

Can Global Standards Be Principle Based?

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This paper examines issues pertaining to standard setting in an increasingly interconnected world. It is argued that many present day accounting standards are flawed, generally because of inherent compromises welded into their structure, yielding needless complexity and sometimes absurd results. Using examples drawn from contemporary practice, including pension accounting, financial instruments and lease accounting, an argument for a move towards more simplified, principles based accounting is made. Some of the potential gains from such a project are discussed, as well as potential barriers and how these might be avoided in the quest for better accounting.

Introduction

The focus of this paper lies on the future direction of accounting, in particular whether it is possible to create and implement a set of common set of international accounting standards that are principles-based and eliminate the need for 'bright lines' and unnecessary rules.

When contemplating this topic it is not difficult to be struck by a growing sense that accounting is becoming too complex, that an audit partner must increasingly rely on the expertise of specialists to conduct an audit, and that financial statements are becoming ever more difficult for even the sophisticated investor to use. Of course, some of the complexity of today's accounting is a reflection of a marketplace where transactions are also complex. However, an element of these concerns is justified. Some of today's accounting standards are needlessly complex.

My goal at the IASB is to make accounting more understandable, while providing transparency to transactions where current rules obscure rather than highlight economic reality. Many in the readership may be sceptical of our ability to achieve that aim and arguably the trends more generally are not encouraging. The Lord's Prayer has 56 words, the Ten Commandments 297 words, the US Declaration of Independence (mistake though that was) 300, and the European Commission Directive on the Importation of Caramel Products 26,911 words.

Clearly, it will be a challenge to reverse this trend. However, the cause of principles-based accounting standards is a worthy cause. If we succeed in developing a principles-based system used internationally, we will have served a future generation, preparers, and investors well and probably saved the accounting profession from itself.

A growing consensus on global standards

The IASB is well-positioned to take the lead in the effort to develop principles-based standards with the great majority of the world's economies moving towards IFRSs. Broad acceptance exists over the logic of adopting a single set of high-quality accounting standards relevant to the world's capital markets. "The life blood" of capital markets is financial information that is:

1. Comparable from company to company;
2. Relevant to investment financing decisions;
3. A faithful depiction of economic reality; and
4. Neutral, favouring neither supplier nor user of capital, neither buyer nor seller of securities.

At the same time, national borders have less meaning as barriers to international capital flows disappear, and investors seek higher returns and diversification opportunities. Companies are increasingly operating in multiple jurisdictions, and the cost of consolidating different national accounts is costly and prone to error. In this environment, it makes sense to have a single set of high-quality financial reporting standards used throughout the world's capital markets. The creation of such a set of standards is the IASB's mission.

As a country dependent on trade and with sophisticated capital markets of its own, Australia, at the initiative of the FRC, recognized the benefit of IFRSs at a very early stage in the IASB's existence. Australia's decision to adopt IFRSs in 2005

served as a catalyst for others to adopt the standards in the Asia-Oceania region. Indeed, it is significant that all of the region's major economies—including China, India, Korea, and Japan—all are moving in the direction of IFRSs.

Outside of the Asia-Oceania region, Australia is in good company as well. In 2005, the countries of the European Union joined Australia in adopting IFRSs. Deloitte estimates that 102 countries either permit or require the use of IFRSs for listed companies, while a large number of other countries have formal policies of convergence towards IFRSs. Two hundred companies in the Fortune Global 500 are using IFRSs, and IFRS preparers account for US\$11 trillion of the world's equity market capitalisation of US\$36 trillion. By the end of 2011 it is expected that some 150 countries (including China, Canada, India, Israel and Korea) to be using IFRS and US GAAP and IFRS to be giving virtually the same results.

The Situation Today

Despite the advance of IFRSs, it is not appropriate to draw a conclusion on the IASB's commitment to a principles-based approach on the basis of the existing set of IFRS standards. Until now, the primary focus of the IASB has been on preparing the set of standards for use by countries, like Australia, for their adoption in 2005.

