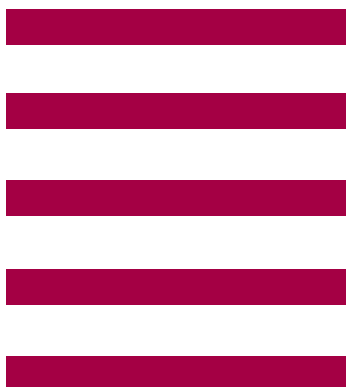




Principles into Practice

Key points from the
“Too Late for Principles?” Conference
held in October 2006



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FOREWORD by David Wood

When we interviewed for our report “Principles Not Rules: A Question of Judgement” we found almost unanimous agreement for principles-based accounting. Against that background, it seems surprising that so many of the parties involved in accounting are demanding more and more rules. If all parties support principles, why can’t we get there? Why do we seem to be heading in the other direction?

Moving from where we are today to a more principles-based environment is not straightforward. One reason is the status quo itself: although they are principles-based, International Financial Reporting Standards currently embody a significant volume of rules and guidance. This cannot easily be undone overnight, if only because there are large institutional barriers to overcome. A second reason is international convergence. With so many cultures and business environments to cater for, it is a real challenge to develop principles which are robust and workable in all jurisdictions.

Having published its report in April 2006, ICAS was keen to explore the challenges of reversing the expansion of rules and prescription and moving to a more principles-based accounting framework. To that end, the “Too Late for Principles?” conference was held in October 2006 and, as can be seen from the following pages, the views highlighted the challenges of this transition.

None of these challenges are insurmountable, but they do require concerted action by all the stakeholders in financial reporting, and the development of trust by and between all parties.

I would like to thank all the speakers at the October conference for their contribution to this debate, and for agreeing to the following summaries being published.

I would also like to thank Robert Bruce for his support and interest in this project, and for agreeing to summarise the conference proceedings.

Last of all, I would like to thank you, the reader, for picking this up and starting to read. I hope the pages which follow are enlightening and contribute to the advancement of the debate.



David Wood
Executive Director

David Wood is Executive Director, Technical Policy at the Institute, and was a member of the Working Group which produced the original “Principles Not Rules: A Question of Judgement” report.

INTRODUCTION by Robert Bruce

When ICAS published its ground-breaking and influential report “Principles Not Rules : A Question of Judgement” in April 2006 it became obvious that it had struck a chord which resonated through all of business. The months which followed were full of comment and discussions which suggested that this was a central issue which was exercising people in all areas of business life.

It cropped up in the obvious arena of the implementation of international accounting standards and financial reporting generally. But as the year progressed it became obvious that it was also at the heart of the arguments in the wider business world. It was cited as being central to the perceived lack of competitiveness of the American capital markets compared to those of the UK, Europe and elsewhere in the business world, for example.

Hugh Shields, Director and Head of Financial Reporting at Barclays Capital and the Chairman of the Working Group which produced the report had summed it all up in his introduction to the report back in April. ‘The key to true and fair reporting is the balanced exercise of judgement’, he had written. ‘If standard setters, preparers and regulators could all exercise judgement on broadly equal terms, then this would provide the healthy tension which is needed for true and fair financial reporting and for communications with stakeholders’.

It became clear that frustrations in the business world were running high. The growing feeling that a tide of rules was strangling peoples’ ability to behave in an effective and useful way was tangible. Common-sense and judgement were being squeezed out by the insistence that rules should hold sway. The results of such decision-making were seen to be legally correct but misleading and of little use in a business context. And judgement, the exercise of what experience suggested was right, was becoming rarer. The ICAS report quoted the philosopher Confucius. ‘To see what is right, and not to do it, is want of courage, or of principle’, was his view. And it was obvious that more courage, and principle, was what was required right across the business world.

By the autumn it was clear that the many issues raised by the report and the discussions it had prompted over the summer needed to be collected together and brought under one roof to see where the future direction of the debate might lie. In early October a group of speakers and interested parties from throughout the business world gathered in London for an ICAS conference entitled: “Too Late For Principles?”

This report is an account of what was said and discussed at that event.

Robert Bruce is a freelance financial journalist and a regular columnist for the Financial Times.

WHY PRINCIPLES NOT RULES - Hugh Shields

Hugh Shields, the Chairman of the working group which produced the original report, opened the conference with some definitions on which to base the discussions. In the absence of any apparent agreed definitions the working group had adopted the following. Principles were defined as: 'A general statement, with widespread support, which is intended to support truth and fairness and act as a guide to action'. A rule was defined as: 'A means of establishing an unambiguous decision-making method'. And in addition: 'There can be no doubt about when and how the rule is to be applied'. He added that: 'Principles cannot be replaced by mechanical rules – although sometimes a set of rules may be used to guide the observance of a principle. But it will always be a matter of judgement whether following these rules will actually achieve conformity with the principle'.

