

“What kind of accounting standards should we write?”

by

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What kind of standards should we write?

Thank you very much for inviting me to address this conference on your 10th anniversary. As Professor Schipper noted, the fact that you are gathering here today for the 10th year is a tribute to the foresight and leadership of Dr Nastase. It is a great pleasure and honour for me to be here and to support the work that this group is doing to train accounting professionals and support high quality financial reporting that serves the interests of investors in capital markets.

I have focused my remarks today on a long-standing challenge for standard setters: what kind of standards should we write? By this I mean, how specific and prescriptive should standards be? How should cost considerations influence requirements? How should we balance comparability with effective communication of an entity's strategy and business model? What are reasonable expectations for the use of judgement? And what is the interaction of the types of standards we write with the training – both skills and subject matter knowledge – of accountants?

To keep this from being too abstract, I'm going to use our recent experiences with our new revenue standard to illustrate the challenges of striking the right balance. I'm going to start by giving away the conclusion – there is no single, simple answer. As standard setters, we need to hear when we're getting it wrong – and getting it right. I hope that my remarks today will help you respond to our proposals; to apply, or to audit the application of, IFRSs; to use financial statements prepared using IFRS more effectively; and help those who train accounting, audit and finance professionals.

Comparability vs communication and the role of the business model

I'm starting with comparability because in our Conceptual Framework comparability is one of the four enhancing qualitative characteristics of financial reporting. The IASB's decision (made jointly with the US Financial Accounting Standards Board) to enshrine comparability in our Conceptual Framework signals its core role in our standards. We emphasise comparability because of our focus on helping investors to make choices between investment alternatives – when to invest, when to hold an existing investment, and when to sell. Some investors may be focusing on a narrow question of, say, buying shares of Bank A or Bank B. Others may be deciding between shares of Bank A or Insurance Company C. Still others may be deciding between Bank B, Insurance Company D or Asset Manager M. I believe that financial statements should play an important role in making that decision, and that means that an investor has to be able to compare the resources, claims and performance of its investment alternatives.

So what's the problem? Why don't we always pursue comparability at all costs? Well, the competing pressure is for financial statements to be a meaningful communication tool. And even Bank A and Bank B, operating in the same sector in the same country, may have different strategies and perhaps even different business activities. Time and time again we hear concerns that accounting standards are rigid and too prescriptive to let an entity reflect how IT is using its resources, and how ITS performance should be measured.

I think that it's important for financial statements to be a communication tool and not just a compliance exercise, so I support the proposal in our recent Conceptual Framework Exposure Draft that a measurement basis should reflect both the characteristics of an item and how that item is used by the entity to generate cash flows. The cost of this type of flexibility is that tailoring the measurement to how an entity uses an asset may reduce the immediate comparability of financial statements of two entities that hold the same asset and use the asset in different ways.

Staying with my Bank A and Bank B example, both banks may participate in a loan to Borrower C. Bank A intends to hold and collect the interest and principal while Bank B intends to package the loan with similar loans in a securitization transaction. Under our new financial instruments standard, Bank A would classify the loan as measured at amortised cost while Bank B would measure the loan at fair value. Arguably the different measurement of the same loan is, in each case, better aligned with the planned use of the asset and a better – more faithful – representation of how the owner expects to generate cash flows from the asset. Therefore, the financial statements are a relevant, faithful representation – a better communication – of each entity's business activities. But the direct comparability of their balance sheets probably has been reduced, since the same item is measured in different ways.

Would it be better to force Bank A, the “hold to collect” entity, to measure the loan at fair value, even if changes in value are not expected to be realized? Would it be better to force Bank B to measure the loan at amortised cost unless and until the loan is sold? Or would that fail to provide relevant information about current values and cash flows expected to be generated by Bank B in the near term?

The balance that we struck in our financial instruments standard is to focus on both the asset characteristics and the business model holding the asset. The asset characteristics and the facts of the business model – not just the intention of management – are the discipline that impose consistency and, I hope and expect, comparability, both across periods and between entities. The comparability across entities is less direct – the loan is, after all, measured two different ways – but ultimately investors can compare how efficiently and effectively management has used the resource – the loan – in its business. We hope that this makes financial statements more effective communication tools of what has been achieved and why, providing a better basis for investors to make a choice between investing in Bank A or Bank B.

