IOSCO endorsement ... and beyond

The British experience

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THEMA

1 Introduction

The need for accounting standards might be nicely illustrated by the following anecdote. I would like to take you back to the time that you went for your present job. Most people have gone through an interview and I am sure you remember the objective of that interview. It never is to tell the truth, which is usually disastrous; what you were trying to do was give a picture of yourself that you thought the interviewer wanted. Now he knew that, so his job was to get past this picture, i.e., to try to find the person underneath. There are various ways to go about that. For example, you can bring the applicant into a room with a thick pile carpet and a walnut desk. You sit him down, light a cigarette for him and then you turn away and look out the window and start telling him about this terrific organisation he hopes to join. The applicant puffs away contentedly thinking what a nice fellow you are until he discovers there is no ashtray. Well the obvious thing to do is to ask you for one. However, he is nervous, since he has just met you. Moreover, you are not even looking at him and you are eulogising about this company he wants to join. People start doing the most peculiar things. They flip the ash into the palm of their hand and then it might end up in their jacket pocket or trouser turn-up, depending on fashion, or handbag depending on sex, though not necessarily in London. Ultimately of course, they have not solved the problem because they are going to be left with this burning stub. Now they can stub it out on your walnut desk in retaliation or set fire to the wastepaper basket by way of diversion. Usually, however, they will ask you for an ashtray and then you ask them what they have done with the rest of the ash. When they explain they normally keep it in their jacket pocket they are at a slight disadvantage. These stress-interviews are used for accountants too. Thus, when the accountant comes in you do not shake his hand, you do not take his coat, and you just treat him like the auditor. You point to the books and say: 'Right, half an hour. I want the company's profit or loss'. The first one came in, scribbled away, and came back to the CFO who looked at it. 'Wrong', he said, 'next'. The next one came in and the CFO put the same problem to her. 'Certainly', she said, 'what would you like, a profit or a loss?' She got the job. This is why we need accounting standards.

2 The IASC and the role of national standard setters

The IASC should not work, but it does. In 1995, I joined the IASC for the second time. I was astounded by the *eighty* people around the table. This is no way to set accounting standards. Nevertheless, the IASC actually functions appropriately in spite of the number of people involved. One explanation is the first-class calibre of some of the people around that table. The other characteristic that benefited the IASC was the improvements project. International accounting standards were initially a joke. It was easy to reconcile with IAS, because just about

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everything was allowed under these standards. However, they gradually cut down the options permitted under the standards. At this time, people started to take the IASC seriously as a standard setter. The appointment of Sir Brian Carsberg as Secretary General helped as well, he has shown very good leadership. Finally, the IOSCO proposed endorsement of the IASC's core programme enhanced its reputation.

IASC has worked diligently on its core programme and I hope it is crowned eventually with success. Ultimately, we only need one method of accounting for a transaction no matter where it occurs in the world. The aim in the UK is to have UK standards equivalent to IASC standards, equivalent to standards in the European Union and equivalent to US GAAP, i.e., we need a global set of standards.

Changes are about to occur, until now IASC has been borrowing heavily from national standard setters. It has to decide how it is to go forward. A strategy document was published in December 1998, proposing to expand the board of the IASC to include more countries (especially from South America and Eastern Europe). Probably the most controversial part of the document is the proposal to do away with the steering committees. These committees will be replaced with a Standards Development Committee, on which mainly standard setters will be represented, although nobody presently knows who will be included and who not. The big question for Europe is whether we are going to have one or several representatives (six at present on the IASC Board) the latter emphasising the different strands of European accounting thinking. We need to tackle this issue soon. Meanwhile, we in Europe have to be careful not to end up with just one vote. If we all speak the same way by pre-arrangement, I predict the US will soon insist that Europe obtains the same number of votes as the US – namely one!

We also must be careful to avoid ending up with two sets of standards. We do not want IASs and a competing set of standards since this would be a disaster for the world financial community. The UK attitude in this matter is that we should certainly strive for just one set. The IASC is ideally placed to handle this, provided their efforts are internationally recognised. Nevertheless, the IASC has to be effective and innovative, i.e., it should not simply be reactive, borrowing from national standard setters. The IASC has to find a way of harnessing the views of Europe and of other countries on a proactive basis.

If Europe does not work with others in setting international standards, there is a threat that we will be pushed towards harmonisation with the US whether we like it or not. It seems a much better strategy to keep the US involved in the IASC and to keep using the IASC as a forum for settling international accounting issues. The UK attitude toward the IASC standards is simple. If we like method A and IASC likes method B but both methods do not differ a lot, the UK will switch to method B. If the IASC decides in favour of method C and we consider that method to be wrong, we will hold on to the preferred method A. Nevertheless, if eventually we are unable to persuade the IASC that its standard is wrong, we will have to change. Actually, this process seems quite natural, even after one set of standards has been agreed upon, some standard setter believing that a better solution existed may want to diverge from these standards. This implies reconciliation, but at least it would keep practice advancing. The current EU directives are, because they are law, not very flexible. Personally, I would like to get rid of the directives. Accounting standards can be used instead, the benefit being that they can be changed quickly.