That done, he set out some ground rules. 'This debate is not about whether we should have principles only or rules only', he said. 'The debate is about where we are on the spectrum, which includes both principles and rules'. He said that principles-based accounting meant an approach where there is: 'A clear hierarchy of overarching concepts, principles that reflect those overarching concepts, and limited further guidance'. And he moved the debate from any possibility of a narrower focus. 'This debate is not just about standard-setting', he said. 'A key point is that standard setters, preparers, auditors and regulators all need to exercise judgement for true and fair financial reporting to be possible. Guidance anticipates the use of judgement, while rules discourage judgement'. The fundamental lesson was that: 'Rules discourage judgement, principles encourage judgement'.

He emphasised that the working group had found a surprising degree of consensus in favour of a principles-based approach. He said that, for example, there 'was a consensus that only principles-based accounting standards can serve both the needs of business and the public interest'. That said he wanted to underline that 'complete comparability is never possible in accounting'. The working group which produced the report believed that: 'There had to be an acceptance that you may end up with different accounting answers, and that there needs to be more emphasis on the disclosure of key judgements'.

Once that was understood then: 'Additional guidance should be restricted to brief explanation built into the standards themselves, possibly with a small number of interpretations where absolutely necessary'. The essence was that: 'It is all about principles and limited additional guidance'.

There needed to be a clear understanding of why rules are not the answer. 'Rules-based accounting adds unnecessary complexity, encourages financial engineering and may not lead to "a true and fair view", he said.

'People simply say "show me a rule which says I can't do this"'. In other words: 'Rules encourage compliance with the detail and not the overall spirit, and they foster creative accounting, abuse and avoidance'. This obsession with the detail removes any chance of useful thought. Principles-based accounting, on the other hand, 'provides a comprehensive basis for the preparation of financial statements', he said, 'and has the flexibility to deal with new and different situations as they arise'. It also acts as a deterrent. 'Principles-based accounting leaves less scope for people to convince themselves that an "inappropriate" interpretation is acceptable'.

For this to work the accounting profession

*Rules discourage judgement.
Principles encourage
judgement.*

would have to take on much more responsibility. ‘Principles-based standards require preparers and auditors to assume more responsibility for their judgements and seek less detailed guidance’, he said. This would mean that the training of both current and future professionals would have to be looked at and in particular there is a need, he said: ‘to ensure that accountants have the expertise, and the courage, to make sound and ethical judgements in the overriding interest of a true and fair view’. The critical underpinning of all this is for the profession to make judgements and have them documented and not to seek additional guidance on detailed matters so as to avoid the need for judgement. He stressed that this applied as much to preparers of financial reporting as it did to auditors.

He then turned his attention to the challenges of enforcement and convergence. The role of standard setters was to set standards and not to enforce them and it was not the function of accounting standards to prevent abuse. Enforcement and policing was down to auditors and regulators and they, for their part, had to be willing to accept a range of judgement-based outcomes.

‘The working group, he said, ‘was firmly of the view that there needed to be a single interpretive body which should focus only on significant issues’. It should not get enmeshed in detailed matters. The movement toward the convergence of financial reporting standards towards global harmonisation had to take all these issues into account. ‘Convergence cannot be achieved’, he said, ‘if the basis for convergence is a detailed rules-driven approach, as this will be difficult to roll out across the different jurisdictions and cultures around the world’. In essence convergence cannot be achieved if there is a large body of rules. ‘We think that high quality principles-based

standards should take precedence over the speed of convergence’. And he also argued that problems with translation would be hugely magnified under a rules-driven approach.

Much of the attraction of a rules-based world is that it is easier to protect yourself from lawsuits and he accepted that it would be necessary to address those concerns if a judgement-based world was to be encouraged. This was why he advocated the importance of being able to ‘demonstrate that judgements were reasonable at the time they were made and in light of the facts and circumstances then present’. This meant that ‘the careful generation, collection, and retention of documentation is critical in minimising legal risk’.

He concluded his thoughts with a quotation from Albert Einstein. He said that the statement : ‘Everything should be made as simple as possible, but not simpler’, perfectly captured the view of the working group’s view of the importance of high-level principles backed with only the absolute minimum of additional guidance.

He said that since the report had been published there had been a huge amount of feedback. Most agreed that the ideas expressed were right but that the biggest issue to be faced was the implementation.

‘But if we all agree that principles-based standards is the right idea then surely we can find a way to get there.’

Hugh Shields is Director and Head of Financial Reporting, Barclays Capital. Hugh is Convenor of the ICAS Accounting Standards Committee. He chaired the ICAS Working Group which produced the original “Principles Not Rules: A Question of Judgement” report.

THE PREPARER'S VIEW - Douglas Flint

Douglas Flint spoke from the perspective of being Group Finance Director with HSBC Holdings. He said that the background to the debate could not be more challenging and listed issues like corporate scandals, governance failures, shareholder activism, accounting restatements and managerial greed and fraud, as all leading to the growth of a huge governance framework around stewardship and financial reporting.

'It is paradoxical', he said, 'that the reason there is so much anguished debate over perceived failures in the framework of accounting is that accounting and accountants have built such a framework of respect over the years that their role in capital formation and market efficiency is unquestioned. It is also obvious', he said, 'that although philosophical and practical tensions regarding the application of both accounting and disclosure practices are very real, there is unanimous agreement that the application of accounting techniques, regardless of the model, requires judgement, and there is also unanimous agreement that such applications require standards and transparency'.

