation since compensation may be recognised when the receivable from the insurance company occurs in legal terms. The receivable can only be realised if it is quantitatively determined. This is never a problem since such a claim is established by the insurance contract signed by the company and the insurance company and by an expert's report assessing the damage suffered by the asset.*

Keywords *- Loss of assets, Damage to company assets, Insurance compensations.*

JEL Classification Codes *- G00, G39, G 41, M00, M10, M14, M42, M49, Q59*.

1. Introductory concepts on damage to company assets[1]

Damage to company assets can be divided into two broad categories: partial injury or total damage, which essentially entails property loss.

With total damage, the asset is destroyed or, in any case, is eliminated from the company's economy since real damage means that the asset is substantially deprived of all productive utility. It should note that when this last case occurs, rather than damage to the property, one speaks of the loss of the asset precisely to highlight the total elimination of the property from the business economy. The loss of the asset falls into that category of events that are not subject to the control of company management, such as theft or destructive events resulting from fires, floods, earthquakes, etc. On the other hand, the term damage refers to damage that reduces the asset's functionality from a limited to a very high percentage of damage.

Assets subject to loss or damage may be part of the products in the inventories or multi-year assets that are part of the company's assets. Concerning possible insurance compensation, there are no distinct differences between the two categories of assets, and in the following paragraph, we will highlight when such compensation can be accounted for. On the other hand, concerning damage or loss, the situation concerning inventories differs from that concerning long-term assets. With regard specifically to the loss of the asset, i.e. total damage that eliminates all functionality of the asset or loss due to theft, the accounting attitude which must be implemented varies depending on whether the asset belongs to one of the two categories mentioned above. If the asset belongs to inventories, no accounting entry must be made since loss or total damage that essentially eliminates the asset from the economy of the business is recognised indirectly at the closing of the accounts when valuing the inventories at the end of the administrative period which, of course, will be valued net of what has been lost.

In the event of a tax audit by these bodies, the lack of inventories that, according to the accounts, should exist leads to the hypothesis of provoking tax evasion, i.e. sales without an invoice (Italian Accounting Board). To avoid such a situation, it is sufficient, when the adverse event of the loss of goods belonging to the inventories occurs, to send a communication to the bodies that carry out tax audits with attached documentation, in the case of theft, from the police to whom a report must be made, or, in the case of the total loss due to fire earthquake flooding, documentation from an expert certifying the complete loss of the goods. It should be noted in this regard that when events occur that result in the loss of inventories, it is

[1]To facilitate reading, I have decided not to include in the text, except in exceptional cases, the names of the scholars who have dealt with the subject under analysis. I have opted not to indicate all the terms of the scholars in the text because this would have meant a continuous interruption of the reading of the complete sentence in which I express my thought. References are placed at the end of the article

advisable to send an official notice to the tax authorities in the various countries.

When this hypothesis occurs, therefore, as far as inventories are concerned, loss OR total damage of asset does not require any direct accounting at the time of the event's occurrence but is taken into account indirectly at the time of the final valuation of the inventories.

Quite different is the situation where the loss or damage relates to assets that are not part of the inventories and, in particular, are part of the category of deferred business assets.

In this case, accounting entries must be made in accounts leading up to the preparation of financial statements at the time of the occurrence of the damaging event. The specifics of such recognitions and accounting will be discussed in more detail in the next section.

2. Damages of Corporate Assets: Accounting Impact of Adverse Events that Limit the Functionality of Tangible Assets Belonging to Corporate Assets

Suppose the damage to an asset over several years is not such that the asset's value is practically nil. In that case, maintenance can fall under ordinary or extraordinary maintenance, as the case may be. In this regard, it is helpful to refer to the definition of such maintenance indicated in the Italian national accounting standard number 16, "The tangible fixed assets", issued in 2017 by the Italian Accounting Board, i.e. the body that in Italy manoeuvres national accounting standards to introduce in this country the part of the IAS/IFRS compatible with the Italian regulations in force. However, the definition of ordinary and extraordinary maintenance that this principle provides is commonly accepted internationally. Therefore, we believe that the explanation given by the Italian accounting principle OIC (ITALIAN ACCOUNTING BOARD) number 16 is perfectly usable in any country.
In the cited accounting standard, it is stated that:

"49. Ordinary maintenance costs are recognised in the income statement when they are incurred.
Incurred.

Non-routine maintenance costs are capitalised to the extent of the asset's recoverable amount.