The IASB's existence and shape owes much to a major re-structuring initiative taken by Michael Sharpe in his role as Chairman of the former IASC (our predecessor body)- the result of his vision being the formation of the IASB in 2001. From the IASC we inherited a suite of 34 standards. While most of these standards were principle-based there were, due to US influence, some that could be described as overlaid with additional guidance and rules. Of these 34 standards, 14 had been heavily criticised by the International Organisation of Securities Regulators (IOSCO). It was quickly realised that if IFRSs were to be accepted on capital markets throughout the world, these 14 standards had to be improved as soon as possible.

The Board's work, therefore, for the first five years was to try to get the 34 standards ready for 2005 - given the request to have a year's breathing space this meant that most of the improvements (to 17 standards) had to be, and was, completed within three years - by 31st March 2004. There was no time for major revisions. Even for the new IFRSs adopted for business combinations, share-based payments, and extractive industries, it was necessary to borrow from other literature or grandfather existing national practice.

During its first few years, the IASB was also presented with an opportunity. The US Securities and Exchange Commission (SEC) and the FASB have always been consistent supporters of international standards. However, following the collapse of Enron and other financial scandals in the US, the willingness to accept international approaches to accounting standards grew. It was this changing mood that led the FASB and the IASB to capture what was a small window of opportunity. The Norwalk Agreement was the result.

The aim was to merge two internationally used forms of accounting into one by choosing "the gold standard" ie where the Boards' standards differed, by choosing the better of the two or, if neither was of appropriate quality, writing a new standard. The boards agreed to remove the differences between their standards as quickly as possible; to align their agendas to avoid future differences; and to interpret all the standards in the same way. The aim was to reach a posi-

tion where the requirement for companies listed on the US financial markets using IFRSs to reconcile to US GAAP would be removed as the standards would be virtually the same.

Some of the differences between IFRSs and US GAAP have now been eliminated, and we are beginning to see the light of the end of the tunnel regarding the potential elimination of US reconciliation requirement. The SEC has set a target for the elimination of the reconciliation requirement for IFRS accounts by 2009.

Admittedly, the IASB may have reached different conclusions and drafted standards differently if it had inherited a clean sheet of paper. However, events did not present us that opportunity, and we adapted to a rapidly emerging market place. This was largely to enable countries like Australia to adopt a workable platform of standards in 2005.

The Future of Accounting is Now

Today, the pressure to repair the inherited standards or focus on short-term convergence projects is over. The IASB can now do some real standard-setting with our objective in mind - to produce one set of high quality global standards. It is from this point forward that observers should judge our commitment to principles-based accounting standards and to the elimination of unnecessary complexity in accounting.

I often hear that the effort to write principles-based standards is doomed to failure, because of our partnership with the US FASB. This view unjustly states that our work programme is focused too narrowly on the removing the reconciliation requirement and will lead us to adopt an overly complex and prescriptive approach used in the United States. I do not believe that is the case, because the fundamental nature of the convergence programme has changed.

An agreement (known as the Memorandum of Understanding) between the FASB and the IASB and involving the SEC and the European Commission was completed in February 2006 setting out a roadmap for the removal of the need for the reconciliation requirement. The focus has evolved from the elimination of differences of existing standards to a new emphasis on a joint effort to develop new standards where current accounting is deficient.

The approach adopted in the Memorandum of Understanding enables us to adopt a clean sheet approach to new accounting standards. For these new proposals, the IASB is determined to write standards based upon clearly articulated principles. Arguably, a good principles-based standard must pass four tests:

- i. Is the standard written in plain English? (This is also important to enable easy translation of our standards.)
- ii. Can the standard be explained simply in a matter of a minute or so? If not, why does it take longer? (i.e. can only specialists understand it or can most accountants use it?)
- iii. Does it make intuitive sense?
- iv. Does management believe it helps them to understand and describe the underlying economic activity?

