21st Century Accounting Standards

"At times we lose people because they don't understand what we are saying, because we have forgotten the language of simplicity and import an intellectualism foreign to our people"

Pope Francis - Rio - 2013

“There is a growing dissatisfaction with a corporate reporting process viewed by many as an exercise in regulatory compliance.........
The reform of corporate reporting is now a global priority.”

ICAS – Making Corporate Reports Relevant - 2012

By Edward Beale

CityGroup
Company Secretarial Services

www.city-group.com 0207 796 9060

Contents

	Page
Introduction	1
Executive summary	3
Purpose of Financial Accounts	4
Who should accounts be written for?	6
What is useful (relevant) information?	10
Approach to standard setting	12
Characteristics of useful (relevant) information	15
Structure of financial accounts	22
Principles not rules	34
True & Fair	36
Sector specific standards	39
Conclusion	40

Introduction

Accounting standards determine the form and content of the financial accounts. But users of financial accounts are not widely engaged in the process of setting those accounting standards. So we should not be surprised when users say that financial accounts do not provide them with the information they need. And many users are far less polite than this! This inability to find information maybe because the information is not in the financial accounts, but may also be because it is lost in clutter, or provided in a manner that users cannot understand. Users of financial accounts should be the people determining the form and content of accounts, not technical experts, preparers of accounts, or their advisers.

The absence of users from the debate about accounting standards over an extended period of time has resulted in the language of accounting standard setters evolving to such an extent that their dialect is almost unintelligible to most users of accounts; and language differences mean accounting standard setters now find it hard to understand the concerns of the limited number of users that are still prepared to try to engage in debate.

While we are on language, I have tried to write this pamphlet in a dialect that can be widely understood, and I have avoided accounting jargon wherever possible. This pamphlet uses the term “financial accounts” rather than the IASB's term “general purpose financial reporting”. The term “general purpose financial reporting” covers both the narrative and accounts sections of annual reports. “Financial accounts” is shorter, which is always useful, and this pamphlet is written from a UK perspective. The UK, and many other jurisdictions, have their own local requirements for narrative reporting that, while similar, differ from the IASB's recommended practice.

This pamphlet is aimed at users of financial accounts and accounting standard setters. It looks at ways that users of financial accounts can be brought into the centre of the standard setting process; drawing on my experience as an investor, a non-executive director, a CFO, and as a member of the UK's Accounting Standards Board. I have intentionally restricted this pamphlet to financial accounts and omitted discussion of narrative reporting, since my purpose is to encourage this engagement between users and accounting standard setters

This pamphlet reflects my experience of the financial markets and any apparently unsupported assertions are based on this experience. To avoid clutter, I have consciously tried to omit the phrases: “in my opinion” or “in my experience”.

I have tried to keep this relatively brief. I touch on many topics, all of which are worthy of consideration in far greater depth than can be accomplished in the space limitations of this

pamphlet and the competing demands on my writing time. The purpose of this pamphlet is not to provide solutions but to identify problems, fly some kites and provoke debate about fundamental issues rather than secondary problems. My contact details can be found at the beginning and end of this pamphlet if anyone would like to explore any of the topics further.

Executive Summary

The purpose of accounts is

To Communicate to Users | **Useful information** | **in a Useable format**

Users with the broadest desire for information are long term shareholders not involved in management

We need to assume users are: intelligent, diligent and understand business. Not ignorant or lazy.

Users are the most important constituency and should be in the driving seat when determining accounting standards

Engagement by users is part of their stewardship responsibilities

Information is useful when it relates to past or potential future cashflows

"Relevance" should be the key determinant for inclusion of information

"Faithful representation" is not a gatekeeper and should not be a qualifying characteristic

Replace "Faithful representation" with "Confidence" - the uncertainty surrounding a measurement.

Remove the constraint imposed by the 3 current primary statements, and the uncertainty arising from mixing backward and forward looking measurement bases in one primary statement

Replace current primary statements with a set of statements focussed on answering key questions

Return to a principles based approach, with transparency as a deterrent to abuse, not rules

Identify the principle for when sector specific standards are required

Lack of clarity over measurement bases being used, and approaches to measurement not grounded on the business model, undermine a true & fair presentation

Communication is the overriding objective

Financial accounts today are like the bible which in pre-reformation times was only available in latin. Access to the information contained in the bible was restricted to a limited number of people who could read latin. Only they could communicate this information more widely to those who did not know Latin or could not read. The reformation resulted in the bible being made available in the vernacular and becoming more widely read and debated, if not understood.

We are increasingly getting to a situation where financial accounts can only be interpreted by experts. We need to change the language of accounting and the structure of financial accounts so that more people can better understand the information that financial accounts are attempting to communicate.

It is time for a reformation in accounting.

The Purpose of Accounts

Accounts are all about communication. Their purpose is

Communicating to users

useful information

in a useable format.

It is that simple.

Back in 1977, David Tweedie wrote about accounting as follows:

'Its purpose is not to provide stimulating intellectual exercise for those who do it, not to give them a pleasant means of passing the time. If it does not meet the test of telling the reader something which will help him, it fails in its primary purpose.'

This is the acid test that determines whether accounts are fit for purpose. ***Do they communicate information successfully?*** This same test applies whether you are talking about management accounts, financial accounts or any other sort of accounts. The audience that accounts are prepared for, and the reasons why that audience are looking at accounts will determine the required content and style of presentation; but accounts can only be regarded as a success if they communicate information effectively.

Accounts come in many different guises. As well as financial accounts for companies there are management accounts, trust accounts, charity accounts, pension fund accounts etc.; each trying to communicate information for specific purposes to their different user groups. The discussion that follows focuses on the financial accounts of companies as it is these that drive accounting standards.

In the UK, companies are a legal mechanism for investors to jointly own an enterprise, and in most cases to limit their liability. Financial accounts are part of the annual report from managers to the company's owners, its shareholders. As part of the quid pro quo for the protection of limited liability, financial accounts for UK companies are required to be made publicly available, so that creditors can form a view on the likelihood that they will be paid. With the advent of stock markets, financial accounts have become relevant for potential investors as well as shareholders and creditors. They are also used by tax authorities as the starting point for determining corporate taxes and by regulators, particularly in financial services and rate regulated industries such as water and other utilities. Customers use

financial accounts to assess stability of supply. Trade unions and other employee groups use them when negotiating pay, and increasingly they are being used by disparate pressure groups seeking reliable information to further their campaigns.

These many different classes of users; each attempt to use financial accounts for their own distinct purposes, which presents an immediate challenge when trying to determine the appropriate content for financial accounts. If financial accounts try to satisfy the information demands of all of the disparate classes of users, there is a significant risk that they end up satisfying none. It is much easier to tailor communication to one homogeneous group of people than to communicate simultaneously with people from different backgrounds and different interests.

While there are probably an almost infinite number of ways that users can be categorised, the information content of financial accounts can be broadly categorised into two: backward looking, and forward looking. Crudely, backward looking information is about how much something cost (and was this money well spent) or how much something was sold for (and was this the best deal in the circumstances, or should the sale have been made)? Forward looking information is more focused on the questions: what is something worth, how will this help generate value in the future, or how much is the entity committed to pay in future? While all of these are valid questions, the challenge for preparers of accounts and standard setters is to decide which of the different forward and backward looking measures to include and the degree of prominence to give to each measure. The right balance will depend on who the users of accounts are presumed to be, and the purpose for which they will be using those accounts.