50. Significant changes made to existing assets due to the above transactions require a careful assessment of the costs incurred to determine the capitalisable and ordinary maintenance portions. Sometimes, such estimates may be complex and require adequate documentation to support the choices made.

After the capitalisation of costs, depreciation is applied on a straight-line basis, considering the new carrying amount of the asset and its remaining useful life.

51. Replacement involves substitution and may relate to a specific asset, that is, a tangible fixed asset constituting an economic-technical unit. Replacement of a fixed asset entails capitalising the acquisition cost of the new unit. In contrast, the net carrying amount of the replaced unit is written off, with any loss recognised in the income statement item 'other operating expenses. However, the renewal may also concern only part of a tangible fixed asset to maintain its original integrity. In this case, the costs incurred for this purpose are ordinary maintenance costs.

Maintenance and repairs constitute a single class of costs relating to property, plant and equipment, identified by the term 'maintenance', which, together with depreciation charges, combine to express the contribution that fixed assets make to the results of operations. 52. Routine maintenance may be scheduled following the asset's utilisation schedule. Repairs cannot be planned but may be reasonably expected within certain limits.

Maintenance materials, excluding spare parts, often include items of low unit cost and frequent use that are recognised as costs at the time of their purchase, as they have a similar charge to the income statement over time, and the cost of their administration would be uneconomic compared to the value of the material itself. Higher-cost consumables are generally included in inventories, to which the relevant principle applies (see OIC (ITALIAN ACCOUNTING BOARD) 13 "Inventories")."

If the damage is minor, it is considered that they can be defined as ordinary maintenance costs and, therefore, should be recognised in the income statement in the period in which they are incurred. Ordinary maintenance identifies the set of costs necessary for the long-lived asset to perform the process for which it is intended efficiently and effectively.

In the case of minor damage, therefore, no particular problems arise as to how the costs incurred by the company should be charged to the profit and loss account.

Accounting identifies a complex issue when the damage is severe and reduces the value of the multi-year asset to almost zero. In this case, if the loss is total and the investment is eliminated following an analysis by a technician that it is not possible to recover this asset with any maintenance, the elimination from the production process of the investment will give rise to a contingent liability equal to the difference between the historical value recorded in the assets and the value of the depreciation fund linked to this asset.

By way of example, let us consider the case in which a plant, characterised by a historical value recorded in the assets of €40,000 and a corresponding depreciation fund deducted from the historical value of €16,000, is characterised by a book value of €24,000. Assume that the damage is valued at €27,000, i.e., the maintenance cost that would have to be performed to bring the asset to perfect working order is higher than the book value itself. At this point, the company may decide to dispose of the investment, record a contingent liability for €24,000, and purchase a new asset. If, however, the long-lived asset is characterised by particular peculiarities that would make the purchase cost of a replacement asset much higher than the €27,000 necessary to restore the value of the investment, then, in this case, it can be assumed that the enterprise decides to incur all costs required to bring the asset to its original state. It should be noted that if the charges to be incurred amount to €27,000, the contingent asset arising from the insurance compensation, which we will discuss later, will be less than this figure due to the presence of a deductible always indicated in insurance contracts. Depending on the deductible percentage the insurance company applies, the contingent asset will be less than €27,000 by an amount equal to the deductible.

The situation becomes more complicated if the damage is severe, but you still intend to maintain the asset even if the costs are incredibly high.

When such an eventuality occurs, there are two main ways in which these costs must be assessed and recognised.

The first method is based on the observation that the impairment suffered by the long-lived asset can be accounted for in a manner that identifies the impairment suffered by the tangible long-lived asset with the subsequent capitalisation of the costs to be incurred by the company in an amount equal to the amount spent to restore the recoverable amount. Any excess costs incurred will be charged to profit or loss as an expense in the financial period in which the fees are invoiced.

To fully understand the recognition method, it is helpful to refer to what is stated in Italian Accounting Standard No. 9 Impairment of Tangible and Intangible Assets, issued by the Italian Accounting Standards Board in 2016 and amended in 2022. Italian and international doctrine unanimously accepted the principles contained therein regarding the issue addressed. For this reason, they can be taken as a reference to having a clear view of the method of accounting for the damage described above.

First, it is helpful to give some indispensable definitions for understanding the issue we are analysing.

Principle No. 9 cited above provides helpful clarification of some fundamental definitions, which are set out below:

"4. An impairment loss is defined as an impairment loss that makes the recoverable amount of an asset, determined on a long-term basis, less than its net carrying amount.

