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What kind of accounting standards should the IASB write?

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Disclaimer

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Abstract: This paper focuses on a long-standing challenge for standard setters: what kind of standards should they write? How specific and prescriptive should standards be? How should cost considerations influence requirements? How should standard setters 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 with the training – both skills and subject matter knowledge – of accountants? These issues are explored using examples from recent IASB standard setting, primarily the IASB's new revenue standard. The author concludes that there is no single answer.

Keywords: IFRS, IASB, accounting standard-setting, financial statements, judgement, comparability, materiality, business model

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1. Overview

The purpose of this paper is to explore competing objectives that accounting standard setters face as they try to make financial reporting more relevant and effective. Exploration of these issues is illustrated using examples from recent standard setting by the International Accounting Standards Board (IASB), primarily the IASB's new revenue standard.

The objective of the paper is to help stakeholders to

- respond to proposals issued by standard setters;
- apply, or audit the application of, International Financial Reporting Standards (IFRS);
- be more effective in using financial statements prepared using IFRS, and
- help those who train accounting, audit and finance professionals.

2. Comparability vs communication and the role of the business model

Comparability is one of the four enhancing qualitative characteristics of financial reporting set out in the IASB's Conceptual Framework[1]. The IASB's decision (made jointly with the US Financial Accounting Standards Board (FASB)) to enshrine comparability in its Conceptual Framework signals the central role of comparability in IFRS. The IASB emphasises comparability because it focuses 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. In order for financial statements to play an important role in making that decision, 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 standard setters always pursue comparability at all costs? The answer is because of the competing pressure 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 the IASB is told 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.

In order for financial statements to be a communication tool and not just a compliance exercise, the IASB has proposed[2] 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 the Bank A and Bank B example, both banks may participate in a loan to Borrower C. Bank A's business model is to hold and collect the interest and principal while Bank B will package the loan with similar loans in a securitization transaction. Under the IASB's new financial instruments standard,[3] 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 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 the IASB struck in its 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 is expected to impose consistency and comparability, both across periods and between entities. The comparability across entities is less direct – the loan is measured two different ways – but ultimately investors can compare how efficiently and effectively management has used the resource – the loan – in its business. This is intended to make 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 standard setters 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 the IASB care about supporting comparability across industries rather than focusing only on comparability within an industry? Here are reasons that it should care about cross-industry comparability.

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. Investors look to compare performance, and potential, of different sectors and entities in those different sectors. So comparability across sectors is important, too, not just comparability within a sector.

Cross-sector comparability is one reason that the IASB proposed in its insurance contracts project to measure insurance company revenue in a way that is comparable to how revenue is measured in other industries.[4] For some insurers, this will be a big change, because some measures of volume include amounts that are investment deposits. The IASB's 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 investors have a right to expect that the meaning of "revenue" is consistent regardless of the type of company that is reporting that revenue.

The IASB's recently issued revenue standard[5] also provides some lessons on comparability. This was a long and challenging project that the IASB undertook jointly with the US FASB. It replaces two current IASB standards and over 200 pieces of US generally accepted accounting principles (US GAAP) literature; US GAAP was much more industry specific, with several different models and many different specific requirements. Because there was much more specificity for US GAAP, some 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 – 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 required to apply a single revenue model to different business activities and contract terms.

One reason that the IASB and FASB undertook this project was that different industry-specific revenue reporting requirements were impeding comparability. As industry sector boundaries blurred, many time-consuming issues arose determining which model applied. Consider 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. The changes required by the new standard are a substantial "reset" of revenue recognition reporting. 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 more specificity than it has today.

A single revenue standard does not mean a single revenue recognition approach – there still are 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. 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. The measure of success of the standard and its implementation will be whether 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.

3. The role of judgement in financial reporting

When the FASB and IASB started work on the new revenue standard, 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? These questions sound like they should be easy to answer, but they are 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. The primary vehicle for this has been a new type of activity – a "Transition Resource Group".[6] 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. The TRG does not issue guidance, but rather develops recommendations, on the basis of their discussion, whether the Boards should consider providing additional guidance on a particular issue.