'Obviously there is a point at which the need for judgement and the pursuit of consistent application and interpretations of accounting standards can be in fundamental conflict with each other', he said. 'This conflict is at the heart of the debate over the so-called "principles" versus "rules" approaches to accounting standards. Unfortunately, from my perspective, a number of factors, including elements of scepticism about the extent to which a principles-based framework for accounting standards can be achieved, and inherent complexities, litigation risk, and fear of

political criticism or fear of regulatory sanction, may be tilting the scales of that debate in the direction of more rules and fewer principles. This potential tilt, ironically, is being intensified by preparers and auditors of financial statements, and their lawyers, seeking more specific guidance and clarity from accounting standard setters and regulators'.

'These tensions between philosophy and practicality pose a particularly sharp dilemma in the current setting in which the scandals of the past are, understandably, generating pressures to create a "no-flaw" framework for accounting and disclosures', he said. 'Because such a "no-flaw" world is not remotely within reach, the best that can be achieved is to focus on best practices for governance and control and more effective disclosure which are central to the needed effort to reduce the tensions between philosophy and practice, while at the same time helping to create a framework that will enhance public confidence in financial reporting. In turn', he said, 'reducing such tensions will work in the direction of striking a more reasonable balance between principles and rules than now seems to be emerging'.

Flint suggested that from a preparer's perspective there were a number of issues. The first was a simple one: 'How do you train and retain accounting staff in a rules-based world?' He used the HSBC experience as his example. As a global bank they were carrying out training in over 30 languages and for the majority of staff around the world English was not their first language. So internal technical drafting was a real problem. He quoted an extract from an amendment to

How do you train and retain accounting staff in a rules-based world?

IFRS 3 on business combinations: 'A business consists of inputs and processes applied to those inputs that have the ability to create outputs. Although businesses usually have outputs, outputs are not required for an integrated set to qualify as a business', he read. He gave the audience a wry look. 'Not one person can understand that', he said, 'and people with English as their second language have no chance'.

He said that retention problems arose because people want to use their brains and, frankly, they want to move away from the role of simply preparing financial statements if all they are doing is following a rules-based and time-consuming process. It was a question of production versus analytics. Bright accountants wanted to analyse information and not simply to produce information.

His second issue was that of whether a rules-based system was doomed to fail. He suggested that a rules-based system had to have very clear and unequivocal definitions and objectives. In the legal world how you dealt with a murder was clear. It was a good example of a rules-based system, whereas the issue of how you dealt with obscenity was far less clear-cut, and so was not. He suggested that for rules to work they had to have a legitimate source for interpretation. He quoted from a real results announcement: 'Approximately 48 hours before the Q4 2005 release was issued, the auditors changed their view as to the treatment previously agreed for the accounting treatment of the evaluation of portfolios and goodwill'. US interpretations of accounting treatments changed constantly. 'I don't know anybody who hasn't gone through the process of changing their application of a policy', which they thought they had applied consistently and correctly he said, 'usually as a result of a US interpretation'. And rules simply create further problems down the line. They do not solve problems. Tax rules were a good example of how this worked. He quoted

We are losing the confidence of management that financial reporting reflects business performance.

from the written testimony of the Commissioner of Internal Revenue to the Senate Committee on Finance: 'Every new tax law, even those that are simple on their face, creates additionally complexity while providing taxpayers with further tax planning opportunities'. 'Rules always lead to arbitrage', reflected Flint, 'and unintended consequences'.

His third issue was: 'What are the implications of ever more value-based measurements?'. He said that accounting systems were designed to capture and allocate transactions and accounting staff trained to deal in objective facts. But now there was confusion over hierarchies of measurement bases and confusion over technical versus plain English. Accounting systems were never designed to capture valuations and there was confusion over technical requirements. At HSBC the number of system codes had increased by 67% since the introduction of IFRS in 2004. The annual report and accounts which, back in 1997 was 100 pages long, now exceeded 400 pages and was too heavy to deliver by conventional post. The Royal Mail had deemed its weight a health and safety issue for postmen.

Another issue was the consequence of all this. 'We are losing the confidence of management that financial reporting reflects business performance', he said and quoted Lord Browne, BP's Group Chief Executive, saying that the 2005 results were particularly hit by 'significant non-economic effects of the application of IFRS fair value accounting'.

Equally, complexity in accounting standards was diverting financial management from its core business objectives. The consequences of getting it wrong are far more than embarrassment, he suggested. It was also a question of restatement costs and the misallocation of resources from shareholders' funds. The likelihood was that GAAP accounting measurement and disclosure could become less significant as a means of informing people about business performance.

Different figures under different regulatory regimes did not enhance the credibility of the figures. And at the same time preparers were finding that communication of the information was becoming less effective. Flint quoted from the broker reaction on the HSBC 2005 results issued by Goldman Sachs. It concluded: ‘There was some confusion around the results, with many non-specialists giving up on the 420 page results book’.

But the biggest challenge was how preparers could contribute to maintaining confidence in financial reporting. ‘High profile financial scandals have dominated the headlines for much of the last five years’, he said. ‘Whether the result has been outright bankruptcy or massive restatement of prior financial results, the magnitude of these problems has given rise to a widely held view that there must be something very wrong with accounting standards and practices and/or in the manner in which such policies and practices are administered and audited’.