5. The recoverable amount of an asset or cash-generating unit is defined as the higher value in use and its fair value with fewer costs to selling. Selling costs include transaction-related legal fees, taxes, and direct charges necessary to make the asset ready for sale.

6. Value in use is the present value of the expected cash flows from an asset or cash-generating unit.

7. Fair value is the price received to sell an asset or paid to transfer a liability in an arm's length transaction at the measurement date.

8. A cash-generating unit is the smallest identifiable group of assets, including the measured asset. It generates cash inflows largely independent of the cash inflows generated by other assets or groups of assets.

9. The depreciation capacity of a given period is the economic margin available from operations to cover depreciation expense. Depreciation capacity is determined by subtracting amortisation of fixed assets algebraically from the economic result for the year."

Having summarised the principal terms used in this issue, it is necessary to identify the cases in which reference can be made, in technical terms, to impairment losses. Principle No. 9 OIC (Italian Accounting Board), indicated above, also in this case, provides a unanimously accepted definition in Italy and internationally.

According to this accounting standard, concerning the determination of impairment losses, it should be noted that:

"14. If the recoverable amount of a fixed asset is lower than its carrying amount, the fixed asset is recognised at that lower amount. The difference is recognised in the income statement as an impairment loss.

15. If the recoverable amount of the individual fixed asset cannot be estimated, the company determines the recoverable amount of the cash-generating unit to which the fixed asset belongs. This is when fixed personal assets do not generate cash flows independently of other fixed assets."

Concerning Indicators of Potential Impairment, document n. 9 OIC (Italian Accounting Board) states that:

"16. The company assesses at each balance sheet date whether an indicator exists that a fixed asset may be impaired. If such an indicator exists, the company estimates the recoverable amount of the fixed asset. It makes an impairment loss only if the latter is lower than the corresponding net book value. In the absence of indicators of potential impairment, the recoverable amount is not determined.

17. In assessing whether there is an indication that an asset may be impaired
the company considers, as a minimum, the following indicators:

- The market value of an asset has declined significantly during the period, more than would be expected with the passage of time or normal use of the asset
- During the period, significant changes with an adverse effect on the company have occurred or will occur shortly in the technological, market, economic or regulatory environment in which the company operates or in the market to which an asset is dedicated
- Market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and reduce the recoverable amount
- The carrying amount of the society's net assets is greater than their estimated fair value (such an estimate would be made, for example, in connection with the potential sale of all or part of the society);
- Obsolescence or physical deterioration of an asset is evident;
- Significant changes with an adverse effect on the society have occurred during the period or are expected to happen shortly, in the extent to which, or manner in which, an asset is used or is expected to be used. Such changes include cases such as:

- the asset becomes idle,
- plans to divest or restructure the operating segment to which the asset belongs,
- plans to dispose of the asset before the earlier expected date,
- the redefinition of the useful life of the asset,
- it is clear from the information provided that the economic performance of an asset is, or will be, worse than expected.

18. If there is an indication that an asset may be impaired, it may be appropriate to revise the remaining useful life, the depreciation method or the residual value and adjust them accordingly, regardless of whether the impairment loss is subsequently recognised.

To determine the recoverable amount and fair value, the OIC (Italian Accounting Board) standard 9 cited above sets out the following guidance:

"19. The recoverable amount of an asset is higher than its fair value and value in use. Suppose it is impossible to estimate an individual asset's recoverable amount because it does not generate cash flows independently of other assets. In that case, references to 'an asset' in paragraphs 16-26 should be read as references also to 'a cash-generating unit (CGU)'.

20. It is not always necessary to determine an asset's fair value and value in use. If either value is higher than the carrying amount, the asset is not impaired; therefore, estimating the other amount is unnecessary. If there is reason to believe that the fair value approximates the value in use, estimating the latter is unnecessary.

21. Fair value is the price received for the sale of an asset or paid for the transfer of a liability in an arm's length transaction at the measurement date. The best evidence of the fair value of an asset is the price agreed in a binding sale agreement established in an arm's length transaction or the market price in an active market. Suppose there is neither a binding sale agreement nor any active market for an asset. In that case, fair value is determined based on the best information available to reflect the amount that the company could obtain, at the balance sheet date, from the sale of the asset in an arm's length transaction between knowledgeable, willing parties. In determining this amount, the company considers the result of recent transactions for similar assets within the same industry sector. To determine the recoverable amount, selling costs are deducted from the fair value."