A second type of comparability that we wrestle with is comparability across industries. How does an investor decide between investing in a bank, an insurance company, an asset manager, restaurant chain or pharmaceutical company? Should we care about supporting comparability across industries rather than focusing only on comparability within an industry? I think we should. First, business is evolving constantly. For example, insurance product offerings are becoming more like investment vehicles – still with an insurance element, but often with a significant deposit that is guaranteed to be returned, along with actual or sometimes guaranteed minimum returns. So choices that may have been starker 25 years ago – invest in an insurance company or an investment management company – may be blurred now. I also think that investors look to compare performance, and potential, of different sectors and entities in

those different sectors. So I believe that comparability across sectors is important, too, not just comparability within a sector.

That's one reason I'm a big supporter of the proposal in our insurance contracts project to measure insurance company revenue in a way that is comparable to how revenue is measured in other industries. For some insurers, this will be a big change, because some frequently used measures of volume include amounts that are investment deposits. Our proposal is to require measurement of revenue to exclude deposit amounts, which is what is done in other industries. Some insurers are struggling with this change in current practice, in part because they will lose a component of volume and therefore look smaller. But I believe that when an investor picks up a set of financial statements that the meaning of "revenue" should be consistent regardless of the type of company that is reporting that revenue.

I'm going to wrap up my comments about comparability by offering the first of several reflections on lessons learned from the revenue project.

As many of you know, in May 2014 we published a new standard on revenue recognition. This was a long and challenging project that the IASB undertook jointly with the US FASB. It replaces two current IFRS standards and over 200 pieces of US GAAP literature; US GAAP was much more industry specific, with several different models and many different specific requirements. And, because there was much more specificity for US GAAP, many entities reporting under IFRS looked to industry-specific practices under US GAAP for their revenue recognition policies, for example in areas like software development, licensing and entertainment.

The new revenue recognition standards – which are very close to wholly converged, same words and all – should be a very significant move to enhanced comparability of revenue recognition across industries because virtually all industries are now sent to a single standard with a single model for revenue recognition. Making "one size fits all" work is proving challenging, however, in part because of the judgement that is expected – nay, required – to be used to figure out how the single revenue model applies to different business activities and contract terms.

But, what standard setters found is that lots of siloed industry-specific revenue reporting requirements were impeding comparability. As industry sector boundaries blurred, lots of time was spent figuring out which model applied. Think of how the evolution of business raises problems – when the sale of music via a record (tangible) becomes sale of a CD (still tangible) becomes the download of a file (an intangible) becomes the license to listen x number of times or for x period of time (a license or a lease). Having inconsistent thresholds for revenue recognition, resulting in different allocations across periods and sometimes bringing along different cost (expense) recognition models, was making comparability more challenging without enhancing the communication aspects of standards. So revenue recognition became an area that needed a reset, and it's a pretty radical one – sweeping away all the different pieces of industry-specific guidance and replacing them with one standard. This change probably is more pronounced for those using US GAAP than for entities reporting using IFRS, though it is a significant change for IFRS as well. While US GAAP is "losing" lots of specific guidance, IFRS is gaining a lot more specificity than it has today.

A single revenue standard does not mean a single revenue recognition approach – we still have two types of revenue recognition. The two approaches are for two different types of performance – point IN time and performance OVER time, with percentage of completion used when goods or services are delivered over time. And it's expected that entities in a single industry should reach consistent conclusions regarding whether delivery (performance) for a specific type of product is over time or at a point in time. My hope is that the consistency is comparable – that the same decision is reached for comparable economics, and not just for the sake of consistency when terms and conditions may vary and the underlying promise – and therefore performance – differs.

The role of judgement in financial reporting

I tried to introduce judgement softly in my last few thoughts, let me now turn to address it head on – what is an appropriate level of judgement to embed in accounting standards?

When the FASB and IASB started work on the new revenue standard, about 100 (OK, 10) years ago, it debated some radical new approaches, including revenue recognition on an activities basis – as an entity undertakes productive activities. The alternative view was the contract principle – recognise revenue as performance occurred. The boards decided to base revenue recognition on contract performance. But, with all the focus on which model to use, people may have failed to notice another change that got embedded in the new standard – a step up in the level of judgement needed. By sweeping away hundreds of pages of industry-specific guidance, and removing the crutches of lots of specific “if this then that” guidance, entities are required to focus on the economics of their transactions with customers. What has been promised? Are those promises distinct performance obligations? How do you measure performance? And what consideration has been promised in return for each performance obligation? Don't these questions sound like they should be easy to answer? Well, they're sometimes proving difficult in practice – and it sometimes is unclear whether the problem is lack of clarity in the standard, or whether it's a change management issue.