‘First, in the high profile cases of financial misrepresentation gaining so much media attention, the essential problem was not systemic flaws in accounting standards, but serious breakdowns in governance and control and/or outright fraud’, he said. ‘This is not to deny that there were cases in which aggressive accounting practices were pursued or disclosure practices were flawed, but the number of prosecutions being brought for fraud suggest strongly that accounting practices may have been an instrument of misdeeds but not their cause. Thus governance and control issues should be examined as an essential component of the project’.

‘Second’, he said, ‘no system of accounting, of official regulation and supervision, or of public disclosure can provide anything approaching fail-safe protection against fraud. Still, public policy and private actions, including those directed at accounting policy and practice, disclosure

practices and official oversight, must be framed in a manner that seeks to sustain the broad-based discipline that is needed to avoid the cumulative and self-reinforcing erosion of business practices that characterised the bubble years of the late 1990s. It is in the interest of promoting a disciplined approach that principles are required to guide disclosure and accounting policy choices for the future.’

In a nutshell, the preparers of accounts want principles. ‘We want to do the right thing,’ he said, ‘mostly because it works’. ‘We want to be trusted’. ‘And if you don’t trust us then replace us’.

Summing up, Flint quoted from the G30 report ‘Enhancing Public Confidence in Financial Reporting’ which he co-chaired with Jerry Corrigan in 2003

noting that the messages delivered then remained just as valid today: ‘The reliability and integrity of accounting practices have profoundly important implications for economic well-being on a broad scale. Thus in macro terms, the effectiveness of accounting policy and practice relates directly to the broad policy goals of economic growth and financial stability. However policy makers, practitioners and the public at large must recognise that accounting, like virtually all instruments of public policy, is at least as much an art as it is a science. Indeed, regardless of the accounting model, the application of accounting policies must, day by day, come to grips with far more grey than either black or white. Judgements, close calls and informed subjectivity are the norm, not the exceptions’, he said. ‘Thus the choice of the accounting model comes down to what is best, not what is perfect, since perfection is not realistically within reach’.

Douglas Flint is Group Finance Director, HSBC Holdings plc.



We want to do the right thing... and if you don't trust us then replace us.

THE AUDITOR'S PERSPECTIVE - DO AUDITORS LIKE RULES? - Hans van Damme

At a first glance, suggested Hans van Damme, auditors did like rules. Times had changed. 'At the start of the last century accounts were audited and found correct', he said, 'and auditors, many of them also active at universities, were at the forefront of setting accounting rules'. All that had changed. 'Today's world is a totally different concept', he said. 'We have now developed to a situation where people say: 'Prove to me why I cannot do it?'. And this was leading to excessively detailed standards with anti-abuse provisions. The result was both depressing and difficult to deal with. 'Auditing is now less fun, less judgement (more "ticking the box") is required and auditing is now undertaken in a more litigious environment', he said. 'How can we keep up with IFRS standards which are a few thousand pages long?'

He suggested that more effort should be made to train and retain people who can make judgements. Auditors needed to stand up to clients more. 'You need to be able to say that your gut feeling is that you can't do something, even if it is not explicitly prohibited in the relevant standard',

he said. A new generation of auditors needed to be developed and the audit business needed to remain attractive so as to recruit talent. There also needed to be more attention paid to audit documentation to prove that a proper job has been done and a review of auditor liability was required to reduce both the fear of litigation and the practice of second-guessing by regulators.

The pendulum needed to move back to principles. People needed to recognise that not all situations are totally alike. Auditors and preparers needed to be more daring in exercising judgement within the framework of standards. And auditors needed to be able to stand up for their judgements. 'Principles', he concluded, 'are better to live with and leave more fun for the profession. Therefore, in conclusion: Auditors do not like rules'.

Hans van Damme is a partner with KPMG Amsterdam. He is a member of the Executive Board of the European Federation of Accountants, (FEE), and Vice-President in charge of financial reporting.

Auditors and preparers needed to be more daring in exercising judgement.

THE ROLE OF PRINCIPLES IN THE CURRENT CONVERGENCE PROCESS - Sir David Tweedie

Sir David Tweedie first set the scene. He said that the life blood of capital markets is financial information that is comparable from company to company, relevant to investment financing decisions, a faithful depiction of economic reality and neutral, favouring neither supplier nor user of capital, neither buyer nor seller of securities. These were the qualities which would provide the strong, stable and liquid market which was essential for economic growth.

He talked through the plans to bring about convergence of accounting standards around the world and the problems which this would create in both the US and the UK and elsewhere. In particular he stressed the difficulties under which the Americans, and, in particular, FASB, the US standard-setting body, were labouring. He quoted Harvey Pitt, past-Chairman of the main US regulatory body, the Securities and Exchange Commission, on how accounting standards are not useful unless they help to produce the transparency required by the analysts. Pitt said that: 'Much of FASB's recent guidance has by demand become rule-driven and complex. The areas of derivatives and securitisation are examples. This emphasis on detailed rules instead of broad principles has contributed to delays in issuing timely guidance. Additionally, because the standards, while based on broad principles are accompanied by considerable rules-based guidance, they are insufficiently flexible to accommodate future developments in the marketplace. This has resulted in accounting for unanticipated transactions that is less transparent and less consistent with the basic underlying principles that should apply. The development of rules-based accounting standards has resulted

in the employment of financial engineering techniques designed solely to achieve accounting objectives rather than to achieve economic objectives', Pitt had concluded.