Today, it would be an understatement to say that some of the standards on the books cannot meet these tests. Accounting can be both primitive and a closed book to outsiders. The blame is shared. Many standards are difficult to understand because the main principles are submerged under a series of

exceptions and detailed guidance. This does not have to be the case. Furthermore, in many cases, by popular demand the basics of transactions are frequently disguised to avoid volatility in income or to disguise the real levels of debt of a company.

It is possible all too frequently to despair of accounting. Frankly, accounting is not rocket science. It is often said of the professions that they try to surround their activities with mystique to confuse the layman. Accounting standards can do more than that - they frequently baffle many accountants so much so that few audit partners can complete an audit without relying on the advice of experts within the firm. A useful retort when confronted by many supporters of complicated accounting policies is: "Explain that to your granny".

The next section of the paper explores this approach to the contemplation of accounting rules by examining three of the most egregious cases where exceptions in accounting rules to accommodate different interests have added complexity, while reducing transparency. All three are now under review.

Pension Accounting

Contemplate the application of the "granny" test to the existing pensions standard. Suppose a pension fund is in equilibrium, having liabilities of A\$40 million matched by assets of a similar amount. If the value of the assets was to fall to A\$30 million and liabilities remained the same, the fund would have a deficit of A\$10 million. Under what is the most commonly used option of IAS 19¹, the deficit is reduced:

- a. by a reduction of 10 percent of whatever is the higher of assets or liabilities—in this case liabilities, leading to a reduction of A\$4 million
- b. by 'spreading' the remaining deficit of A\$6 million (A\$10 million minus the \$4 million) over the expected working lives of the employees—say 10 years for this example.

The result is that deficit shown in the financial statements becomes A\$600,000. The incomplete nature of such an amount recognised in income and expense and the balance sheet obscures the impact of the loss in value of the fund assets on the entity. While information about the total deficit is shown in the notes, standard-setters know that disclosure is no substitute for good accounting. Moreover, there is a growing body of academic research indicating that market participants do not incorporate the disclosures in decision making. This does not make any sense. I know that I couldn't explain that to my granny.

Furthermore, not only is the change in the value of a pension fund not reflected in the financial statements correctly but the annual cost of pensions charged against annual income is offset by the estimated long term return on the assets in the fund. Some of these estimated returns have been heroic! In the United States from 2000 - 2004, the income statements of the top 500 companies, recorded these estimated returns at US\$498bn. The actual return amounted to US\$197bn.² In other words, US\$301bn of phoney profits flowed through the profit and loss accounts of the top 500 American companies over a period of five years.

Leasing

On leasing, there is some good news—the standards internationally are harmonised. The bad news is that they are absolutely useless! One of my great ambitions before I die is to fly in an aircraft that is on an airline's balance sheet. Why does this not occur? Because most aircraft are leased and the standards divide leasing into two types: operating leases and capital/finance leases in which (broadly speaking) the asset is owned for almost its entire life. For operating leases the only amount shown in the financial statements is the annual lease payments which are charged to the profit and loss account.

For finance leases, the present value of the future payments under the lease is shown as a liability and on the other side of the balance sheet the right to the asset. Why aren't aircraft shown? This is because aircraft are not leased for their entire life. They are usually leased for only seven years; therefore, they fall into the operating lease category. But ask the airline the following questions:

- Q: Can the airline escape from the lease? A: No, it is committed to annual payments over the next seven years.
- Q: Can the airline measure the amounts it has to pay over seven years? A: Yes, it is written into the lease contract.

The definition of a liability is met. The airline has an obligation from which it cannot escape and which can be measured reliably. It should, therefore, show as a liability the present value of the payments that have to be made and on the other side the rights to the aircraft for the same period. These would not be trivial figures. The leasing volume for the year of 2005 amounted to US\$582bn³ - and this was for only one year. Most of it was off balance sheet.

Financial Instruments

Finally let's turn to financial instruments (especially IAS 32 and IAS 39) because they are the poster children of 'rules-based' accounting. However, the 500 pages of IASB guidance or nearly 1200 pages in US GAAP are not the result of a standard-setter's whim—they reflect the two boards' desire to address their constituents' desire to account for specific transactions, to reduce reported earnings volatility, and to have more certainty through guidance.