How does this definition of the purpose of accounts differ from the IASB's Conceptual Framework?

The IASB's Conceptual Framework defines the objective of general purpose financial reporting as being "to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity".

This differs from the more general definition above in that it limits the user group and limits uses that are being considered. It also does not address the critical requirement for clear communication: that the format in which information is presented is accessible. It is all very well supplying the necessary needle, but not if it comes hidden in a haystack.

I shall consider these differences further in the following chapters.

Who should financial accounts be written for?

Before discussing the question of who financial accounts should be written for we should first address the question of why does this matter? The purpose of accounts is communication, and communication can be best achieved where there is a clear understanding of the target audience. That is not to say that others will not find such documents useful. J.K. Rowling wrote the Harry Potter books for teenagers, but adults still enjoyed them in droves. The point is that if the target audience is clear, then the structure and the language used can be tailored to make the content not only useful, but also more easily understood by the target audience.

The main downside of focussing communication efforts on a limited target group is that information that is useful to other users, but not to members of the target group, may be omitted. This is a price worth paying. Losing focus by trying to satisfy all potential users risks introducing clutter and making financial accounts more difficult for their primary audience to navigate. This danger is well recognised and there have been a number of recent projects addressing the issue of cutting clutter such as the ICAS/NZICA report "Losing the excess baggage" and the IASB's current "Disclosure Initiative" package of projects.

Potential users of financial accounts can be summarised as:

- Equity Investors (both existing and potential shareholders),
- Suppliers (including suppliers of labour, finance, goods and services),
- Customers, and
- Regulators and other special interest groups (including tax authorities).

They use financial accounts to find information to help them answer questions such as:

- How well have management performed in the past?
- Is this the right management team for the future?
- Will I be paid (is the business a going concern)?
- Will I be able to trade with the entity over time (will it continue to be a going concern)?
- How much surplus cash will the business be able to return to shareholders?
- Are there any indications that regulations have been breached?
- Do they include information that the special interest group is seeking?

The above list intentionally does not include questions that are primarily answered from narrative reports, supported by information in the financial accounts, such as how does the business make money and how will it be able to sustain that ability?

The table below summarises the different interests of the different user groups:

Users interest in financial accounts				
	Stewardship	Valuation	Going Concern	Other
	Is this the right management team for the future?	What will returns to shareholders be?	Does the business have the funding to execute its business plan?	
Types of User				
Investors				
Shareholders involved in management	No	Yes	Yes	No
Other shareholders	Yes	Yes	Yes	No
Potential shareholders	Yes	Yes	Yes	No
Suppliers				
Labour	Yes	No	Yes	No
Non-equity finance	Yes	No	Yes	No
Goods and services	Yes	No	Yes	No
Customers	Yes	No	Yes	No
Regulators	No	No	No	Yes
Pressure Groups	No	No	No	Yes

This table takes a "black or white" approach to categorisation. Taking a "shades of grey" approach, "yes" should be read as "usually", and "no" as "rarely", or some similar terminology.

So who should the target audience for financial accounts be? Looking at the table above, we see that the users with the broadest interest in financial accounts are "shareholders not involved in management". Accounts prepared for them will therefore go furthest to satisfy the information needs of other users.

The main area of potential omission arising from focussing on the information needs of "shareholders not involved in management" is information sought by regulators and other special interest groups. But regulators are in the position to be able to demand that the information they seek be provided: in separate returns, in the narrative sections of the annual report, or in the financial accounts. Such information does not have to be specified by accounting standards since regulators can require publication themselves.

This leaves the question of which other information demands from special interest groups should businesses acquiesce to? Businesses are always able to voluntarily provide additional information sought by special interest groups, but they should be able to pick and choose the information that they provide, rather than being forced by accounting standards to provide information requested by any special interest group. Where politicians see a need for particular information requested by a special interest group, they can always regulate to require publication of this information, for example the recent introduction of reporting on greenhouse gas emissions.

In order to tailor the manner in which information is communicated, more is needed than just identifying who the target audience is. The common attributes and characteristics of users also need to be identified. There are many different types of investor with different investment strategies, and different time horizons, but what do they have in common?

First we need to make assumptions about their capacity: users are reasonably intelligent but are not technical accounting experts; they can grasp new concepts that are clearly explained, can manipulate data to best extract the information that they find useful, and can draw logical conclusions from the information provided. Otherwise financial accounts would need to be an "idiots' guide".

Second their approach: users are reasonably diligent; they will devote the time necessary to understand what are sometimes complicated business models, and they will read the notes as well as the primary statements. Notes can therefore be used to communicate useful information. The alternative, trying to encapsulate all useful information in the primary statements, leads to the primary statements being overburdened and high levels of complexity.

But we should not extend the idea of reasonable diligence to assume that users will learn a new language in order to understand financial accounts. Accounts need to be written in a manner such that the meaning of commonly used words accords with common usage, and words do not have special technical accounting implications. Special meanings could well be missed by those not accustomed to technical accounting debates. Special meanings can also be hard to translate into other languages.

Thirdly their background: users have a reasonable understanding of business. If financial accounts needed to explain the mechanics of how the business functions they would quickly become unmanageable. An explanation of the business model is necessary as a foundation to understanding the financial accounts, but it is best included in the narrative reporting section

of the annual report and not in the financial accounts.

Fourth we need to consider the relationship between shareholders and companies. In the UK the legal position is that shareholders as a body are the owners of a company run on their behalf by the directors. The other main view, more prevalent in the USA, is that a company is a stand-alone entity run by the directors with shareholders as the suppliers of risk capital. Some consider that shareholders are just gamblers, with no interest in the success of the company, only in short term share price movements. If shareholders are gamblers or just suppliers of risk capital, then their interest in the company is obviously more limited than that of a joint owner. Since we are trying to identify the users with the widest possible interest in a company, it is clear that this is shareholders who consider themselves to be joint owners.

Readers who are interested in the different views about who users are, and their information needs, will find that the joint literature review by EFRAG and ICAS on “The use of information by capital providers” provides a useful starting point.

So to summarise: **accounts should be written for shareholders who consider themselves to be joint owners**, who are reasonably intelligent and diligent, and have a reasonable understanding of business. Users should not be considered to be accounting experts and an understanding of technical accounting language should not be presumed.

What is useful information?

We have identified the target audience for financial accounts as being "shareholders not involved in management, who consider themselves to be joint owners", who are reasonably intelligent, diligent and have a reasonable understanding of business.

The next question is what can we say about the types of information that they will find useful? To do this we need to draw on the use to which they put financial accounts. Uses are many fold, but fundamentally equity investors use financial accounts to help them understand what the business is worth. For some this is a matter of what can they sell their shares for today, or what will a buyer pay to acquire the whole business? While others want to know what their future income stream from the business will be, and what this income stream will be worth to them. So the information still needs to meet a diverse range of needs despite the target audience having been restricted.