Because revenue is such an important financial performance measure, and because the boards recognised that adopting a new revenue standard would be a significant change for many entities, the boards have been active in supporting consistent implementation of the new standard. Our primary vehicle for this has been a new type of activity – a “Transition Resource Group”. The TRG is an advisory body to the IASB and FASB, with a brief to discuss – in public, on the basis of publically available issues papers – questions that have been raised about implementing the new revenue standard. They don't issue guidance, but rather try to determine, on the basis of their discussion, whether the Boards should consider providing additional guidance on a particular issue.

What I want to focus on is the lesson from some of the areas discussed by the TRG. I think that those discussions show that we all need to warm up the mental muscles needed to apply judgement.

My first example is the guidance in the standard for determining whether an entity is a principal or an agent. The standard bases revenue recognition on transfer of control of the goods or services to a customer. Control also is the basis for determining whether an entity is a principal or an agent – a principal controls the goods or services before they are delivered to the customer, while an agent

arranges for the goods or services to be provided, but doesn't control them before delivery. The TRG's discussions highlighted the difficulty in applying a control principle to services – can you control a service before it is provided?

The IASB tentatively decided in May that control does work as a test for services as well as for goods, and plans to reaffirm this and clarify how the control test is applied. We will propose clarifications as part of the ED that we plan to issue in the third quarter.

Part of what I heard at the TRG was resistance to change and concern about making a judgement about control without anything specific to point to. Our planned proposed amendments will remove some of the uncertainty by confirming the focus on control and reiterating the supporting role of the indicators. The amendments will not give certainty and all stakeholders will have to step up and be prepared to apply and defend their application of judgement.

Jim Schnurr, the US SEC Chief Accountant, talked recently about the new standard requiring “sound judgement that is supported by evidence¹.” The tip of the iceberg regarding evidence should be visible in an entity's financial statements, in its disclosure. Our new revenue standard has extensive disclosure requirements that are intended to help users of financial statements understand “the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.”² This objective is backed up by 19 paragraphs of specific disclosure requirements, including one that is focused on significant judgements. We see these requirements as a way that an entity can – or rather, is required to – explain its business activities, and how the revenue standard has been applied by the entity. Customised information should be the focus, rather than providing a boilerplate summary of the requirements of the standard.

Another example of the new revenue standard requiring the use of judgement is the step of identifying what the performance obligation is that the entity has promised. A number of issues in this area have been discussed by the TRG, but I want to focus on one in the manufacturing sector.

If an entity enters into a contract with a customer to manufacture 10 units of a physical good then is there one performance obligation (to deliver 10 items) or 10 performance obligations? The answer is – it depends.

Let's analyse one of the more challenging fact patterns discussed by the TRG. This is when a manufacturer agrees to build a customized item, perhaps on demand, for a customer. The entity (the manufacturer) will be involved in the item's design, may specify the materials and design the manufacturing process and then will operate the manufacturing process on demand to deliver up to 10 items over several years as and when an item is ordered by the customer.

¹ Schnurr, James, *Remarks at the 34th Annual SEC and Financial Reporting Institute Conference*, Pasadena, CA, USA, June 5, 2015 (text <http://www.sec.gov/news/speech/remarks-34th-sec-financial-reporting-institute-conference.html>) p3.

² International Accounting Standards Board, *IFRS 15 Revenue from Contracts with Customers*, May 2014, paragraph 110.

Identifying the performance obligations in the example I just described will be challenging and will involve judgement. Questions to be answered include: is the entity delivering design services? Is it delivering a finished product or manufacturing services? In order to answer these questions, an entity, its auditors and investors will have to consider things like who bears the cost of inefficiencies in the manufacturing process (learning curve costs)? Does the entity get compensated for those? There is no “formula” answer – not every long-term contract, or every contract for custom-designed items, will be over time (and therefore accounted for using percentage of completion). These issues also may be relevant for the construction industry and a lot comes back to the basic question of “what is the promise”?

Stepping back from lots of detailed guidance to focus on basic questions and the principles to answer those questions has several objectives, including reducing arbitrage between slightly differing fact patterns because very different accounting models are applied in different fact patterns. But writing a standard that has a clearer focus on principles also serves a second objective – building a more flexible standard that will withstand ongoing evolution in business models, because business is not standing still. Forty years ago retailers bought inventory and took inventory risk. Now, you may find wholesalers compensating retailers for shelf space, paying advertising allowances to have a retailer promote the wholesaler’s goods and giving rebates and refunds for unsold merchandise. At what point does a retailer become an agent? Right now that seems to be happening in selective pockets of product offerings – maybe for gift cards but probably not for cereal or soap. But that may change, and I hope that we’ve written a standard that will cope with changes in business. For that to happen, though, the standard needs to be applied in a disciplined way, using judgement to challenge past conclusions as changes occur, so that financial reporting continues to be a faithful representation of current promises and activities, rather than inherited industry practices that fail to evolve to reflect new business developments.