What then is the role of the national standard setter? In my view, the national standard setter is involved in discovering issues and finding out the views of interested parties in a country. I know some believe that the IASC should be structured so that there are only seven full-time board members establishing standards for the rest of the world. This may be the case some day, but are we ready for such a scenario yet? I have already found it difficult to know what people are thinking in Birmingham and Edinburgh, never mind what people are thinking in Seattle, Moscow, or Buenos Aires. International standards setters must not operate in a vacuum without feedback from local bodies. The national views are the much-needed input to the international debate. The national views might not be reflected in all final standards, but at least there is a chance to put ideas in the spotlight. National standard setters have to be innovative. They have to set their agendas ahead of what happens on the international scene. Only in this fashion will they be able to influence the international standard setting efforts.

3 Using the conceptual framework to forge harmonisation

The events at the founding of the Accounting Standards Board in the UK teach us some lessons about the international harmonisation efforts. When the ASB started its work, it faced the shambles of British accounting in the 1980s when abuses abounded. We were asked to focus attention on three main areas:

1 stamp out the abuses,
2 harmonise accounting practices, and
3 develop a consistent conceptual framework.

Accountants are not great consumers of conceptual products. My partners in KPMG would not have known a conceptual framework if they had fallen over one. Accountants often prefer to speak instead of a statement of principles. The conceptual framework – or statement of principles – is important because it is actually driving harmonisation. The ASB's statement of principles is similar to the IASC's, which is in turn derived from the FASB's. Canada, Australia, and New Zealand also use something close to the FASB's framework. Accounting is changing dramatically because of this. In particular, the objectives of accounting include not only providing stewardship information, but also information for decision-making purposes. Information aimed at aiding decision-making implies a forward-looking focus. It may include the kind of narrative information. Ultimately, providing decision-relevant information requires a trade-off between the reliability and relevance of the information. It seems that relevance is increasingly being highlighted, but it is obvious that there is no gain from providing unreliable information.

The objectives in the harmonisation effort by means of a common conceptual framework are fourfold. First, items that are neither assets nor liabilities are taken off the balance sheet. Second, items that can be identified as either an asset or a liability are brought on the balance sheet. Third, up-to-date measures are used if the historical cost method does not suffice. Finally, gains and losses are shown clearly.

It is relevant to review some basics, which are sometimes taken for granted too easily. There is a lot of argument in Europe, and in the United Kingdom especially, about modern standards being balance sheet-oriented. Accounting is not balance sheet-oriented. However, when you spend something it is either an expense or an asset. If I define one, the other is the reciprocal. Assets are defined as 'the right to a stream of future benefits'. It is almost impossible to define an expense without using a phrase such as 'an expense is not a benefit for the future'. Most people have found it far more simple to define assets than expenses. The problem in accounting is that we do not stick to these well-defined concepts. Then 'whatsit's' appear on balance sheets. 'Whatsit's' are expenses that firms do not want to put in the profit and loss account at the present moment. The conceptual framework eradicates these practices. For example, suppose a firm builds a hotel. The hotel makes losses in the first year and these are capitalised as 'start-up costs'. It is not a start-up cost, however, it is a loss. If we were to allow these accounting methods, balance sheets could be improved by having bigger losses. We have to start showing losses as they occur. A similar argument holds for the other side of the balance sheet. Companies introduce phoney liabilities. The ASB has been actively driving out this kind of accounting.

The effect of the Board's changes in the UK has been quite dramatic. Over the years, the IASC and British accounting standards have become increasingly alike.

4 Some accounting issues for the future

4.1 Financial instruments

I would now like to turn attention to the future. The IASC has to start moving ahead and look at some upcoming issues. The G4-group, the IASC and other standard setters are looking at the question of derivatives. It is clear that a historical cost approach does not work for derivatives, since there is no cost in many of these contracts yet they can rapidly become significant assets or liabilities. Some might argue that only derivatives should be marked-to-market, but often these contracts are hedging other assets or liabilities with the aim of there being offsetting changes in value. Thus to mark to market only the derivatives will show only half of the story. To show the full story the hedged asset or liability must be similarly treated. This could result in half the balance sheet being marked to market.