The other questions that users want answers to include:

- what is the quality of the management team (which in part will be answered by how well the assets of the business have been used in the past, and how well liabilities have been managed),
- what is the position of the business today (both financial and non-financial), and
- what are the business's prospects for the future?

The answers to these questions do not (and should not) lie wholly in the financial accounts, but the financial accounts can provide information that is useful in forming a view on the answers to these questions.

Financial accounts can provide information about: past transactions and commitments entered into, the current financial position, and an indication of the extent that the business risks not being able to pay its debts as they fall due. But they cannot be a crystal ball showing some or all possible futures. The information about the past can provide information about the quality of management and how the business arrived in its current financial position, and this can help users in making their own estimates about the amount, timing, and risk of future cash flows.

Users also want to be able to benchmark against other businesses in the same sector, or of a similar nature. So it is useful for businesses to prepare information in a similar manner to their peers. But care needs to be taken that any comparison is like for like. Comparability of information between businesses is discussed in more detail below.

A number of different approaches to measurement will have to be used in one set of financial accounts. When considering past transactions, backward looking information will tend to be most useful, but when considering financial commitments and future cash generation, forward looking information will be more appropriate.

But fundamentally, whether looking backwards or forwards, financial accounts are limited to providing information about cash flows: past and future, actual and potential; because it is cash that will fund interest and principal payments to creditors, dividends to shareholders, and capital expenditure to maintain and grow the business.

The challenge is to identify for each item in the financial accounts the relative importance of the past (entry) and the future (exit) cash flows, which should be given more prominence, and whether including more than one measure is useful.

A further consideration to be borne in mind is the relative importance given to "income and expenditure", versus "assets and liabilities", and versus "cashflows". In my experience, if users of financial accounts are asked to rank these three classes of information in order of relevance, most will put cashflow first, closely followed by income and expenditure, with assets and liabilities of much less importance. Most of the rest will rank income and expenditure first, with cashflow a close second, and assets and liabilities clearly third. Very few will rank assets and liabilities first.

> *"In broad terms, the information needs for equity investors revolve around the amount, timing and risk of future cash flows, so information is deemed useful if it assists in estimating these."*
>
> ICAS/EFRAG The use of information by capital providers 2013

Yet the current conceptual framework is based upon assets and liabilities. This then leads to academic debates about recognition (which items should be included in the statement of financial position) and measurement (what value should be attributed to these items). A focus on providing information about cash flows will obviate the need for such academic debates, concentrate on consideration of relevant entry and exit cashflows, and increase the likelihood of engagement in standard setting by users of financial accounts.

So to answer the question that is the title to this chapter: **useful information is information about past and future cash flows**. It is cash that allows dividends to be paid, underpins valuations, repays creditors, and returns to lenders the principal advanced and any interest.

Approach to standard setting

A focus on the purpose of financial accounts being "to provide users with useful information in a useable format" needs to be underpinned by a change in the approach to setting accounting standards. Changes in this direction are being made, but the extent and speed of change need to be increased.

Accounting standards that do not have the wholehearted support of investors will be perceived as a compliance burden, and this increases the risk that they will fail in their role as a tool for communicating useful information.

Users need to be fully engaged at all points in the development of accounting standards. But users are busy people with other matters that occupy their time. They will only be prepared to commit time to development of accounting standards if they feel that there will be an adequate return for their efforts, i.e. that what they say will matter.

Some will say that users do not want to become involved in accounting standard setting, or that users do not have sufficient time to engage. Similar arguments have been made about corporate governance more generally, but, having been reminded of their stewardship obligations, many institutional investors and their intermediaries are re-engaging in corporate governance debates. The same rationale supports their increasing involvement in financial reporting which is, after all, only a sub-set of the wider corporate governance conversation between boards and investors.

At the start of any standards project there needs to be a wholehearted effort to engage users and identify the information that they will find useful. Since users of accounts are the key constituency, they must be at the heart of matters. This already happens to a growing extent, but if there is to be extensive buy-in from investors, efforts to involve them must be much more overt. But responsibility does not just lie with the IASB. Investors need to be engaged too.

Following the preliminary discussions with users, the next step in a revised approach to standard setting should be a discussion paper focussing on what users have identified as useful information; seeking to confirm and refine the set of information identified as being useful by users of accounts. The purpose of such a discussion paper will be to engage with users and obtain their contribution to and support for the project, so it needs to be written in a clear and accessible manner. Technical and theoretical discussions should be omitted. At this stage, this is about identifying what information is relevant, not whether there is an asset or a

liability, income or expenditure. The challenge will be to move away from users saying "everything is potentially useful" and instead try to identify the information which is most often relevant.

The next step should be to identify how best to communicate this information in the financial accounts. This will involve discussion, about which information should be included in the primary statements, which information in the notes and where reconciliations of movements, or analysis tables, are relevant. This can then lead to an exposure draft showing how primary statements and notes might look, and with minimal technical jargon. The purpose of the exposure draft is to obtain confirmation from users that the data set to go in accounts will meet their needs and is presented in a manner that is readily accessible. This exposure draft should be full of examples of how information could be clearly presented. The exposure draft will also need to include, or be accompanied by, the text of a draft standard supporting the proposed manner of presenting the information. I would anticipate two sets of questions in the exposure draft: one set asking whether the proposals and examples will provide the information that users seek in an accessible manner, and the second set to preparers and their advisers seeking confirmation that the draft text for the accounting standard will produce the information set out in the examples.

The role of the conceptual framework (what are assets/liabilities, how to measure them and record their changes) in such a regime is to assist in the structuring of a useful format for the communication of information. It helps to provide consistency across standards; when items should be recognised in the primary statements, and how items should be measured. But the conceptual framework should not be the final arbiter of how financial accounts are prepared. A pragmatic approach focussing on the communication of useful information, the ultimate purpose of financial accounts, is required.

I am not saying that this approach will make it easier to arrive at a consensus than is currently the case, nor will it make it easier to write principles based rather than rules based accounting standards. But the approach to standard setting needs to continue to adapt so that it more clearly prioritises users' information needs and produces solutions that meet those needs.

This is only a minor change to the current structure of standard setting: research regarding content, discussion paper, exposure draft, standard. The major change is in the focus, on the provision of useful information rather than identification of assets and liabilities, income and expenditure, enabling much earlier and more significant engagement by users of financial accounts.

Users need to determine priorities for standard setters. That is not to say that standard setters should acquiesce to ill-informed demand. For example if users overwhelmingly want priority to be given to a revised standard on earnings per share (eps), standard setters should not commence a narrow project on eps, but a wider project on key performance measures. Performance cannot be measured by one universal KPI (eps), and the opportunity should be taken to put eps into context alongside other performance measures.

If users of accounts can understand accounting standards and are seen to be supportive of them this will drive wider acceptance and better application of those standards. But this is not a one way street. With rights come responsibilities. **Users need to understand that engagement in the standard setting process is part of their stewardship responsibility**.

Characteristics of useful information

The IASB's Conceptual Framework defines the objective of general purpose financial reporting as being “to provide financial information about the reporting entity that is **useful** to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity” (my emphasis).

The IASB’s Conceptual Framework then explains a number of qualitative characteristics of useful information. Relevance and Faithful Representation are the fundamental qualitative characteristics, and Comparability, Verifiability, Timeliness and Understandability are enhancing qualitative characteristics.