But for the new standard to be effective over a long time horizon, and to be useful in coping with new business models that haven’t been developed yet, we all have to learn the lesson of registering and assessing incremental change. I bet that most of us have heard the story of an experiment that took two frogs and tested their reaction to boiling water. In one case, the frog was put in room temperature water and the water temperature was raised degree by degree. Because each change was incremental the frog didn’t notice until it was too late and died as the water approached the boiling point. In comparison, the frog dropped in a pan of near-boiling water leaped out immediately and saved himself – the significant change registered and he reacted.

For the standard to be durable we need people to challenge their past assumptions and practices over and over, as the water temperature changes by a degree or two. They need to stand back and say “is this transaction really the same as the last one? Have we nudged the balance of terms so that it’s moved from over time to point in time? Have we tuned things a bit so that the entity is an agent even though historically it’s been a principal?” It’s challenging to be the skeptic, to ask questions over and over again, but that’s part of judgement. And if we want accounting to be communication and not just compliance, and for our role to be valued professionals, not just clerks, we need to be challenging and embrace, rather than resist, change.

What does the IASB expect of accountants? What should investors and accountants expect of us?

Once again, I've introduced my next theme – what does the IASB expect of accountants – at the end of the previous section, talking about expectations for the ability to apply judgement and to be challenging and respect the principles in standards, rather than clinging on to current practice without considering how business practices are changing.

Next on my list of expectations is that accountants will apply judgement in the context of the objectives and principles of a standard. This includes reading and understanding the basis of conclusions which provides context for the decisions captured in a standard. It's been disappointing when, a couple of times, the TRG discussions have noted that "it's clear what the boards intended if you read the basis but the basis isn't authoritative and the standard doesn't explicitly require the reading the boards intended so diversity is expected when the new standard is applied". And the boards have heard some suggestions to amend the standard to move a sentence from the Basis for Conclusions to the text of the standard. That's disappointing to me because I expect professionals to approach the standard with the objective of understanding what was intended rather than an objective of creating loopholes or justifications for not changing current practices. Returning to my example of how to measure revenue from insurance contracts, I fear that we are going to have to include a statements in that standard that says "revenue cannot include customer deposits" because of the need to change some existing practice and the resistance to that change. I hope that we can avoid having to spell out everything that is precluded by the statements of objectives and principles that are the core of our standards.

A third expectation is that we work to keep the concept of materiality effective. The effectiveness of materiality – that the requirements of a standard are not required to be applied to immaterial transactions – keeps financial reporting from grinding to a halt with costs exceeding benefits. But the effectiveness of materiality is under attack, with preparers pointing to auditors requiring quantification and documentation of immateriality, and auditors pointing to regulators applying hindsight and challenging lack of documentation. One consequence of this is that standard setters are being asked to specify more explicit relief from the principles and requirements of a standard.

For example, the boards have been asked to introduce several additional "practical expedients" to simplify application of the new revenue standard. The FASB has been encouraged to introduce an accounting policy election to treat shipping and handling as either a cost of sale or as a separate performance obligation. Without this expedient, entities would be required to assess the substance of their promise to customers to determine what the nature of their shipping promise is. I suspect another reason that an accounting policy approach is desired for shipping and handling is because considering shipping and handling to be part of the promise of selling the good might be inconsistent with the assertion that control is transferred and revenue is recognised when goods are delivered to a third-party shipper.

And the FASB is not alone in facing this pressure – in our work on leases, the IASB has decided to create a "low value asset" exception to the requirement for a lessee to recognise a lease asset and liability for all leases. We made this decision because of very high levels of concern that our new leasing standard

would be very costly to apply because it would capture smartphone, iPad and laptop leases, and that demonstrating that those contracts were immaterial might be as costly, on an ongoing basis, as applying the requirements of the standard. So we have decided to create an exception that allows low value assets to be accounted for as they are today, ie as operating leases.

Practical expedients for items that are unlikely to be significant may seem to be a reasonable way forward. But in just a couple of years as a standard setter I've learned to beware exceptions, and that's what practical expedients are. When you create expedients you draw boundaries, create scoping challenges and increase overall complexity.