Also, the OIC (Italian Accounting Board) standard 9 lays down precise rules for determining value in use. Value in use is determined based on the present value of future cash flows expected to arise from an asset over its useful life. The standard states in this regard:

"22. The calculation of the value in use comprises the following steps:
- Estimating the future cash inflows and outflows that will result from the continued use of the asset and its ultimate disposal, and
- Apply the appropriate discount rate to those future cash flows.

23. In determining value in use, estimates of future cash flows include:
- Projections of cash inflows from continuing use of the asset;
- Projections of cash outflows that necessarily occur to generate cash inflows from continuing use of the asset (including cash outflows to make the asset usable) and that can be directly attributed or allocated to the asset on a reasonable and consistent basis
- The net cash flows, if any, expected to be received (or paid) for the disposal of the asset at the end of its useful life in an arm's length transaction at the measurement date.

The company uses the plans or forecasts approved by its most recent governing body to estimate cash flows. In principle, these plans do not exceed a time horizon of five years.

To estimate cash flow projections for a period longer than that covered by the most recent plans or forecasts, the company may extrapolate projections based on strategies or estimates by using a stable or decreasing growth rate for subsequent years unless an increasing rate can be justified. This growth rate shall not exceed the long-term average growth rate of production, industry sectors, the country or countries where the company operates, or the markets where the asset is used unless a higher rate can be justified.

24. Estimates of future cash flows do not include:
- Cash inflows or outflows arising from financing activities,
- Payments or tax refunds,
- Future investments for which the company is not already committed.

25. Future cash flows of assets are estimated by reference to their current condition. Estimated future cash flows do not include estimated future cash inflows or outflows that are expected to arise from:

- A future restructuring to which the company is not yet committed; or
- Improving or optimising the performance of the business.

26. The discount rates used for present value calculations (are) pre-tax rates that reflect current market assessments:

- Of the time value of money, and
- Of asset-specific risks for which estimates of future cash flows have not been adjusted.

The discount rates used) to measure the value in use of an asset does not reflect the risks for which estimates of future cash flows have been adjusted to avoid duplication.

The discount rate reflects the return investors would require if they had to choose an investment that generated cash flows of an amount, timing and risk equivalent to those the company expects to derive from the asset in question. This rate is estimated through its implicit rate used for similar assets or in current market trading or through its weighted average cost of capital of the company."

Concerning the recognition of impairment for a UGC and goodwill, the OIC (Italian Accounting Board) standard 9 states that:

"27. An impairment loss recognised for a cash-generating unit (CGU) shall be allocated as a reduction in the carrying amount of the assets that are part of the unit in the following order:

- First, to the value of goodwill allocated to the CGU;
- Finally, to the other assets pro rata, based on the carrying amount of each asset part of the UGC.

28. to assess its recoverability, goodwill is allocated, on initial recognition, to one or more CGUs. To make such an allocation, it is necessary to identify the expected CGUs to generate the streams of benefits that justify the recognition of goodwill.

It may be that the UGC to which goodwill is allocated coincides with the entire company. Amortisation of goodwill is no substitute for testing its recoverability."

Suppose the multi-year asset's damage is so great as to reduce the investment's value permanently. In that case, it can be stated that based on the considerations outlined in the accounting principle regarding the OIC (Italian Accounting Board) No. 9 above, the accounting operation of reducing the asset's value can be implemented. Therefore, if one intends to pursue this accounting path, according to the provisions of document no. 9 OIC (Italian Accounting Board), whose principles are accepted not only at the Italian but also at the international level, it is necessary to determine the recoverable value of the damaged asset, which, as indicated above, derives from the greater of the value in use and the fair value. If this value were lower than the net book value of the damaged fixed asset, it would be necessary to recognise the asset at this lower value with the possible recognition of the difference in the income statement As a write-down of tangible fixed assets. In the case considered above, the company would have to write down the asset by an amount equal to 24,000 euros.