Set out below are comments on some of these qualitative characteristics, bearing the mind the slightly different objective of financial accounts defined above: “to provide users with useful information in a useable format”.

Relevance

"Relevance" – (include information that is useful), and its converse "materiality" – (omit information that is not useful), relate directly to the purpose of providing useful information. Because of that direct correlation with the purpose of accounts, the characteristic of “relevance” needs to be elevated in the hierarchy above **all** the other qualitative characteristics. This should be the most important characteristic, and the gatekeeper which determines whether items should or should not be included in the financial accounts.

The opposite view is that some other characteristic should be of equal or more importance than relevance. This other characteristic could then determine that certain data is included in accounts even if it is not relevant. Such an approach would just generate clutter.

This will have practical consequences: on "faithful representation" and on "comparability".

Faithful Representation

If “faithful representation” is to be retained as a qualitative characteristic, subservient to “relevance”, it should act as a filter to promote “relevance”. The problem is that the way that “faithful representation” is defined; it does not act as a filter.

To put it crudely, "faithful representation" is about whether a number is what it purports to be. With sufficient disclosure as to how a value has been derived, all measurement bases can meet the test of “faithful representation”. The characteristic of “faithful representation” is

therefore not a "gatekeeper" and does not restrict the use of any approach to value an item.

> *As described in the current Conceptual Framework, a faithful representation is given provided adequate disclosure is made, including the nature of the asset or liability, the measurement basis used and the uncertainties that significantly affect that amount. Given that description, any measurement basis of any asset or liability would be consistent with the idea of 'faithful representation' (with suitable disclosures). Thus 'faithful representation', as described, fails to exclude the provision of any information and therefore cannot guide the development of accounting standards.*
>
> Financial Reporting Council response to the IASB consultation on "A Review of the Conceptual Framework for Financial Reporting"

If "faithful representation" is not working as a filter or gatekeeper, then we need to look at how it can be made to work, or if it can't be made to work, whether it needs replacing, and if so what by?

Valuation

There are two concerns that need to be addressed here. What is the most appropriate way of valuing an asset or liability, and how to cope with uncertainty?

The best case scenario is that the valuations used for items in the accounts reflect the substance of the relevant transactions in accordance with the business model.

Let us look at the current approach to valuation of assets. If an asset is stock in trade or some other current asset, then the general principle is that it is valued at the lower of cost or net realisable value – unless it is a financial instrument, when it is valued at market value. The value of fixed assets on the other hand should reflect their income earning potential, and this is generally taken to be its market value, or if there is no market its value in use.

Of these valuation bases, cost should be readily available, and businesses normally have tried and tested approaches to calculating the net realisable value of current assets. Market value may be available, but frequently it is not. So valuation of current assets is relatively straightforward, except for financial instruments with no market value.

Value in use is rarely easily identifiable and is normally the output from a complex financial model. As a result many tangible fixed assets are valued at cost less depreciation and less any necessary impairment provisions. The most frequent exception to this is financial instruments where market value may be available.

A market value is only the value at which there is a balance between buyers and sellers. Many owners will view an item's value as being higher than the market value and will not therefore be sellers. Similarly many potential buyers will view an item's risk adjusted value as being less than the market value and will therefore not be buyers. This will be the case even if all buyers and sellers have exactly the same information. Markets are not perfect and financial accounts should not be based on the assumption that they are perfect.

Whereas the market value will provide the actual realisable value of an asset or liability at the balance sheet date, it may only provide an indication of the realisable value at the point in time when the item is disposed of, or the financial accounts are being read. But there are many circumstances when a distinct market value is not available and where there is a temptation to resort to marking to model.

Models produce	**fictional values**
derived from	**hypothetical transactions**
between	**imaginary people**
	as I said back in March 2006**.**

Marking to model is useful where historic cost information is of little relevance, there is no market value, and where the model produces information that is more relevant than historic cost, or management's best estimate of future cash flows (usually informed by experience and internal scenario forecasting). In the absence of a market value, or demonstrable value in use, the challenge is which information is most relevant: historic cost, the value produced by a model, or management's informed judgement?

In order to answer this question we need to go back a step. Financial accounts are about communicating useful information about past and future cash flows. So subject only to a cost/benefit test, financial accounts should include all useful information about both past and future cash flows. Whereas past cash flows are known with certainty, the problem relates to

whether estimates or forecasts of future cash flows will be useful, and if so how to calculate them? Should it be left to users to calculate these cash flows based on information provided in the accounts and their views of the future, should management provide their best estimate, or should there be rules in place to determine how an estimate should be calculated?

The risk with a rules based approach is that the resulting value may not provide useful information about the magnitude or possibly timing of future cash flows. Accounts are all about cash flows. So if a model provides useful information about a future cash flow, it is potentially useful and its use should be considered. A model that has not been demonstrated to provide useful information about future cash flows will produce numbers that are of little relevance and its use should be carefully considered, and probably rejected. It is likely that in such circumstances, management's best (informed) estimate, or historic cost, provides the most relevant information.

Even if historic cost provides the most relevant information, that is not to say that all information about current or exit value should be excluded from the financial accounts, only that the degree of uncertainty about current value or exit value means that it is more relevant for this information to be included outside of the primary statements.
A similar analysis also applies for liabilities.

Use of models can also generate a challenge about how to account for the difference between the values derived from such models at the current and previous period ends. What proportion should be included in earnings and how much should go directly to equity? This is a major topic that I do not propose to cover further here.

Uncertainty
One of the limitations within the current structure of accounts is their poor ability to communicate the extent of uncertainty surrounding forward looking information. Some forward looking information can be readily determined e.g. the amount required to settle an invoice from a supplier, but other information is less certain e.g. the sales value of slow moving stock, the cost of a warranty, or the amount required to settle a court case.

Where the range of different values is small, there will be no issue in using a forward looking value. Where there is a wide range of possible outcomes, then there will be question over whether a point value will provide useful information and, if so, how best to determine such a point value? In accounting speak, whether an item should be “recognised” and, if so, how it should be “measured”?

Using a point value could be misleading, and, for those who do not read the notes to the financial accounts, can provide spurious accuracy. Not recognising an asset or liability in the statement of financial position because of uncertainty could also be misleading in that the asset or liability could be overlooked. If no amounts are recognised in the primary statements, the notes will need to clearly communicate information about the existence of the asset or liability and the uncertainty over its measurement, so that it is not overlooked.

On balance, including a point value in the statement of financial position is likely to be the best solution because it highlights the existence of the asset or liability, and the need to consult the notes for more information. But publishing a meaningless number just to point users in the direction of the notes is a waste of time and space. Informing users of the existence of a difficult to value asset or liability could just as well be achieved by a comment below the statement of financial position. Where a point value is used, there should be some useful information content to the point value published. Management's "best (informed) estimate" or historic cost may convey more useful information than the output of a complex model. It is important that management should be able to use their judgement. Whereas complex models can help management arrive at their best estimate, the output from such a model should not be used blindly, and management should be able to use a different amount if they believe this to be more useful to users, and they are prepared to justify its use.

