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GUEST EDITORIAL

FACING UP TO REALITY: ACCOUNTING THAT TELLS IT AS IT IS

By Sir David Tweedie

The impact of the recent accounting scandals on financial markets demonstrates the central role that financial reporting plays in today's increasingly integrated global economy. Our economic health depends on the effective functioning of equity and debt markets in order to allocate capital efficiently and promote growth. Markets will operate effectively over a sustained period only if there exists a sound financial reporting infrastructure on which to build.

Strengthening the Pillars of Capitalism

Such a financial infrastructure must include three basic pillars: (1) accounting standards that are consistent, comprehensive, and based on clear principles to enable financial reports to reflect underlying economic reality; (2) auditing practices and policies that are able to confirm that those standards have been translated into accurate, understandable, and timely reports by individual public companies; and (3) a regulatory framework capable of ensuring that the principles, as laid out by the accounting standards, are followed. Because of the growing complexity and speed of change in the marketplace, those involved with safeguarding the soundness of financial markets must continue to ensure that the financial infrastructure remains relevant. It is clear now that in various parts of the world the financial reporting system, including the corporate governance and auditing practices, failed to keep pace with a rapidly evolving marketplace, made more complicated by a corporate culture fuelled by perverse compensation incentives.

There have been some observers in Europe and elsewhere who have argued that the crisis in confidence sparked by Enron's collapse is a United States issue, and that action is not needed elsewhere. My experience as a practising auditor and as a professional standard-setter over the last two decades leads me to believe that that is not the case. Companies today are global players, compete against each other for the same pool of capital and face the same business pressures. Most multinationals, U.S.-based and otherwise, must set performance objectives, observe each other's activities, and implement similar practices to ensure that their competitors do not have a competitive advantage. And in many areas outside the U.S.A., the accounting literature remains incomplete or insufficient to address the complexities of the modern market. Now there exists a clear impetus to improve the financial reporting system, as an essential element in ensuring the effective functioning of global capital markets and the economy at large.

Some guidance should be drawn from the United Kingdom's experience of responding successfully to financial reporting crises. There are clear parallels between today's crisis and the one faced by us in the early 1990s. To restore confidence in the quality of financial reporting after the collapse of Coloroll and Polly Peck, the U.K. Accounting Standards Board (ASB) was established. The ASB believed that the only way to deal with the accounting scandals was to set the highest quality standards. In the process the ASB brought long-hidden liabilities back onto balance sheets. It stopped manipulation of the income statement by abolishing 'acquisition' and 'big bath' provisions. The so-called 'extraordinary' item used to massage earnings per share was banned. These changes were introduced in the face of significant opposition from some in industry and the accounting firms. The easy thing would have been to compromise on the most controversial issues of the day — making incremental changes at the expense of quality in order to please various interested parties. The ASB did not, and the U.K. markets recovered. The only way to win back the faith of the markets is to avoid shocks — full transparency, not obfuscation, is the answer to lack of confidence in accounting.

A Set of Accounts for 2005 and Beyond

The recent accounting failures demonstrate the clear need to continue to modernise the existing accounting model to reflect modern business practices accurately and to suit the needs of today's investors. Accounting standard-setters must address the fact that accounting has only gradually evolved away from the traditional cost-based model and begun to develop an approach that is suitable for the economy of the post-Industrial Revolution era. Another problem is that, although capital flows freely across borders, accounting rules are still largely determined by national jurisdictions. This reduces the comparability of financial statements. The likely result is that investors fail to allocate their capital in the most efficient manner.

The International Accounting Standards Board (IASB), which was reconstituted in 2001, has the mandate to create a single set of high quality, enforceable, global accounting rules for use by the world's capital markets. With the European Union's decision to adopt International Financial Reporting Standards (IFRSs) in 2005, the U.K. interest in the setting of international standards is great.

Since 2001, the IASB has been working on completing a platform of standards to be ready for the adoption of IFRSs by companies throughout the world in 2005. The IASB's initial efforts have focused on improvements of existing International Accounting Standards (IASs), providing guidance to those companies adopting IFRSs for the first time, and issuing standards in the areas where current IASB literature is deficient (for example, business combinations and share-based payment). At the same time, the IASB and other national standard-setters, including the U.S. Financial Accounting Standards Board, are working together to reduce differences among existing standards. The result should be that the set of standards required for 2005 should provide a high level of quality, transparency and comparability for investors. Our work for 2005 is nearly complete, and the IASB has pledged to finalise all of the standards to be mandatory for 2005 by 31 March 2004.