As far as maintenance repair costs are concerned, which should, at least in theory, bring the asset back to a situation of efficient use of the multi-year asset at least equal to that which existed in the period immediately before the damage, it is believed that recognition among the costs about the year cannot be hypothesised, i.e. ordinary maintenance, as such maintenance is repairs of a recurring nature and serves above all to ensure that the asset can continue to work in good condition and an efficient manner. In the case analysed in this article, the costs to be recognised do not serve to maintain the asset, usually inefficient, but are necessary so that the asset, almost destroyed, can still be used. While it is not possible to hypothesise recognition as ordinary maintenance costs, most scholars believe that they cannot be used to account for extraordinary maintenance costs either, as these costs generally relate to OA enhancements that produce a significant and measurable increase in the productive capacity of the asset's safety or extend its useful life. In the case under study, the costs incurred to repair the damage do not modernise, expand, or produce an increase in the productive capacity or safety of the assets or extend their useful life. Therefore, they cannot be considered extraordinary maintenance costs since such costs only ensure that the asset can generally re-enter the production process at most, with an efficiency equal to that existing in the pre-damage period. The authors who support the above claim that accounting should be done with a general capitalisation of costs incurred up to an amount equal to recoverable value, the amount of the costs after this, according to these scholars, should be charged to the profit and loss account as costs about the administrative period considered.

The second method that could be used to account for the damage to the asset and the subsequent incurrence of costs to restore the asset to working order is proposed by some scholars who consider the two events (damage and restoration of the investment) as a single event. In this case, there would be no permanent asset devaluation and the subsequent capitalisation of the costs, as indicated above. Still, simply the asset would remain in the accounts valued based on its net book value, and all repair costs would be considered as costs for the accounting period in which they were incurred and therefore charged to the profit and loss account. If the damaging event and the incurrence of costs were to occur in two different accounting periods, accounting would have to follow the accrual rule so that nothing would be recognised in one year because the net book value of the damaged asset would remain as such. All costs to repair the asset would be recognised in the following period. This would cause a discrepancy between related events: damage and asset restoration. However, scholars who support this thesis believe that it is correct to recognise in two different accounting periods the operations that must be connected to the two events. OIC (Italian Accounting Board), while in the first financial year, the net book value does not change, and any accounting operation is carried out. Whereas, in the second financial year, all costs for restoring the damaged asset are recognised, and, according to scholars who support this thesis, this postponement by one year of the restoration costs concerning the time of the damaging event does not create any problem for the preparation of the financial statements as the postulates of truthfulness and correctness would be observed in any case.

On the other hand, there is no difference in the recognition of insurance compensations if the management decides to opt for one or the other method of recognising the damage and the costs of restoring the damaged multi-year asset. Here, too, reference should be made to accounting standards and, in particular, to the OIC (Italian Accounting Board) standard 15 Receivables, issued in 2016 and amended in 2022, which establishes an internationally accepted primary criterion:

"30. Receivables that arise for reasons other than the exchange of goods and services (e.g. for financing transactions) are recognisable in the financial statements if there is "title" to the receivable, i.e. if they effectively represent an obligation of a third party towards the company ".

For insurance compensation to be recorded, if it exists, it is necessary that the relative claim has a separate existence and is objectively determinable in quantitative terms. In most cases, this value is indicated in the insurance contract signed by the company, supplemented by a special report drawn up by the expert in charge of assessing the damage suffered by the multi-year tangible asset.

As is the case concerning the timing of the damaging event and the incurring of the restoration costs, it is possible that the insurance compensation can only be accounted for in the financial year following the year in which the damaging event occurred, as only in the following financial year do the necessary conditions arise for the receivables as mentioned above to be accounted for in the financial statements. The doctrine holds that also, in this case, there are no problems at the level of truthfulness and correctness of the financial statements since the fundamental financial statement postulates are observed even in the hypothesis of recording values in two different financial years when the damage can be recorded in a given year. The insurance compensation cannot be recorded in the same year for lack of fundamental conditions. Still, its recording must be postponed to the following year when the necessary accounting conditions will have been fulfilled so that the receivable from the insurance company can be correctly recorded in the accounts.

3. Conclusion

After these brief considerations regarding the damage of assets in the company, it can be stated that the cases which may fall within this theme are varied and present very different accounting problems. They range from the hypothesis of a total absence of accounting entries in the accounts, in the case of damage or complete loss of inventories, to a plurality of accounting choices that may be used to hypothesise that the damaged asset is a tangible asset multi-year asset. On the other hand, concerning insurance compensation, whatever the investment subject to damage, the rule is univocal: insurance compensation may be recognised as a receivable originated for reasons other than the exchange of goods and services if the title to the receivable exists, i.e. at the time when the receivable arising from the insurance company legally represents an obligation of a third party towards the company.

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