The concern about using management's "best estimate" is that this can be manipulated to influence reported profits. But if the notes provide adequate information regarding the uncertainty, explain the process used to arrive at the numbers being used, and reasons for changes in management's "best estimate" over time, users can form their own opinion on the quality of profits, and the quality of management's judgement. If the notes provide inadequate information, this still gives useful information, but this time about the quality of management and auditors.

Publishing a number that is simply the result of a complex calculation, and is unlikely to relate to a future cash flow, provides less useful information than management's informed best estimate. There is a lot of information content to management's "best estimate", especially with the benefit of hindsight, and where changes to "estimates", and the difference between "estimate" and outcome, are clearly communicated in subsequent financial accounts.

Reviewing the above section on "faithful representation", it is mainly about practical application of the concept of "relevance" i.e. what is useful information, and very little about the concept of "faithful representation". If we accept the primary importance of the concept of "relevance", then "faithful representation" is not very important. What is important is

delivering the best balance between the ***confidence*** that can be applied to a measure of cash flow and ***relevance***. If all forward looking measures are too uncertain, then it may be necessary to use a historic cost, even if this not particularly relevant. However if historic cost is totally irrelevant, there is no market value, and models are unproven or their results are too volatile, then management's "informed best estimate" may be the most relevant measure, no matter how open to manipulation.

In summary, the **fundamental qualitative characteristic of "faithful representation" should be replaced by a secondary qualitative characteristic of "confidence"**.

At present the characteristic of "faithful representation" also incorporates the old concept of "substance over form". If faithful representation is replaced by "confidence", then further changes will need to be made to the conceptual framework to retain substance over form, or this can be incorporated within a broader understanding of the term "confidence".

Comparability

The concept of comparability covers both consistency in accounting, year on year, and consistency of accounting treatment between businesses. The former is to be supported, but the latter can be taken too far. It can lead to all businesses being required to account for items in a similar manner no matter what their business model, and can introduce unnecessary complexity, leading to reduced relevance.

What is useful information about an asset or liability in one business may not be useful information in another business in a totally different industry. It should be possible for the same item to be accounted for in different ways depending on the business model.

A van manufacturer should not be expected to account for a van in the same way as a leasing company or a delivery business. Similarly the issuer of a debt instrument should not be automatically expected to account for the debt instrument it issues (a long term liability) in an equal and opposite way to a short term investor in debt instruments (where it is a current asset).

If we are basing accounting standards on the assumption of reasonably intelligent and reasonably diligent users, then what matters is not that all items are accounted for similarly no matter what the business model is, or the legal form of an item. What is important is that users have the information to enable them to make valid comparisons. This information requirement may be best met through disclosures in the notes, rather than over-complicating the primary statements. For example, rather than put operating leases on the balance sheet,

disclosure can provide information about lease commitments and a fixed asset movement type table can provide information about material leased assets employed in the business. Users can then manipulate this information to make their own comparisons between different businesses that use leases to a greater or lesser extent.

Comparability is a useful concept, but it needs to remain subservient to concepts of relevance and confidence. Comparability should not be used to justify inclusion in the primary financial statements of irrelevant or unreliable information.

Prudence

The other big debate at present is about the role of the lovely lady "Prudence". The accepted view is that there should be neutrality over "measurement" but prudence over "recognition". But what does this mean to the non-technical reader?

Measurement of the carrying value of an asset or liability should be on an impartial basis, neither cautious nor aggressive, with the usual provisos such as a liquid market, full information, and a willing buyer and seller. But, as noted above, it may not be appropriate for the buyer and seller to account for a transaction in an equal and opposite manner.

Recognition however should be approached more cautiously, with a higher hurdle for recognising an asset than for recognition of a liability.

Prudence also needs to be consistently applied. It does not seem right that used cars are more tradeable than certain more obscure financial instruments, and their value is more readily ascertainable, but some companies have to recognise unrealised profits on stocks of financial instruments, while others are forbidden from recognising unrealised profits on used car stocks.

Summary

In summary, the qualitative characteristics need to more clearly prioritise the information needs of users.

"Relevance" is the most important characteristic. "Faithful representation" should be replaced by a secondary characteristic "Confidence", and the other (tertiary) qualitative characteristics need to support these characteristics.

In the past a combination of supporting characteristics and "faithful representation" appear to me to have led to the use of measures with questionable relevance. Supporting characteristics should never be used to over-rule the primary and secondary characteristics of "Relevance" and "Confidence".

Structure of financial accounts

I do not know when the current structure of financial accounts was devised, but it was certainly a long time ago. Since then accounting standards have increasingly codified the contents of financial accounts, and fair value is increasingly being used for measurement. It is well past time that the structure of financial accounts was examined to see whether it is still fit for purpose, or whether minor, or fundamental, changes are required. This is a major area for debate that, to the best of my knowledge, is not being widely debated. Many learned tomes could be written on this subject by people better qualified than I, so this chapter restricts itself to throwing out a few ideas in a simplistic manner, in the hope that these ideas may be worthy of development, or at least spark a more high profile debate.

Accountants need to recapture their drive to challenge the status quo. We need to start with a clean sheet and examine how accounts can best communicate in today's information age. Nowadays it is much easier to re-sort and analyse information (e.g. XBRL, and advances in search engines that may render XBRL obsolete), and financial accounts should be prepared based on the assumption that users have access to modern computers. We are not still in the age of the quill pen.

As always, the starting point needs to be identification of the problem. Once upon a time historic cost accounts provided certainty about the past (to a greater or lesser extent e.g. the level of provisioning), but were lacking in information about the future. Since then fair value has introduced more current/forward looking information, and, in some areas, more sophisticated approaches to the determination of fair value have been adopted, to try to reduce uncertainty.

The problem is that with three primary statements, each of which ideally fit onto one page, there is a limited volume of data that can be communicated. In today's data intensive world we have reached the limits of the information that can be clearly communicated in this restricted volume of space. We need to step outside of this restriction and think anew about the different types of information that users would like to see, and how best such information can be clearly communicated.

Rather than have primary statements that try to answer many questions simultaneously, I think that we need a set of separate linked primary statements, each focussed on answering a particular question. These questions might be: what has happened in the past, what are the cash flow commitments, what unrealised profits exist, what are the major areas of uncertainty and judgement, what is my equity interest and how might it be diluted?

My suggestion is that financial accounts should include:

1. Profit and loss account, balance sheet and cash flow based on historic cost- essentially backward looking to record past transactions
2. Payment schedule - to show when liabilities and off balance sheet commitments fall due for payment
3. Valuation report - to give an indication of unrealised profits not reflected in the balance sheet
4. Judgement report - to identify areas of significant uncertainty and discuss the extent of uncertainty and how values used in the accounts have been derived
5. Equity report - to record actual and prospective changes in shareholders' proportionate interests

These would need to be supported by notes providing further analyses and supporting information, as at present.

We are already moving in this direction. The payment schedule is a development of the IFRS7 disclosure requirements. We have increasing disclosures in areas of judgement. But the suggestion above moves us further along the mixed measurement model by separating out different information types to minimise the opportunity for confusion.