It could be argued that those who claim to understand IAS 32 and IAS 39 haven't read these standards carefully enough. Here's why. IAS 32 requires an asset or liability to be recognised when an entity uses its own equity instruments as 'currency' in a contract to receive or deliver a variable number of shares whose value equals a fixed amount, which is inconsistent with the conceptual framework. The treatment of impairment is different depending whether it is for goodwill or a tangible asset, or (separately) whether it is an equity instrument or a debt instrument held as available for sale.

While these inconsistencies can be overcome, some would argue that the business world is complex and accounting standards that would overtly simplify a complex world, would do a disservice to the financial community. No-one could argue that IAS 39 does not attempt to deal with complexity. It is also true that there are clearly articulated principles in IAS 39. The standard applies to cash and contracts for cash. From a measurement perspective:

- all financial assets and liabilities are measured at fair value on initial recognition.
- subsequent measurement should reflect the nature of the instrument and purpose for which it is held
- all derivatives are measured at fair value

It is in the application and in the exceptions to the principles that the problems occur. For example, paragraph 9 of IAS 39 defines a derivative instrument. The definitions are discussed further in Application Guidance paragraphs AG9 to AG12A. The definition is further elaborated on in paragraph 38 and AG53 to AG56 dealing with regular way contracts. These paragraphs are then supplemented in the implementation guidance to IAS by nine issues dealing with the definition of the derivative and five issues dealing with regular way contracts.

Similarly, financial instruments are defined in four categories in paragraph 9 which is then expanded upon in AG14 to AG26. Another 13 issues dealing with these definitions appear in the implementation guidance. Paragraphs 10 and 11 describe an embedded derivative and illustrate the appropriate accounting treatment. Such derivatives should be separated from the host contract and accounted for as a derivative unless the embedded derivative is closely related to the economic characteristics of the host contract (there are also a couple of other conditions in paragraph 11 relating to separation of embedded derivatives from a host contract).

However, an entity may elect, in certain situations, to measure the entire hybrid instrument at fair value through profit or loss under paragraph 11A. If the embedded derivative cannot be measured separately a further exception is given in paragraph 12. Eleven further issues involving embedded derivatives are dealt with in the implementation guidance.

Similarly, IAS39 allows optional hedge accounting. Gains and losses on derivatives can be held back (breaking all the normal rules) if cash flow hedge accounting is used. If it is not, these gains and losses will be recognised as they arrive. The timing of these gains and losses is essentially a management choice. I have long given up asking my colleagues to explain this one to their granny.

A Better Way

The sections above discussed three clear cut cases where accounting is needlessly complex or fails to reflect the economic facts, but there are certainly other examples. The question is as to possibilities in the future. Can standards be written differently? Can the standard-setter deal with the main issues related to a particular type of transaction (what is known as an 80% standard) leaving the other problems to be dealt with by reference to the standard's main principles and the use of professional judgement?

Returning to the four tests set out earlier, the answer lies partly in developing standards that make intuitive sense, partly in the drafting, and finally in the way financial statements are presented and explained.

A principles-based standard⁴

If principle-based standards are to be introduced then lessons must be learned from the problems arising from existing standards. If complexity is to be avoided the exceptions to the scope and to treatments will have to be eliminated. Similarly, application guidance will have to be limited to only what is absolutely necessary to operationalise the principle.

It would not, however, be enough simply for a standard setter to make the above a desirable objective. A process would have to be introduced to ensure that principles-based standards are delivered. All exceptions should be questioned and re-debated before a final standard is issued. Applications of exceptions by analogy would have to be prohibited - thereby eliminating a major source of interpretations.

The core principles would have to be clearly stated. Other sub-principles should be related to these in a tree-like structure. Inconsistencies with other standards should be dealt with. Despite the potential delay consequential amendments should be made if by doing so collectively standards now use the same principles.