Sir David referred in particular to the standards on financial instruments, IAS 32 and IAS 39, which he and the IASB had inherited. They were, he said, 'overly complex, inconsistent with the conceptual framework and / or each other'. He repeated his famous remark that if you think you understand IAS 39 then you obviously haven't read it properly.

His point was that, having sorted out as much of the inherited standards as possible and brought an acceptable package of international financial reporting standards to implementation across Europe and much of the rest of the world, the time was now ripe for a proper programme, in partnership with FASB, to bring order, credibility and consistency to standards. And this was where the conflict between principles and rules would come to the surface.

He then provided the essential characteristics of a principles-based standard. 'If principles-based standards are to be introduced then lessons must be learned from the problems arising from existing standards', he said. 'If complexity is to be avoided the exceptions to the scope and to treatments will have to be eliminated. Similarly, application guidance will have to be limited to only what is absolutely necessary to operationalise the principles', he said.

First, there should be no exceptions. People liked using exceptions, he said, because they didn't like volatility in their figures and they liked to smooth their results. People would prefer to

If you think you understand IAS 39 then you obviously haven't read it properly.

use an exception to show their figures more to their own liking. ‘Rules are there because people want a particular accounting outcome’, he said. ‘All exceptions should be questioned and re-debated before a final standard is issued’, he said. ‘Applications of exceptions, by analogy, would have to be prohibited – thereby eliminating a major source of interpretations’.

The second quality a principles-based standard required was that the core principles would have to be clearly stated. Here Sir David referred to the current, and curious, rules on leasing and made his oft-repeated remark that it is his ambition that, before he dies, he should fly on an aircraft which is on that airline’s balance sheet. There should be a simple test in that particular case, he said. Could you get out of the lease and can you measure the cost reliably? If the answer to the first was no and to the second, yes, then the aircraft and a corresponding liability, should be on the balance sheet.

If there was any doubt about how to deal with a particular issue then preparers and auditors should relate back to the core principles. Those principles should be tied to the conceptual framework. The use of principles should eliminate the need for anti-abuse provisions. ‘It is harder to defeat a well-crafted principle than a specific rule which financial engineers can bypass’, he said. ‘A principle followed by an example can defeat the “tell me where it says I can’t do that” mentality’, he said, whereas if the example is a rule then the financial engineers can soon structure a way around it.

A principles-based standard relies on judgements. Disclosure of the choices made and the rationale for these choices is consequently essential. All application guidance and examples to understand the principles have to be questioned – as to whether these are helping make judgements or simply setting rules.

But finally there were, Sir David suggested, three further tests: First: ‘Can the standard be explained simply in a matter of a minute or so? And, if not, why does it take longer?’. In other words can only specialists understand it or can most accountants use it? Second: ‘Does it make intuitive sense?’ And finally: ‘Is the standard written in plain English?’

To achieve this Sir David suggested changes which would have to take place. First: ‘A principles-based system will only work if preparers, auditors, users and regulators wish to make it work’, he said. ‘The use of judgement will require preparers and auditors to exercise courage and to defend their judgements’.

Secondly, and very important, the training of accountants would have to change. ‘Don’t teach the standards’, he urged the audience, ‘teach the theory and the need to defend judgments’. The basic concepts of accounting should be emphasised at degree and professional training level and preparers and auditors would have to accept that a principles-based system would tend to ban the treatments designed to smooth earnings.

Thirdly, he said that greater user sophistication was necessary. ‘Users would have to understand the differences between gains and losses in the short term and those resulting from long-term investment portfolios, revaluation of buildings, and changes in pension fund surpluses and deficits’, he said. ‘This “tell it as it is” effect would reveal economic volatility’.

There should be no second-guessing by regulators. ‘Regulators should not be able to second guess preparers who have made honest and reasonable judgements and which meet the objective of a principle’, he said. ‘If a regulator insists on one method he is, in effect, inventing the rule and moving away from a principles-

Can the standard be explained simply in a matter of a minute or so? And if not, why does it take longer?

based system’, he said. ‘Regulation can be the enemy of principles – a danger that has to be watched by securities and prudential regulators alike’. And, for the same reason, there should not be lots of request for interpretations. ‘You can’t have principles-based standards if there are 400 different interpretations’, he said. ‘Every interpretation is a rule’.

Finally the legal situation should be taken into account. Full documentation would be required if people were to escape being accused, with hindsight, of being wrong and thus legally liable. ‘It will be much more difficult in the US to introduce a principles-based system given the litigious nature of that society’, he said. ‘The risk can be mitigated however by the careful generation, collection and retention of documentation and the seeking of expert advice and the views of professional colleagues throughout the life cycle of transactions’, he said. ‘Above all, those who make such judgements, document them and who have made an honest and fair attempt to meet the principle should be defended’.