Hedging will cause some interesting issues. Consider the following example. Suppose, the exchange rate between the pound sterling and the D-mark is 1 to 4. A manufacturer wants to buy a machine for DM 100,000 next year. He is worried it will cost more than £ 25,000 if the D-mark strengthens against the pound. (He can make a profit on the output if the machine costs no more than £ 25,000.) Thus, he takes out a forward contract to buy DM 100,000 at £ 25,000 next year. He gets it wrong, the D-mark weakens. The question now is what is the cost of that machine. The manager could have gone out and bought the machine for the equivalent of £ 20,000. Is this the amount shown on the balance sheet? Should we say the manager lost £ 5,000 on the currency markets and charge that loss to income? Or, should we add the loss to the cost of the machine, i.e., show it at £ 25,000?

Industry wants to record the machine on the balance sheet for £ 25,000. It seems that Japan Airlines did something similar with forward contracts to cover their future Boeing purchases. Japan Airlines thought the yen would weaken against the dollar. After two years, they had already lost a substantial sum on these forward contracts. Their treasurers advised management to terminate the contracts. Management thought this was sound advice, until they realised that this would cause the loss to hit the income statement immediately. They ran the contracts for another eight years and ended up losing £ 1.1bn, which was then capitalised and written-off over the life of the aircraft. Here, accounting considerations have immense economic repercussions. Standard setters should be aware of these.

Consider a second example. Suppose a British company has an American subsidiary. The company wants to hedge next year's profits. The subsidiary makes a profit of $ 20m equivalent to £ 10m. The parent is concerned the dollar will weaken. They thus sell 20 million dollars forward for £ 10m. Suppose the parent was right and the dollar weakened. At year-end there is a £ 5m gain (using the mark-to-market method). How should this gain be accounted for? Most would argue that the gain should ideally not affect this year's income since it is to hedge next year's income. However, it is not a liability, so we can not put it on the balance sheets. What should be done? Perhaps we should use a new kind of income statement, which distinguishes between profit related to this year and gains recognised in the year? These questions are currently being addressed.

4.2 Leasing

We also have to review some of our traditional standards. The standard on leasing is going to change dramatically. Presently, a lease is either a capital lease, shown on the balance sheet or an operating lease, in which case only the rent expense is charged to the P&L – there is no balance sheet entry. In most countries, the rules on leasing specify that the lease contract is considered a capital lease if the present value of the minimum lease payments equals 90% of the fair value of the initial value of the leased asset. Not surprisingly, the present value of the lease payments is usually in the neighbourhood of 88%. If we were to cut the limit to 80%, the PV of the lease payment would be about 79%. Thus, not many capital leases can be found. Read the annual report of any airline. Many of these enterprises can hardly be distinguished from taxi companies; there are no aircraft on the books. The reason is that airlines do not lease aircraft for their full economic life, but instead for about seven years. These contracts contain penalty clauses, which requires a payment to the lessor if the lease is not renewed after the end of the period.

Let us use the conceptual framework to evaluate these lease contracts. Do these leases constitute a liability? A liability is an irrevocable obligation that leads to resources leaving the organisation. Thus, since we have this seven-year leasing contract with a penalty-clause it seems obvious that a lease is a liability. Can we measure the liability reliably? Yes, there is the amount shown in the contract – the seven years' payments plus the penalty. In conclusion, we have identified a liability, and on the other side, the property right to a 747 aircraft for seven years. The leasing industry is vehemently opposed to this accounting reasoning.

4.3 *Intangible assets*

Consider the issue of intangibles. When the ASB first started some members of the IASC told us very bluntly, that the UK had to adopt the international twenty-year write-off period for goodwill and intangibles. Unfortunately, 90% of British industry thought that was nonsense. As in the Netherlands, we used to write-off goodwill against reserves.

Only three methods exist to treat goodwill in the accounts. First, the British/Netherlands method – purchased goodwill is charged against reserves since we do not account for internally generated goodwill. Second, goodwill can be capitalised and written off, which is I like to call 'sweet shop goodwill'. Suppose, you buy a sweet shop. The goodwill generated by the old man who used to run the sweet shop will remain for a period. Nevertheless, the nice old fellow will gradually be forgotten thus the goodwill amount should be written off, say in twenty years. You do not show the new goodwill generated by the new owner. Third, the industrial choice – suppose a company buys an investment, which costs a billion. This billion is split in the consolidated balance sheet between assets, liabilities and the part that is left: goodwill. The goodwill is written off through the earnings. The entrepreneur will rightfully ask why a charge is put through the P&L account while the investment is rising in value. What is the economic signal? The accountant's answer is going to be something like 'Ah, it is the goodwill you purchased being replaced by internally-generated goodwill'. At which time the entrepreneur may reply, 'I do not care. I am not losing anything. Why are you writing something off my profits? Your proposal is just a theory and I reject it.' In the UK, we would have preferred that companies could choose not to write-off acquired goodwill. Nevertheless, the ASB decided to accept the fact that goodwill is required to be written-off by law. However we insisted on allowing the possibility of a long economic life. It is even possible to have an indefinite economic life-span, but if the estimated life of the goodwill or intangible is more than twenty years an impairment test is required. (The ASB's impairment test is tougher than the IASC's.) Brands can be treated in the same fashion as goodwill, since they too are intangibles. The ASB took these proposals to the IASC and the Board eventually endorsed it by fourteen votes to two. The American representatives were among the two opposing votes. One senior American became quite upset about the outcome of the vote and mentioned that the US solved the intangible issue forty years ago. Their answer was to write off intangibles over forty years. I pointed out to him that in the UK we have brands such as Gordon's Gin, and Johnnie Walker, which are actually older than the United States. Moreover, in my humble opinion, they have done more for the sum of human happiness than the US. I personally would sooner write off the US in twenty years, rather than write off a penny of Johnnie Walker.