So, a challenge for all of us, to which I have no easy solution, is to look for ways to strengthen the application of the concept of materiality (and immateriality). I believe that improvements in this area require behavioural changes that are difficult to mandate. The IASB is trying to do its part, initially focused in the area of disclosure. In December 2014 we finalised some wording changes to IAS 1, our standard on presentation of financial statements, to confirm that materiality is an overarching principle that applies throughout the standards, including to disclosure requirements. So, even if a standard says "an entity shall disclose..." , this applies only if the disclosure is material.

We also are working on guidance for determining what is material. We are due to publish an exposure draft of a "materiality practice statement" in the third quarter of this year. This will include proposed guidance on how to apply the concept of materiality both to recognition and measurement and also to disclosure. I hope and expect that we'll hear whether this guidance is helpful – both what we have to say about applying the concept of materiality and whether a practice statement, which is non-authoritative, is the right vehicle for such guidance.

Feedback

The proposed materiality practice statement is just one of the things that we want and need to hear from you about. Feedback from stakeholders is a critical ingredient for the IASB's effectiveness, and we want that feedback, whether it's positive or negative.

I've talked a lot today about the Revenue TRG, which is an experiment with post-issue involvement in the translation of our standards into practice. We took the step of forming a TRG because of the significance of revenue to virtually every organization. I'm sure that you can sense some frustration on my part with some of the discussions we've had, but overall I'm positive about this experiment. I think we should undertake this kind of work during the post-publication/ pre-adoption phase only on an exceptional basis – when there's a major change to be made.

I've already mentioned both our Conceptual Framework exposure draft, which was issued at the end of May, and our expected EDs of the materiality practice statement and the clarifications of the revenue standard, the latter responding to issues coming from the TRG discussions. I hope that we hear from many of you here in response to those and other consultations that we have planned. We can't set standards without stakeholder input, because developing standards includes building buy in to the

outcomes and the changes required. As standard setters we balance the costs and benefits, working to satisfy the needs of investors at a cost that is reasonable for those who prepare financial statements.

Closing

Today I've spoken about what standard setters expect from accountants and how these expectations shape how we write standards. I want to close by touching on what you should expect from us and also on how our expectations interact with how accountants are trained.

First, what you should expect from us. This personal list includes:

- Open, thoughtful consultation with stakeholders
- Well considered Board conclusions that are reached in open, honest and well prepared debates in public meetings and captured in well drafted proposals and standards
- Well articulated objectives and principles in those standards so that the standards address the problems we set out to fix and are capable of coping with unexpected developments
- Standards that work together, are consistent with the Conceptual Framework and help financial reporting realise our objective of satisfying the information needs of investors
- Facilities within the IASB to raise issues and have them evaluated, and, when needed, responded to, including a well resourced and effective interpretation committee
- Undertaking change when change is needed and when significant improvements can be realised that justify the cost of change

These are ambitious goals to realise day in and day out in everything we do. And we need to hear from you with ideas about how best to realise them, and when we are not hitting our targets. We have a tremendous responsibility, and all of us feel that and want to live up to it.

And now, to close, I want to offer a few thoughts on what our standards mean for the training of accountants, a subject that I hope is of interest to most of you.

The item at the top of my "wish list" for accountant training is training in reasoning and logic. Knowing the subject matter is important, but memorizing requirements without working to understand what they are trying to achieve will leave us falling short of giving investors what they need and will end up in endless debates responding to questions that boil down to "where does it say I have to do that? Where does it say that I can't do that?"

A second "wish list" item is another skills training point – practicing the application of judgement. That's a hard thing to teach, but it is necessary to apply our standards and to deal with many other issues in a professional's career.

A third skill that accountants need is understanding how business works. We need to account for the substance and not just the form of transactions.

Today's accountants need more training in finance than we got when I was training 35 years ago. As companies and transactions get more sophisticated, they are more influenced by finance concepts in

setting the terms of transactions. For example, I believe that many more “ordinary” transactions reflect consideration of the time value of money than they did 30 years ago, and we consider the time value of money much more in thinking about reporting requirements. The introduction of accounting for share-based payments reflects accounting catching up with transactions that reflect understanding of the value of options even when they are out of the money. So a good grounding in finance theory will help accountants to work through understanding of the economics of a transaction and the appropriate accounting.

I appreciate all that you are doing to train the accountants and business professionals of the future and hope that I’ve given you some useful insights into how and why we write the standards that we do. I look forward to your questions and comments.

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