In his conclusion Sir David issued a clarion call. ‘Ultimately the profession will get the

standards which it deserves’, he said. ‘A rules-based system is inevitable if: the profession does not act with integrity; in court firms attack other firms’ reasonable judgements which have turned out to be, with hindsight, incorrect; the profession keeps asking for voluminous interpretations or additional guidance; raw economic facts set out in financial statements are unpalatable; or the regulators insist on one particular way of dealing with each situation’, he said.

‘This is probably our last chance to move the clock back to try to write shorter, less complex standards’, he said, ‘to remove the cottage industry of the expert and return accounting to the profession. We have to move away from the position where only the technical partner understands, or thinks he understands, the standards. Accounting is not rocket science’, he said. ‘We have to write standards for the bulk of the profession. We are going to try. It will then be over to you’.

Sir David Tweedie is Chairman of the International Accounting Standards Board.

A rules-based system is inevitable if:

- the profession does not act with integrity;
- in court firms attack other firms’ reasonable judgements which have turned out to be, with hindsight, incorrect;
- the profession keeps asking for voluminous interpretations or additional guidance;
- raw economic facts set out in financial statements are unpalatable; or
- the regulators insist on one particular way of dealing with each situation.

THE REGULATOR'S PERSPECTIVE - Richard Thorpe

Richard Thorpe started by pointing out that the Financial Services Authority has no direct responsibility for the enforcement of accounting standards in the UK. But it does have a close interest in their application, as a listing authority, and as a prudential regulator.

He made it clear that 'the mantra is consistent application, interpretation and enforcement' and he stressed that 'principles-based standards rely on experience and knowledge of preparers, users and auditors'. It was the consistency of accounts with the principles which was the most important element. 'This means', he said, 'that markets must accept that there may be more than one policy that is acceptable'. This put considerable emphasis on clear disclosures which explained the options taken.

But he warned that 'while consistent doesn't mean identical, it also should not mean a free-for-all'. 'Whilst principles-based standards have the advantage of encouraging innovation', he said, 'the profession has a responsibility to ensure

some degree of consistency of interpretation and judgement. The alternative is an enormous rulebook'.

He also warned of the dangers of regulation. 'The danger is that close and detailed enforcement will turn the principles into rules', he said. 'We do not have a single EU enforcement agency and decisions will continue to be taken at a national level. The next couple of years are crucial', he said. 'If we encourage widespread pre-clearance then we will stifle innovation and take away management's responsibility. We must all

accept that sometimes the accounts will not be perfect and that sometimes results will differ', he said. That should be simply accepted and no fuss made.

We must all accept that sometimes the accounts will not be perfect.

Richard Thorpe is Head of Accounting and Auditing Policy at the Financial Services Authority, (FSA).

THE REGULATOR'S PERSPECTIVE

Discussion and Questions from the Floor

The section of open debate within the conference produced a wide range of views, questions and odd facts. Richard Thorpe said that 'IFRS standards had very different underlying principles to those which applied in much of the EU and that there was a danger that some EU members would find implementation difficult'. Sir David Tweedie expanded on his remarks about leasing standards. 'In the US the standard is six inches thick and there is still nothing on the balance sheet', he said. He also expressed his infuriation with the number of requests for interpretations of particular areas of the standards. 'People are cheating with IFRIC, (the interpretations body), at the moment', he said. 'When IFRIC turns down a request for an interpretation because they believe the standard is clear firms are asking for a reason why it is clear and so are trying to get an interpretation either way'. He said this had to stop. 'When people ask us what should they do we should simply answer: "Do your best"', he said. 'But everyone wants something in writing, and that's got to stop'. He said auditors need to show a bit of backbone and also keep lawyers away.

Douglas Flint was asked about the length of annual reports and their ability to communicate. He thought that they would get longer in the future but said he was encouraged at the growth in narrative reporting which he said was the part of the report which would become more informative.

On the other hand the pure accounts were simply an aggregation of technical information which people didn't read. '500 page documents are simply not about communication', he said. 'It is only when something goes wrong that people read the notes to the accounts'.

Flint was also asked who he considered the primary user of the information. 'Stewardship is the primary purpose and is fundamental to financial reporting', he said. But he also said that such an approach was complicated if standards moved to a full fair-value model. Sir David Tweedie disagreed and said that you could have fair values with a stewardship model, as under the agency model it showed more effectively what you had done with the funds entrusted.

The panel was asked how calls by regulators for consistent application of standards could be reconciled with a principles-based approach. Douglas Flint said that 'consistency is unsustainable and unrealistic'. He said that shareholders wanted to hear about strategic objectives and plans and how you were going to execute them. 'The fact that someone else comes to a different answer is fine', he said. 'It doesn't make it wrong. The consistency argument is a cop-out'. Richard Thorpe said that the FSA felt that the accounting should be consistent with the underlying principle of the standard but that was enough.