Looking at these new primary statements in more detail:

<u>Profit and loss account, balance sheet and cash flow based on historic cost</u>
Purpose - record of transactions in period, commitments and impairments; in order to help assess quality of management and inform going concern judgements.

Profit and loss account – showing:

- the results of transactions,
- depreciation, amortisation and impairment of assets, and
- adverse changes in the estimated settlement value of liabilities (impairment of liabilities).

The profit and loss account needs to reconcile directly, or via a note, to movements in retained profits and losses line on balance sheet. This includes realised profits and both realised and unrealised losses. Information about unrealised profits is included in the Valuation Report (see below).

Balance Sheet - show separate sections for:

- fixed assets,
- current assets,
- current liabilities,
- long term liabilities,
- hybrid financial instruments (with characteristics of both equity and liabilities), - to highlight such instruments and avoid the need for an artificial split into debt and equity components
- equity financial instruments, and
- retained profits and losses.

On the balance sheet, assets should be shown at cost less depreciation/amortisation and impairment; liabilities should be shown at the higher of value at inception or anticipated settlement value (undiscounted). The carrying value of liabilities does not need to take into account interest rate as interest information is shown on the Payments Schedule (see below). If a comparison of liabilities between businesses is required, the information to perform such a comparison will be readily available from the Payments Schedule.

Cash flow - reconciles from either PBIT back to an EBITDA number and down to movement in debt (where movement in debt relates to movement in specified lines on the Balance Sheet) or from EBITDA number down to movement in debt (when EBITDA is identified in the Profit and Loss Account or in the notes). This is relatively unchanged from current requirements.

Payments schedule

Purpose - to show committed cash outflows for use in going concern assessments and in valuation models. This will include both legal and constructive obligations. This table removes the need for "mark to model" and discounted cash flow valuations.

I envisage this as a table with individual columns for next 5 years (if required), a column for cash flows after more than 5 years (if required) and a total column; and with rows broken down into sections for: current liabilities, hybrids, long term liabilities, and other items. Other items will include cash flows arising from e.g. interest, derivatives, and operating leases.

Note: this table not only shows the run-off of liabilities on the balance sheet, but also off balance sheet commitments such as interest, derivatives and operating leases. There is the possibility of turning this into a full cash flow forecast, but this is likely to be strongly

resisted by preparers of accounts and should remain voluntary. Including the run-off of assets is a possibility, but will probably not add much value to users.

An example of how this schedule might look is included below.

Payments schedule

	Notes	Balance Sheet Carrying Value	Expected cash flows						
		2015	2016	2017	2018	2019	2020	2021 and later	Total
		£m	£m	£m	£m	£m	£m	£m	£m
Current liabilities									
Interest bearing loans and borrowings	X	XX	XX						XX
Trade and other payables	X	XX	XX						XX
Deferred purchase consideration	X	XX	XX						XX
Current tax liabilities	X	XX	XX						XX
Non-current liabilities									
Interest bearing loans and borrowings	X	XX					XX		XX
Provisions and other liabilities	X	XX		XX		XX			XX
Deferred purchase consideration	X	XX		XX	XX				XX
Deferred tax liabilities	X	XX		XX	XX	XX	XX	XX	XX
Defined benefit pension fund liability	X	XX	XX	XX	XX	XX	XX	XX	XX
Other items									
Deferred tax assets	X	XX	XX	XX					XX
Interest payable on loans and borrowings	X		XX	XX	XX	XX	XX		XX
Receipts/Payments relating to derivatives	X		XX	XX	XX				XX
Operating lease payments	X		XX	XX	XX	XX			XX
Committed capital expenditure			XX						XX
			XX	XX	XX	XX	XX	XX	XX

Valuation report

Purpose - identify where the market value of an asset or liability differs favourably and materially from its carrying value in the balance sheet, and how this has changed over the period. It gives an indication of unrealised profits not included in the proposed historic cost balance sheet.

This will be a table with sections for intangibles (e.g. Goodwill, brands), other fixed assets (e.g. investment properties, land and buildings, investments), current assets, current liabilities, hybrid financial instruments and long term liabilities. The table should have separate columns for historic cost (cross referencing to the balance sheet) and market value less costs to sell.

There will need to be an explanation here or in notes of (i) how market value is arrived at and (ii) changes in market values.

Notes:

1. This table shows market values not model value. Where model values are currently used and are considered to be useful, it may be necessary to disclose further information in the notes – either of model inputs themselves so that users can produce their own model valuations, or of both model inputs and output.
2. This table shows favourable changes in asset and liability valuations because prudence (as it applies to this model of reporting) dictates that favourable valuation changes are not recorded in the profit and loss account or balance sheet until they have been realised. Prudence requires that adverse changes (impairments) are recorded in the profit and loss account and balance sheet.
3. The anticipated cash settlement value of hybrid financial instruments may be less than their balance sheet carrying value because some are expected to be settled with equity instruments.
4. This table could be extended to give net asset value or NAV/share where this is a relevant performance measure.

An example of how this report might look is included below.

Valuation Report

This report is required because there is no upward revaluation of assets or downward revaluation of liabilities in the balance sheet below inception value. It gives an indication of unrealised profits in the balance sheet.

	Notes	Balance Sheet Carrying Value		Market Value less costs to sell	
		2015	2014	2015	2014
		£m	£m	£m	£m
Intangible Assets					
Goodwill	X	XX	XX	XX	XX
Internally Generated Brands	X	0	0	XX	XX
Brands	X	XX	XX	XX	XX
Fixed Assets					
Investment Properties	X	XX	XX	XX	XX
Land & Buildings	X	XX	XX	XX	XX
Investments	X	XX	XX	XX	XX
Current Assets					
Investments	X	XX	XX	XX	XX
				Anticipated Settlement value*	
Current Liabilities					
Deferred consideration	X	(XX)	(XX)	(XX)	(XX)
Long Term Liabilities					
Loan note	X	(XX)	(XX)	(XX)	(XX)

Where desired this table could be extended to provide a total for net asset values and a net asset value per share. Material changes in value will need to be explained in the notes or by extension of this table.

* show where less than value at inception - value in balance sheet is greater of settlement value or value at inception.

Judgement report

Purpose - explain judgements made, and quality of past judgements, to help in assessment of the quality of management

This should identify in a narrative section where there are areas of significant uncertainty, the extent of such uncertainty (a description, sensitivity and limits if any), and management's judgement of the likely outcome. These judgements may relate to recognition or measurement issues. This section should also compare outcomes against past judgements and explain any major differences.

Many areas of judgement involve provisions and the level of provisioning is the easiest way to manage results. There therefore needs to be transparency over the level of provisioning and the movement in provisions in order to deter the manipulation of results.

The Judgement report needs to include a table showing for each major class of provision and total:

- provisions brought forward,
- re-assessment of provisions brought forward,
- provisions made relating to events in the year,
- provisions used in year,
- provisions released in the year, and
- provisions carried forward

To demonstrate the track record of management judgements, there should also be an additional table including the same lines and showing in separate columns total movements in all provisions over the past 5 years.

An example of how these tables might look is included below.

Judgement Report

Discuss areas of judgement that may have a material impact on reported profits or net assets.
Identify the reasons for and range of uncertainty, and explain why a particular point value has been arrived at.
Identify sensitivities around this point value in the notes or here.