The TRG discussions have provided some instructive examples about the challenges of and skills needed to apply judgement. For example, the TRG has had several discussions of 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 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.[7] Part of the TRG discussion suggested that some of the questions arose from resistance to change and concern about making a judgement about control without anything specific to point to. The 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.

The US SEC Chief Accountant has commented that the new revenue standard requires "sound judgement that is supported by evidence[8]." The tip of the iceberg regarding evidence should be visible in an entity's financial statements, in its disclosure. The IASB's 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."[9] This objective is backed up by 19 paragraphs of specific disclosure requirements, including one that is focused on significant judgements. These requirements are 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 requirement to identify what the performance obligation is that the entity has promised. A number of issues in this area have been discussed by the TRG. For example, 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.

Consider one of the 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.[10]

Identifying the performance obligations in the example described above 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 extensive, 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, wholesalers may be 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 some gift cards but probably not for cereal or soap. But that may change, and a well written, principles-based standard should be able to cope with changes in business better than a prescriptive rule with detailed implementation guidance. In order for the new revenue standard to remain effective, though, it 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.

One challenge 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, is to learn the lesson of registering and assessing incremental change. Many 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 new revenue recognition standard to be durable, established assumptions and practices will need to challenged 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 the terms been nudged so that the transaction has moved from over time to point in time? Have one or two terms been changed a bit so that the entity is an agent even though historically it's been a principal?" It's challenging to be the sceptic, to ask questions over and over again, but that's part of judgement. And if accounting standards are intended to deliver communication and not just compliance, and accountants to be valued professionals, not just clerks, then all stakeholders in financial reporting need to be challenging and embrace, rather than resist, change.

4. What does the IASB expect of accountants? What should investors and accountants expect of it?

Some of the things that the IASB expect of accountants were discussed in the previous section, including expectations for the ability to apply judgement and to be challenging and respect the principles in standards.

Another expectation 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 suggested that while it is clear what the boards intended if the basis is considered 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.[11] That's disappointing because it seems reasonable to 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 the example of how to measure revenue from insurance contracts, it seems that the IASB may find it necessary to include a statement 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. Having to spell out everything that is precluded by the objectives and principles that are the core of standards will leave standard setters playing catch up with new products and deliberate structuring and is not a sustainable approach to standard setting.

A third expectation is that all stakeholders 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[12] – keeps financial reporting from grinding to a halt with costs exceeding benefits. But the effectiveness of materiality is under pressure, 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.[13] 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. Perhaps 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 its 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. The IASB made this decision because of very high levels of concern that its new leasing standard would be very costly to apply because it would capture smartphone, tablet 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 the IASB decided to create an exception that allows low value assets to be accounted for as they are today, ie as operating leases.[14]

Practical expedients for items that are unlikely to be significant may seem to be a reasonable way forward. But standard setters need 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 stakeholders-, is to look for ways to strengthen the application of the concept of materiality (and immateriality). 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 it finalised some wording changes to IAS 1, the standard on presentation of financial statements, to confirm that materiality is an overarching principle that applies throughout the standards, including to disclosure requirements.[15] So, even if a standard says "an entity shall disclose…", this applies only if the disclosure is material.

The IASB also is working on guidance for determining what information is material. It is planning to publish an exposure draft of a "materiality practice statement" in 2015.[16] This will include proposed guidance on how to apply the concept of materiality both to recognition and measurement and also to disclosure. Responses to the draft guidance will be used to assess whether this guidance is helpful – both what is said about applying the concept of materiality and whether a practice statement, which is non-authoritative, is the right vehicle for such guidance.

5. Feedback

The proposed materiality practice statement is just one example of how standard setters seek feedback on their proposals. Feedback from stakeholders is a critical ingredient for the IASB's effectiveness, and the Board wants that feedback, whether it's positive or negative.

The revenue TRG discussed above is an experiment with post-issue involvement in the translation of standards into practice, using feedback from those who will be preparing and auditing the application of the new standards. The TRG was formed because of the significance of revenue to virtually every organization. This kind of work is undertaken during the post-publication/ pre-adoption phase only on an exceptional basis – when there's a major change to be made.