*500 page documents
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communication.*

INVESTOR VIEWS ON CONVERGENCE, PRINCIPLES AND TRUST - Michael McKersie

Michael McKersie tied the whole debate back to the idea of the true and fair view. He made it clear that from the point of view of the investment community this was fundamental. He said that it was a contentious subject which consumed a lot of time and angst in discussions. But in spite of that: ‘The true and fair view is a cornerstone of UK financial reporting’, he said, ‘and our members make it clear that it is essential to the whole debate. In particular the true and fair override is so important’, he said. ‘This is the way that principles are made superior to rules’.

He argued that narrative reporting was increasingly important. ‘The increasing complexity of financial reporting needs to be complemented by quality discursive reporting in order to allow a rounded understanding of the company’, he said.

He suggested that, in terms of the convergence agenda of the IASB and FASB, while the objective of comparability was a good thing the idea of a global monopoly of financial reporting was not necessarily also a good thing. ‘We need to ask the question whether some degree of competition is necessary to achieve objectivity or better standards’, he said and argued that the IASB had to stand up for the non-US views around the world.

He said that in the end ‘substance over form is what matters’. He said that to an English audience he tended to use the metaphor that a cricket pitch can look nice and neat but still be poor to play on and to a Scottish audience a putting green may be fairly presented but that doesn’t mean the same as a ball running fair and true. And in the end: ‘The objective of general purpose external financial reporting should be to present a true and fair view of the performance and financial positions or state of affairs for the benefit of shareholders and other users of accounts’.

He concluded that true and fair is vitally important and the real objective of financial reporting is for the benefit of shareholders. Promoting economic efficiency, the concept of resource allocation and decision-usefulness are valid objectives of financial reporting but are not the whole story. Principles are absolutely right but there are enormous grey areas which may need rules.

Michael McKersie is Manager, Investment Affairs, Association of British Insurers (ABI).

A putting green may be fairly presented, but that doesn’t mean the same as a ball running fair and true.

CULTURAL PERSPECTIVES IN INTERNATIONAL CONVERGENCE - John Hegarty

John Hegarty, as befitted a senior member of the World Bank staff, took a wider view. He suggested that underlying differences in countries' institutions and incentives impacting the quality of financial reporting were not being given their due weight in the move towards global convergence of international accounting standards. High quality accounting and auditing were important. They were essential for providing access to capital markets and investment, mobilizing domestic savings, enhancing access to credit, and reducing the risk of financial crisis. Poorer countries often suffered greater losses from a financial crisis than they received in development assistance. 'The best thing to do to support the poor is to reduce the risk of further financial crisis', he said. But the quality of the statutory framework, monitoring and enforcement systems, education and training, the accounting profession, and ethics also played their part.

He talked of the challenges of rules-based accounting standards. They were not aligned with principles-based standards in other areas of financial and corporate regulation, such as corporate governance, banking supervision, or securities regulation. Developing countries had problems keeping up with frequently changing IFRSs, a difficulty made worse by the need for translation. IFRS is generally accepted as not being suitable for small and medium-sized enterprises, yet these were the dominant business model in such places and often lack the capacity to apply the detailed, extensive and complex requirements of IFRS. Often in these countries only the audit firms understood IFRS so they

prepared the accounts, and that compromised both their independence and the "ownership" by management of the enterprises' financial statements. Complexity was a threat to auditor independence and in any case the international audit firm networks do not deliver consistent audit quality or implementation. This was a major problem. 'The international community has lost confidence in the role of the auditor', he said.

'We need to start fixing countries' infrastructure and getting their institutions right', he said. 'The roles of disclosure and financial reporting differ from country to country, and therefore financial reporting practice differs'. He said that most countries do not have properly functioning systems to ensure public disclosure of the legally-required audited financial statements. 'The people who can bring influence to bear on legislators and politicians are often the ones who get rich through opaque business dealings', he said. And that doesn't encourage transparency.

He saw problems with the US model. He saw a picture of 'the emergence of detailed rules-based accounting standards and enforcement by securities regulators to compensate for weaknesses elsewhere in governance and regulation. Shareholders are treated as providers of finance', he said, 'not as owners. Audit committees do not necessarily represent shareholders' interests.

He said there were difficulties globally in agreeing what the underlying principles were. There was a move away from auditor transparency and direct accountability. The growth of the large accounting firms had an impact on the exercise

The international community has lost confidence in the role of the auditor.

of individual professional judgement. The professional bodies had diminished in stature. ‘Where are the bodies which foster debate?’, he said. ‘Do we have anything equivalent in our profession to the teaching and research hospitals, and practice-oriented research journals, of the medical profession, which are considered essential to equip future professionals to exercise judgment?’, he said. ‘We do not’.

He suggested that there needed to be a global voice and global responsibility to decide what the principles were. But even then, he was doubtful.

‘If the exercise of judgement is shaped by local institutions and incentives’, he said, ‘can there be global accounting convergence without prior convergence of these pre-conditions? “Offshore” IFRS can’t stand alone’, he said.

John Hegarty is Manager, Financial Management, World Bank. He is Chair of the World Bank Financial Management – Private Sector Committee.