Principles should be tied to the conceptual framework. The basis for conclusion of the standards should have specific discussion of the how the principles in the standards compare with the framework. Any departure would have to be explained. It may be necessary to depart from the framework if emerging transactions indicate that the framework is out of date. Any exception to the framework, however, should provide a basis for elimination of the exception by later changes to the framework itself.

The use of principles should eliminate the need for anti-abuse provisions. It is harder to defeat a well crafted principle than a specific rule which financial engineers can by-pass. A principle followed by an example can defeat the 'tell me where it says I can't do this mentality'. If the example is a rule then the financial engineers can soon structure a way round it. For example, if the rule is that, if A, B and C happens, the answer is X, the experts would restructure the transaction so that it involved events B, C and D and would then claim that the transaction was not covered by the standard.

A principle based standard relies on judgements. Disclosure of the choices made and the rationale for these choices would be essential. If in doubt about how to deal with a particular issue, preparers and auditors should relate back to the core principles. The basis for conclusions should also include, in particular, the question of whether there is only a single view to tackle the economics of the situation. Often there are competing views - is one deemed to be more relevant. If so, reasons for choosing that particular view should be explained in the basis for conclusion and reasons for rejecting the others clearly outlined.

All application guidance and examples to understand the principles have to be questioned. Would anything be missed if they were deleted? If guidance is necessary, is the principle sufficiently clearly stated? Does the standard include bright lines and arbitrary limits? Why are these necessary? Does the transition follow the normal pattern? If not, why is a change proposed?

How could this be put into practice? Taking the leasing example from earlier, the core principle in a new leasing standard could be expressed as:

"The entity is required to show the liability it has incurred by signing the lease contract and the rights to the asset obtained thereby."

That is the thrust of the standard. How much more would be required? It would possibly be necessary to define sub-principles related to the core principle in a tree-like structure dealing with:

1. the definition of the particular liability incurred and the rights obtained;
2. the treatment of renewal options or cancellation features; and
3. residual guarantees.

Telling it as it is

The result of such an emphasis on principles, and a reluctance to provide detailed guidance, will necessarily lead to what might be called 'tell it as it is' accounting. Now, the application of this approach could lead to increased volatility in financial statements. For this reason, it is necessary to focus on presentation and management commentary as well.

Presentation should show where volatility will have an effect in the short term and where it relates to long term matters. Users would have to understand the differences between gains and losses in the short term as part of the opening cycle reflecting nearness to cash and those resulting from long term investment portfolios, revaluation of buildings and changes in pension fund surpluses and deficits. The financial statements should reflect these differences in the timing and uncertainty of the realisation of the gains and losses - and enable management to explain their company's performance appropriately.

In this new world, management commentary takes on added significance. Make the company tell its shareholders what it tells the analysts. For example, in the UK, while many companies were upset at having to show their pension fund deficits they soon learned how to deal with the problem. Companies were saying things such as:

"We have a pension deficit of A\$40m, we expect to put an extra A\$5m per annum into the fund over the next few years. We assume the assets in the fund will grow at 4% per annum and we will change the scheme slightly. We therefore expect that by 2011 the scheme will be back in equilibrium. The effects on profits, assuming they stay at today's levels, will be 1.3%."

All we standard-setters have to do is provide the vehicle in the form of the management commentary. As in many cases standard-setters know what has to be done - but can we make it understandable.

A Shared Challenge

A principle based system will only work if preparers, auditors, users and regulators wish to make it work. Use of judgement will require preparers and auditors to exercise courage and to defend their judgements. Users would have to accept that companies would not always adopt exactly the same treatment for dealing with particular situations but over time it is likely that the better treatment would emerge as being favoured. If an inappropriate treatment emerged then clearly the standard setter would have to step in to correct the situ-

ation by amending the principle or by dealing with the issue specifically (another rule?).