Movement of provisions in the year	Impairment		Pension	Warranty	Bad	Stock	Def.	Other	Total
	Goodwill	Investments	Fund		Debts		Tax		2015
Notes:	X	X	X	X	X	X	X		
	£m	£m	£m	£m	£m	£m	£m	£m	£m
Provisions brought forward	XX	XX	XX	XX	XX	XX	XX	XX	XX
Reassessment of provisions brought forward	XX	XX	XX	XX	XX	XX	XX	XX	XX
New provisions arising from transactions/events in the year	XX	XX	XX	XX	XX	XX	XX	XX	XX
Provisions used in the year	XX	XX	XX	XX	XX	XX	XX	XX	XX
Surplus provisions released in the year	XX	XX	XX	XX	XX	XX	XX	XX	XX
Provisions carried forward	XX	XX	XX	XX	XX	XX	XX	XX	XX
Provisions carried forward are recognised in:									
Fixed Assets	XX	XX							XX
Current Assets		XX			XX	XX		XX	XX
Current Liabilities				XX				XX	XX
Non-current Liabilities			XX	XX			XX		XX
	XX	XX	XX	XX	XX	XX	XX	XX	XX

Judgement Report (continued)

5 Year history of movements in total provisions

	2015	2014	2013	2012	2011
	£m	£m	£m	£m	£m
Provisions brought forward	XX	XX	XX	XX	XX
Reassessment of provisions brought forward	XX	XX	XX	XX	XX
New provisions arising from transactions/events in the year	XX	XX	XX	XX	XX
Provisions used in the year	XX	XX	XX	XX	XX
Surplus provisions released in the year	XX	XX	XX	XX	XX
Provisions carried forward	XX	XX	XX	XX	XX

The principle is that liabilities should be carried in the balance sheet at the higher of inception value or anticipated settlement value.
The tables above should be based on balance sheet amounts. Cross reference should be made to the payments schedule where the balance sheet value of provisions exceeds the amount expected to be paid.
The 5 year history provides a starting point for a discussion about how good management have been in assessing the size of provisions required.

Equity report

Purpose - to explain to shareholders any dilution or subordination of their interest

For each class of equity instrument this report needs to show number of shares in issue at start and end of period, and reasons for any movements.

This report will cover options over equity instruments - since the focus of the reports is on cash flows, options do not need to be valued and put on balance sheet.

An example of how this table might look is included below.

Equity Report

	Notes	2015	2014
Ordinary shares in issue at start of period		XX	XX
Ordinary shares issued in the period due to:			
Exercise of options	X	XX	XX
Conversion of loan stock	X	XX	XX
Private placing	X	XX	XX
Net movement out of/(into) treasury	X	XX	XX
Ordinary shares in issue at end of period	X	XX	XX
Future dilution			
Anticipated			
Exercise of in the money vested options	X	XX	XX
Unvested options expected to vest in the money	X	XX	XX
Loan stock expected to convert	X	XX	XX
Sale of shares held in treasury	X	XX	XX
		XX	XX
Not anticipated			
Exercise of out of the money vested options	X	XX	XX
Options not expected to vest or vesting out of the money	X	XX	XX
Loan stock not expected to convert	X	XX	XX
Shares held in treasury	X	XX	XX
Fully diluted ordinary shares in issue		XX	XX

Main advantages/disadvantages

The benefits of such an approach would be in the reduction of complexity from the mixing of types of information, but this benefit can only be achieved by increasing the length of reports. Under this approach, it should be much more transparent how the business is affected by transactions and by changes in valuations. The main areas of uncertainty would be highlighted so that the judgements made can be discussed. It will eliminate the need for a statement of Other Comprehensive Income and the debate about what should go into it.

The main criticisms of such an approach are likely to be that there is no universal statement of performance and that it would allow the easier manipulation of historic cost results and the earnings figure in the P&L will be even less representative of performance than it is at present. These criticisms derive from the relative importance attached to an earnings figure. In my view although earnings are an important performance indicator, what is more important is the level of sustainable earnings. We need to move away from a mechanistic assessment of a business based on its reported earnings to a more judgemental approach informed by a number of key performance measures.

Instead of struggling to define "profit" as a change in value of (some of the) business's assets and liabilities we should focus in on cash generation, i.e. an EBITDA before re-measurements.

Businesses should be free to report their performance in a manner that their management considers to be appropriate. Instead of being discouraged, businesses should be encouraged to produce a pro-forma performance report suited to their business model and reconciling to the primary statements (and to segmental reporting disclosures). Investors could encourage standardisation within sectors of such pro-forma reports, perhaps through an endorsement mechanism facilitated by the IASB, similar to the FRC's SORPS.

Principles not rules

> *It is a brave standard setter indeed who can be certain to have covered every possible situation, both current and potential, and to have provided a detailed rule for it. A set of principles can cover every situation whether foreseen or unforeseen. As I said in my earlier talk, rules encourage avoidance, whereas principles encourage compliance.*
>
> *By background, I am a tax specialist; I know how tax laws are exploited wherever possible. I also know that from time to time tax laws produce inequitable results. Unfortunately, the taxing system requires the certainty which can only be produced by rules and it is accepted by all parties that from time to time the wrong answer will result. Financial reporting, on the other hand, does not require the level of certainty which can only be obtained from detailed rules; the imperative, unlike for a taxing system, is to produce the right answer.*
>
> 'Accounting Standards and Financial Reporting'
>
> Peter Wyman, Past President of the ICAEW, speech at the ICAEW/ICAI Joint Conference 2002

The current approach to standard setting seems to be one of identifying principles but then, through the consideration of more and more extreme examples, codifying a set of rules in an attempt to cover all eventualities.

This has the perverse effect of reducing professional judgement and allowing the rules to be gamed so that the result may be counter to the principles that were the original starting point. This demonstrates the futility of trying to set rules to cover all eventualities. Standards should be based on principles, not rules.

Professionals should be able to make informed judgements in the exceptional cases where application of the principles is not clear, and there should be clear disclosure in such circumstances in an area of the financial accounts devoted to judgements. The subsequent accounting treatment can then be debated and if necessary challenged; and professionals held to account for their judgements. This is one of the areas where the suggested judgement report could be useful in highlighting and explaining accounting treatment.

Users of accounts should be provided with sufficient information to enable them to understand where judgements have been made and, if necessary, to be able to constructively

challenge those judgements. Engagement by investors in areas of accounting judgement is just as important as engagement in corporate governance for the deepening of trust.

Where there is opportunity for abuse the approach should not be to set rules, but to set principles and require quality disclosure so that any attempted abuse can be identified. Transparency is a much better deterrent than a set of rules.

There is a lot more that I could write on this topic, but it has already been excellently covered in ICAS's 2006 publication "Principles not Rules: A Question of Judgement". Readers wanting to explore this topic in more depth are referred to this paper.

True & Fair

All UK companies are required by law to publish financial accounts that show a true and fair view. There is an additional requirement on boards of premium listed companies to confirm that "the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the performance, strategy and business model of the company".