THE PLACE OF TRUE AND FAIR: BUILDING TRUST IN THE PROFESSION - Isobel Sharp

Isobel Sharp pointed out that UK companies legislation in 1856 had introduced the concept of the ‘true and correct view’ and that this had become the ‘true and fair view’ in the ground-breaking 1948 Companies Act. The idea has found its way into European Directives. But it has never been required in the US albeit one firm experimented with the two part audit opinion in the 1950s. She quoted from the famous analogy of a picture originally put forward by Arthur Morison in a paper to the Institute’s Summer School in 1970. ‘We do not condemn the activity of portraiture because different artists present different views of the same thing’, he said. ‘Indeed we only condemn it when they do conform to a single imposed view’.

She quoted Professor David Flint: ‘It must be an expression of opinion within an established, credible frame of reference in order to achieve effective communication’, he wrote. ‘It must be an opinion arrived at on a rational and supportable basis – both theoretically and pragmatically – and it requires to be capable of being substantiated by the directors to the auditors, who have the responsibility to consider independently on the evidence whether the accounts prepared by the directors so indeed give, by reference to known criteria, a true and fair view’. Isobel explained that it is more than mere compliance with the accounting rules. There are three tests on whether financial statements are true and fair, namely:

- satisfying professional technical information requirements (e.g. the IFRS accounting standards);

- fulfilling a general legal requirement for protecting shareholders through full and frank disclosure on relevant matters; and
- meeting the societal expectation of what is necessary, judged against the ethical standards of society in communicating with shareholders and other relevant groups.

She traced the problems which the concept has faced in recent years. The duty of directors to prepare accounts which show a true and fair view was lost during the implementation of the EU Regulation on international accounting standards. IFRS require merely the ‘faithful representation’ of a company’s financial position, performance and cash flows. But the new Companies Act 2006 says that directors must not approve accounts unless they give a true and fair view of the assets, liabilities, financial position and profit and loss of the company.

She said that there was a need for an overriding principle in IFRS. In the exposure draft on the conceptual framework it simply talks of ‘providing information useful in making investment and credit decisions’. Thus detailed rules are determining disclosure. Unless we wanted to be with the US in having a rules-based environment, she said: ‘We need to get back to ‘true and fair’ being the prime and ultimate standard’.

Isobel Sharp is a partner with Deloitte and Senior Vice-President of the Institute of Chartered Accountants of Scotland.

We need to get back to ‘true and fair’ being the prime standard.

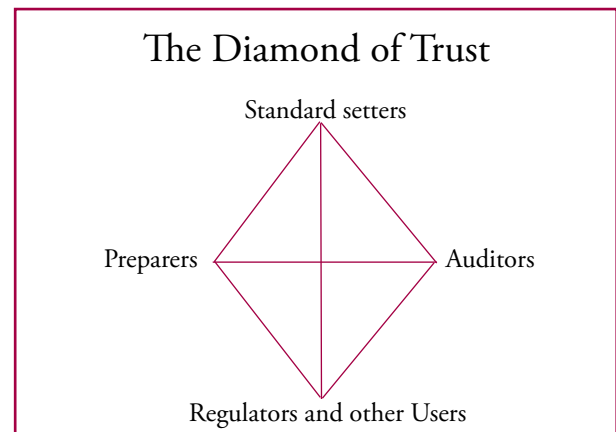
APPENDIX

SUMMARY OF RECOMMENDATIONS

From the April 2006 report “Principles Not Rules: A Question of Judgement”

The Working Group’s recommendations are as follows:

1. We support the consensus that only principles-based accounting standards can fully serve both the needs of business and the public interest.
2. It is necessary to recognise that complete comparability is never possible in accounting. More emphasis needs to be placed on explaining the key judgements made by preparers of financial statements. This is critical to effective communication in financial reporting.
3. Principles-based accounting requires a clear hierarchy of overarching concepts, principles that reflect the overarching concepts and limited further guidance. The additional guidance should be restricted to brief explanation built into the standards themselves, as well as a small number of interpretations on major issues.
4. Rules-based accounting adds unnecessary complexity, encourages financial engineering and does not necessarily lead to a ‘true and fair view’ or a ‘fair presentation’.
5. Principles-based accounting provides a comprehensive basis for the preparation of financial statements that has the flexibility to deal with new and different situations as they arise and leaves far less scope for people to convince themselves that an ‘inappropriate’ interpretation is acceptable.
6. Our vision of principles-based standard setting will require a change in the global profession, with both preparers and auditors assuming more responsibility for their judgments and seeking less in the way of detailed guidance.
7. In order to implement these changes the training of both current and future professionals will need to be addressed to ensure that accountants have the expertise, and the courage, to make sound and ethical judgements in the overriding interest of a true and fair view. To support this approach, the judgements need to be documented and disclosed.
8. Responsible enforcement of accounting standards requires regulators to be willing to accept a range of judgement-based outcomes. Regulators need to be able to trust preparers and auditors, who in turn must be capable of exercising judgement (see The Diamond of Trust below). One corollary is that anti-abuse provisions and ‘bright lines’ should not be included in accounting standards.
9. A single interpretative body should focus on significant issues rather than detailed matters. Detailed matters should be left to the judgement of preparers and auditors with clear disclosure of how that judgment has been exercised.
10. Convergence cannot be achieved if the basis for convergence is a detailed rules-driven approach as this will be difficult to roll out across the different jurisdictions and cultures around the world.





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