Perhaps more important is the direction in which the IASB will head beyond 2005 in order to make the accounting model relevant. For too long some accountants have sought to provide results as they wanted them to be, not as they are. In this light, earnings have been smoothed in an effort to show investors a steady upward trajectory of profits. While this approach provides a simple and understandable model, it is simply not consistent with reality. Publicly traded companies are complex entities, engaged in a wide range of activities and subject to different market pressures and fluctuations. Accounting should reflect these fluctuations and risks. The focus on providing a steady stream of earnings only distorts the picture and encourages practices that run counter to the aims of providing investors with accurate information.

The current direction that we are taking will be what I like to call 'tell it as it is' accounting. This may mean an increasing reliance on fair values, when those values can be determined accurately. Financial results may therefore become more volatile. However, hiding the truth from investors will only make the shocks that markets receive more severe. The implication of this transformation in accounting is great. Assets and liabilities, when obligations exist, will be brought back onto the balance sheet.

An example that demonstrates this change and affects the actuarial profession is the treatment of pensions. Under existing standards in many jurisdictions (including existing international standards) a company's obligation to a defined benefit pension plan is reported on the company's balance sheet. However, the amount reported is not the current obligation, based on current information and assumptions, but instead represents the result of a series of devices designed to spread changes over several years.

While I was chairman of the U.K. Accounting Standards Board, the ASB introduced a new standard on pensions (FRS 17) which provides an example of how accounting standard-setters might deal with the issue. This standard requires pension assets to be valued at market values rather than using actuarial measurements, and changes in the pension deficit or surplus should be reflected in the statement of recognised gains and losses annually, removing all smoothing mechanisms. The basic premise is that the pension surplus or deficit should be shown in the balance sheet for investors and employees to see and for management to determine pension policies. In this manner, management has the opportunity to explain to those employees dependent on the pension promise whether the company will be able to meet its obligations. I believe that this is an example of the direction that accounting should take.

The Challenge and Opportunities Ahead

Undoubtedly, the use of more fair values and the removal of smoothing mechanisms will represent a sea change for those accustomed to both traditional cost accounting and existing accounting standards. The increasing use of fair values does not mean the end of the need for actuaries, and the actuarial profession will need to continue to play a large role in the development and implementation of IFRSs. Actuarial assumptions and techniques used in financial reports will need to be more explicit in order to give investors adequate information to make decisions.

This message is not new for the actuarial profession in the U.K. FRS 17 demonstrates that that is the case. When initially put forward, the proposal to use market values for assets faced widespread opposition from the actuarial profession. After close consultation with the ASB and with the development of new techniques, the actuarial profession provided significant support for FRS 17's approach. A major role for actuaries in the future may well be to assist company management in explaining, in the operating and financial review, how any deficit in the pension could be covered (e.g. by a change in the plan, by a change in the assumed growth in the plan's assets, by extra payments in the future).

Now the IASB is preparing to address the issue of pensions on a global basis, and has taken on a project that is looking to overhaul accounting for insurance contracts. Once again the actuarial profession will need to be closely involved in the IASB's efforts — to paraphrase one of the Institute's slogans — to make financial sense of the future.

It is not surprising that, in the context of financial reporting, any systemic change generates much controversy, given the many interests at stake. Already the opposition is mounting to several of our proposals and previously existing standards, and the IASB hears threats regarding the possible rejection of its standards in jurisdictions that have already committed to adopt IFRSs. Keenly aware that the market needs assurance and not compromise on ill-considered solutions, the IASB and national standard-setters should, and will, proceed with what we believe is right. Too often in the past threats and political interference have sought to stop standard-setters from implementing their conclusions made after a deliberative process.

The IASB will be open minded. It will continue to consider all views carefully on every issue, and it has established internal processes to ensure that it receives the best thinking. This includes meeting with a 50-member advisory council, creating issue specific advisory groups, and adhering to procedures that require public comment on proposals.

The stakes and potential pay-off for the global economy are large. If it succeeds, capital markets will have a single set of global accounting standards which they can trust. Confidence will be enhanced, and the opportunities for rational global investment decision-making and growth increased. This is the opportunity of a lifetime to select the best of the national standards and make them the world's standards. Accounting is the foundation stone of the market economy. We must ensure that the global market's view of companies throughout the world is founded on a single, solid base.

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