The training of accountants would have to change. The basic concepts of accounting would have to be emphasised at degree and at professional training level. Preparers and auditors would have to accept that a principle-based system would tend to ban the treatments designed to smooth earnings.

Greater user sophistication is necessary. Investors will need to rely on the variety of information that corporations are giving to explain financial results and be able to recognise the different sources of performance and volatility. Regulators should not be able to second guess preparers who have made honest and reasonable judgements and which meet the objective of a principle. If two or more methods are appropriate to achieve the result the principle desires then these have to be accepted. If the regulator insists on one method he is in effect inventing the rule and moving away from a principle based system. Regulation can be the enemy of principles - a danger that has to be watched by securities and prudential regulators worldwide.

Similarly, we cannot deal with high volumes of requests for interpretations - whether as formal International Financial Reporting Interpretations Committee (IFRIC) pronouncements or explanations of decisions not to offer an IFRIC interpretation. Every interpretation is a rule. For example, in several issues brought to IFRS recently, it is often difficult to choose between two competing treatments. The question that has to be asked is: does it matter if management select one policy and disclose the effect of selecting another? The information will be in the market place and adjustments can be made if necessary. If the effect is material and the issue occurs frequently a case may arise for a few paragraphs being added to the standard to ensure greater comparability.

Finally, the legal situation. It will be much more difficult in the United States to introduce a principle based system given the litigious nature of that society. This must be acknowledged as a risk to IFRSs as the goal of convergence is pursued. However, it is arguable that the risk has been overstated in some quarters. The risk can be mitigated however by the careful generation, collection and retention of documentation and the seeking of expert advice and the views of professional colleagues throughout the life cycle of transactions. Above all, those who make such judgements, document them and who have made an honest and fair attempt to meet the principle should be defended.

If the United States cannot accept the degree of judgement deemed appropriate elsewhere then the FASB may have to issue requirements additional to those of the IASB. The IASB would then have to consider ways of ring-fencing the additional US guidance to prevent such guidance associated with a jointly written standard from being deemed compulsory by IASB's current requirements to look to the standards of other standard setters if an IFRS does not deal with a particular situation.

The last, best chance

We are at an important juncture in accounting. The integration of the world's capital has led to the emergence of IFRSs as a broadly accepted set of accounting standards. This development has also provides us with a unique opportunity to write standards that focus on clearly articulated principles, making financial reporting more accessible to a broader range of users again.

Ultimately, the financial reporting world will get the standards which it deserves. A rules-based system is inevitable:

- If those involved with financial reporting do not act with integrity,
- if in court accountants attack reasonable judgements which have turned out to be, with hindsight, incorrect,
- if auditors and preparers ask for voluminous interpretations or additional guidance,
- if raw economic facts are unpalatable and exceptions to the principles sought,
- if the regulators insist on particular ways of dealing with a situation.

This is probably the standard-setters' last chance to move the clock back to try to write shorter, less complex standards, to remove the cottage industry of the expert and return accounting to the profession. We have to move away from the position where only the technical partner understands (or thinks he or she understands) the standards. Accounting is not rocket science - we have to try to write standards for the bulk of the profession. The IASB is going to try this, but it will then be over to the profession. **JARAF**

Footnotes

1 See "Post Retirement Benefits, Outside the Corridor" *Company Reporting No 199, January 2007, p 3.*

2 'Pondering Pensions: How They Affected the S&P500 in 2004' *The Analyst's Accounting Observer May 27, 2005 (Revised June 27, 2005)*

3 Source: *World Leasing Yearbook 2007, p1*

4 I am indebted to my Board colleagues and in particular to Mary Barth, Jim Leisenring, Trish O'Malley, Warren McGregor, John Smith and the Directors, Liz Hickey and Wayne Upton, for their observations on this issue. See also, *Principles - Based Approach to US Standard Setting FASB, 2002; Katherine Schipper 'Principles - Based Accounting Standards' Accounting Horizons, March 2003, and Principles Not Rules: A Question of Judgement; Institute of Chartered Accountants of Scotland, 2006.*