Not all goodwill issues have been solved yet. We ignored the question of internally-generated goodwill, which is different because it does not involve a transaction. One of the concerns that needs to be addressed is the reliability of the valuation methods to record internally created intangibles. A preliminary solution might be to record internally-generated goodwill and intangibles below the balance sheet – added on to net assets. In this way such intangibles will start to become visible, rather than being tucked away. Again, this is a huge area for accountants in the future.

4.4 *Stock options*

We also need to tackle one of the scourges of our time: stock options. A common misconception is that granting stock options is without cost. Stock options take money out of the company and we need to start charging these amounts in the income statement. This issue is going to require political support.

4.5 *Restructuring the income statement*

Attention also needs to be directed at new forms of presenting the income statement. Financial analysts are primarily interested in net income. I like to call this the 'bottom line obsession'. Given this obsession, it is easy to manipulate the numbers shown. Consider the practice of accounting for extraordinary items in the UK. What happened was that firms reported losses, if at all possible, as extraordinary and gains as the result of regular business activities. The official definition of extraordinary items was 'an item that does not reoccur and is outside the normal activities of a company'. It turned out that 53% of UK companies had an extraordinary item every year; therefore, we abolished it. Instead, we broke up the income statement into continuing and discontinuing operations. The UK also brought in a new statement, the Statement of Recognised Gains and Losses, to show the items that went to reserves. There was a company in the UK, Polly Peck, that went bankrupt. It reported profits of £ 161 million. However, if the foreign currency losses in its overseas investments had been observed, it would have become clear that these wiped out the profits. The foreign currency losses were reported around note 22.

The ASB is trying to fix people's eyes on the various components of the income statement. It is like a girl writing home from boarding school. She writes to her mother 'there has been a terrible fire in the dormitory. At the last minute, the handyman of the school rescued me and now there is no dormitory. I fell madly in love with the handyman and I have been living with him in his one-room flat for the last three weeks.' Down at the bottom of this letter to her mother was a little post-script, which said, 'there has not been a fire. I am not living with the handyman. I failed, however, my history examination and I wanted you to get it into perspective'. The same holds for the income statement. New accounting developments are starting to push for changes to the P&L. Various standard setters are suggesting that we add a 'statement of recognised gains and losses' to the P&L. We are then left with three sections in the income statement: operations, financing and 'other'. All three sections show changes in equity excluding transactions with owners. The remaining question is what should go into the 'other' section. The answer is that the 'other' section should include the financial consequences of events extraneous to management, i.e., peripheral to the organisation.

4.6 Pension costs

The final issue I want to touch upon is pension costs. IASC made a quantum leap forward under Jan Klaassen's leadership when they proposed to abolish the actuarial basis for pension costs. The latter is still the accepted method in the UK, although the ASB has suggested that the UK should move – as the IASC proposed – to market values. The market will tell us what shares are worth, there is no need for actuaries to value these securities. It is not as easy to value liabilities, but we are moving in the direction of obtaining the current value of the liability.

The next question is why the surplus or deficit is not recorded on the balance sheet. Obviously, the reason is the volatility of the stock market. Using market values for pensions could lead to very volatile charges to the income statement. The UK is experimenting with different ways to go about this issue, and we are actually going a step further than the IASC. The volatility caused by the pension costs should appear in the 'other' section of the newly income statement – the theory being that the company is not in the business of running a pension fund. Changes in the fund's value is peripheral to the management of the firm.

5 Conclusion

In recent years, most of the pro-active work in accounting has been conducted internationally. Provisions, impairment, goodwill and intangibles have all benefited from the international debate. In these areas most countries have very similar standards or are about to adopt them. We are presently moving into a totally different area in which national standard setters and the IASC are all working together; namely on derivatives, leasing, stock-options, income presentation, and pensions. Regardless of what happens to the IASC – IOSCO agreement, globalisation is coming. Globalisation makes sense, it is what we want and it is going to happen.