There has been some discussion recently about whether the inclusion in earnings of unrealised profits arising from fair value changes provides a true and fair view, and the extent to which the balance on the profit and loss account represents, or should represent, distributable profits. Tackling the easy bit, the amount of distributable profits is useful information that should be presented to investors, but this is probably a disclosure issue e.g. retained profits can be split into separate lines on the balance sheet to show separately distributable and non-distributable profits. But the true and fair debate extends beyond the issue of distributable profits to when/whether fair value movements should be part of earnings, and when/how fair value provides useful information about the magnitude of assets or liabilities.

This debate is complicated by the interrelationship of accounting directives, company law, case law and accounting standards. I will not even attempt to discuss the relative merits of the legal opinions that have been produced on this subject.

The need to call upon barristers to interpret whether accounting standards permit the "true and fair" requirement to be met is an admission that the situation is not clear cut.

The EU has complicated matters by defining the limited data set that micro-cap companies are required to publish as being true and fair. This serves only to discredit and further undermine the principle of true and fair.

This whole true and fair debate illustrates to me the need to go back to first principles and re-consider the structure of financial accounts. If there is confusion, then this needs to be tackled at source; which means clarifying the objective, or changing the objective, so that this confusion does not arise. Denying that there is confusion is not an appropriate response. The fact that there is confusion demonstrates the need for major change.

The concept of "true and fair" was introduced when accounts were prepared on a purely historic cost basis. With such a backward looking approach to financial accounts it was much

easier to determine whether something was “true”. The increasing inclusion of current and forward looking measures into the accounts, introduces more uncertainty, and is the main reason why accounts are being challenged as not being “true and fair”.

Once we acknowledge that there is a problem, there are two possible approaches to a solution. We can either try to reduce the uncertainty in the accounts to swing the balance back towards true, or we need to replace the concept of “true and fair” with something that better fits an approach to financial accounting with more of a forward looking bias.

The obvious replacement for “true and fair” is the recently introduced requirement for the annual report and accounts of premium listed companies, taken as a whole, to be “fair, balanced, and understandable”. The problem is that financial accounts are not at present “understandable”.

So, going back to basics, assuming we retain the objective of “true and fair”, who should be the judge of “true and fair”, and what does “true and fair” mean to those judges?

Surely the judges need to be the target users of accounts; those shareholders who consider themselves to be joint owners, who are reasonably intelligent and diligent, and have a reasonable understanding of business. The judgement of whether a set of accounts is “true and fair” should not be the preserve of technical accounting specialists, and certainly not the preserve of lawyers.

The target users, not being technical accounting specialists or lawyers, will have a plain English approach to interpreting the meaning of “true and fair”. They will certainly not think that “true and fair” means “complies with accounting standards”, since if the requirement for accounts was for them to comply with accounting standards, then the audit report should be limited to the auditors opinion on compliance with accounting standards and the law and not include an opinion on a “true and fair” view. Presenting a true and fair view is an additional requirement, over and above compliance with accounting standards. Regulation recognises this by allowing accounting standards to be over-ridden in order to provide a “true and fair view”.

The most relevant dictionary definition of “true” is: “in accordance with fact or reality”.

The most relevant dictionary definition of “fair” is: “just or appropriate in the circumstances”.

We should not overlook the link word, “and”. The requirement is for the accounts ***as a whole*** to be both “true” **and** “fair”. Not for some parts to be “true” and other parts to be “fair”.

So a logical layman's interpretation of "true and fair" is: "in accordance with fact or reality, and just or appropriate in the circumstances".

The challenge for standard setters and preparers of financial accounts arises due to areas of uncertainty. How can information in areas of material uncertainty be presented in a manner that allows the financial accounts as a whole to be both true and fair?

We currently have a mixed measurement model that does not clearly identify in the statement of financial position which amounts are historic cost and which are fair value, and where the income statement does not clearly differentiate between elements that arise from actual transactions and those that arise from movements in fair value. This lack of differentiation between measurement approaches in the primary statements introduces additional uncertainty over and above the uncertainty relating to the approach being taken to measurement.

How can marking to model be true (i.e. in accordance with fact or reality) when it is the absence of fact or reality which drives the requirement to mark to model?

Any solution to the issue of "true & fair" needs to incorporate a new structure of financial accounts to provide clarity by differentiating between the measurement bases being used, and if possible avoid the requirement of marking to model. The new structure of financial accounts suggested previously would help cut this Gordian knot. It separates out the backward and current/forward looking measures which will go a long way to supporting an argument that accounts are both "true and fair". It eliminates the need to mark to model. It is also more "understandable".

Sector specific standards

At present there is confusion over where sector specific standards are needed. They are in place for agriculture, and (sort of) for insurance companies. But the rationale behind why these sectors have been chosen is not clear.

What is it about a particular sector that it needs a separate standard?

As previously discussed, users need to drive this debate. What are the characteristics of a sector such that normal accounting standards do not produce useful information? Is it that business models are such that the normal ways of determining relevant cash flows are not appropriate?

The obvious candidate for a sector specific standard is therefore financial institutions since financial institutions use financial instruments for trading purposes, while in a "normal" business those financial instruments would (in most cases) be an investment, hedging or part of long term financing.

I do not think that a separate standard is required for extractive industries. The main issue for such companies is over the capitalisation of exploration costs. The issue here is very similar to the issue of research and development. Accounting standards impose limitations on what can be capitalised, with expenditure that cannot be capitalised being permanently written off. A less prescriptive, more principles based, approach to capitalisation and impairment could be the solution. Companies could be allowed to capitalise all exploration/R&D expenditure, but be required on day one to provide against the asset created except to the extent that there was a financially viable well/mine/product. If a financially viable well/mine/product was subsequent identified then provisions against prior expenditure could be written back, creating an asset valued at the lower of expenditure to date or expected return.

This approach could also be adopted for plantations and similar agricultural assets.

Conclusion

I liken current financial accounts to the bible which in pre-reformation times was only available in Latin. Only a limited number of people could access the information contained in the bible, and communicate this information more widely to those who did not know Latin or could not read. The reformation resulted in the bible being made available in the vernacular and becoming more widely read.

We are increasingly getting to a situation where financial accounts can only be interpreted by experts, and we need to change the language of accounting and the structure of financial accounts so that more people can better understand the information that financial accounts are attempting to communicate.

It is time for a reformation in accounting.

Conclusion (part 2)

"Bad men need nothing more to compass their ends, than

that good men should look on and do nothing."

John Stuart Mill,
Inaugural Address delivered to the University of St. Andrews, Feb. 1st 1867

"In the end, we will remember not the words of our enemies,

but the silence of our friends."

Martin Luther King Steeler Lecture, November 1967

If current accounting standards are truly bad/evil, many more good (women and) men need to cease looking on and doing nothing.

If you think that accounting standards need improvement, you need to engage in the debate.

If you think consultations are too long, too confusing or do not address the key issues, then this needs to be communicated to those generating the consultations.

Without feedback there will be no improvement, instead there is likely to be continuing deterioration in the ability of financial accounts to communicate useful information.

As the Socialist Workers Party used to say:

"If not us, then who? If not now, then when?"

Edward Beale

CityGroup
Company Secretarial Services

6 Middle Street, London, EC1A 7JA

Email: 21CAccounting@city-group.com

www.city-group.com 0207 796 9060