The IASB can't set standards without stakeholder input, because developing standards includes building buy in to the outcomes and the changes required. Standard setters balance the costs and benefits, working to satisfy the needs of investors at a cost that is reasonable for those who prepare financial statements.

6. Mutual expectations

This section considers what stakeholders should expect from standard setters and how standard setters' expectations interact with how accountants are trained. Stakeholders should be able to expect the following attributes and activities from the IASB, which, although it is a private sector body, works in the public interest:

- 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 they 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 the 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 achieve, and for the IASB to realise them, it needs to hear from stakeholders. It needs to hear from stakeholders with ideas about how best to achieve the goals set out above, and when it is not hitting its targets. The IASB has a tremendous responsibility, and its members, staff and those charged with oversight recognise that and want to live up to it.

The last paragraphs of this paper offer a few thoughts on what IFRS mean for the training of accountants. The item at the top of the 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 accountants 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 item is another skills training point – practicing the application of judgement. That's a hard thing to teach, but it is necessary to apply IFRS and to deal with many other issues in a professional's career.

A third skill that accountants need is understanding how business works. Financial reporting needs to account for the substance and not just the form of transactions. Lastly, today's accountants need training in finance. As companies and transactions get more sophisticated, they are more influenced by finance concepts in setting the terms of transactions. For example, it seems that many more "ordinary" transactions reflect consideration of the time value of money than they did 30 years ago, and that financial reporting considers 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.

7. Summary

The objective of IFRS is to provide useful information to users of financial statements.[17] To achieve this goal, they need to be a communication tool and not a compliance exercise. Setting standards that support this goal requires the participation of many stakeholders, as does interpreting and applying the standards after they have been issued. Good faith application of judgement, seeking to realise the objectives of the standard and questioning established practice are all part of achieving this goal. So are expertise in reasoning, economics and finance. All parts of this equation are critical, but it is a goal worth striving for because it supports efficient and effective markets and makes accounting a rewarding and respected profession.

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[2] IASB *Conceptual Framework for Financial Reporting, Exposure Draft ED/2015/3*, May 2015

[3] IFRS 9 *Financial Instruments*, July 2014. Classification of financial assets is addressed in Chapter 4

[4] IASB *Insurance Contracts Exposure Draft ED/2013/7* published June 2013; see paragraphs 58 and B89 for a discussion of exclusion of investment components from revenue

[5] IASB, IFRS 15 *Revenue from Contracts with Customers*, published May 2014

[6] Information about the TRG can be found at http://www.ifrs.org/About-us/IASB/Advisory-bodies/Joint-Revenue-Transition-Resource-Group/Pages/Home.aspx

[7] This proposal is included in the exposure draft *Clarifications to IFRS 15, ED/2015/6*, published in July 2015

[8] 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

[9] IASB, *IFRS 15 Revenue from Contracts with Customers*, paragraph 110.

[10] *See* TRG paper 9, discussed at the October 2014 meeting http://www.ifrs.org/Meetings/Pages/Joint-TRG-for-Revenue-Recognition-October-2014.aspx

[11] *See* TRG Topic 12 discussed at its January 2015 meeting http://www.ifrs.org/About-us/IASB/Advisory-bodies/Joint-Revenue-Transition-Resource-Group/Pages/Meetings.aspx

[12] *See* IASB *Conceptual Framework for Financial Reporting* paragraph QC11 and International Accounting Standard (IAS) 1, *Presentation of Financial Statements*, paragraph 7

[13] *See* minutes of FASB meeting of 24 March 2015, available at http://www.fasb.org./cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176165893693

[14] *See IASB Update, February 2015*, available at http://media.ifrs.org/2015/IASB/February/IASB-Update-February-2015.html#7

[15] IASB *Disclosure Initiative, Amendments to IAS* 1, published December 2014, paragraph BC30H

[16] *See* "Upcoming Exposure Drafts" section of IASB work plan, available at http://www.ifrs.org/Current-Projects/IASB-Projects/Pages/IASB-Work-Plan.aspx

[17] *See* IASB *Conceptual Framework for Financial Reporting*, Chapter 1 "The Objective of general purpose financial reporting", International Accounting Standards Board, September 2010