Issues for preparers when there are changes in accounting standards

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In the past 15 years, accounting standard-setters, including the Financial Accounting Standards Board (FASB), the International Accounting Standards Board (IASB), and the UK Accounting Standards Board (ASB), have made dramatic changes in financial reporting requirements relating to employee stock options, defined benefit pension plans, post-employment contractual obligations, investments, and derivatives. Looking forward, the FASB and IASB have sent strong signals that they intend to take steps to alter recognition and disclosure requirements relating to asset securitisations, leases, and, yet again, defined benefit plans. These changes obviously impose direct costs of financial statement preparation compliance on corporate preparers, some of which can be quite substantial.

However, as experienced senior finance officers of companies have suggested at this conference, compliance costs paint an incomplete picture of the total costs arising from standard-setting changes. In particular, costs associated with dealing with contracts with various stakeholders, including bondholders and unionised labour, as well as costs associated with a variety of regulatory regimes, often dwarf financial reporting compliance costs. Regarding the former cost, consider the effect on corporate balance sheets of the requirement in the US to recognise the unfunded other post-employment benefit (OPEB) obligation. The OPEB standard, SFAS 106, required most US firms beginning in 1993 to recognise at the date of adoption the unfunded obligation, either in net income or as an unfunded transition liability, which would then be amortised into income for several years. Depending on the choice made by managers, the result would either be an immediate substantial reduction in retained earnings or a drag on income for several years into the future. Those firms that selected immediate recognition could have found themselves in technical default with their creditors, and would be faced with the prospect of amending lending agreements, which could be very costly. Regarding the latter cost—regulatory costs, consider the effect on a major listed UK banking company, which, under FRS17, faced the prospect of having a net pension liability arising largely from its UK defined benefit plans, appearing on its balance sheet. The regulatory cost for that financial institution is that its regulatory capital could be adversely affected, which, at the very least, could impose additional monitoring costs on the firm, particularly given the additional institutional feature of having to address the decisions of the Financial Services Authority (FSA) regarding interpretations of the Basel II capital requirements.

Although there is substantial overlap in the challenges that major listed companies across different industry groups face in minimising the costs of changes in financial reporting rules, the challenges are perhaps greater for a banking company because of the additional regulatory burden it faces. This is not to suggest that, for example, an oil exploration company, does not face substantial regulatory issues. For example, consider the June 2008 exposure draft issued by the FASB, Disclosure of Certain Loss Contingencies: An Amendment of FASB Statements No. 5 and 141(R), which provides for enhanced disclosure of the costs of ongoing environmental litigation and pending unsettled lawsuits. Such disclosures could affect the way in which regulatory agencies such as the US...
Amir, E., Guan, Y. and Oswald, D. (2009). ‘The effect of
Environmental Protection Agency render enforce-
ment actions with energy companies and pharma-
ceuticals in addressing environmental liabilities.
What is clear is that both a financial institution and
an oil exploration company will face the prospect
of greatly altered balance sheets and more volatile
income if several proposals currently being consid-
ered by the FASB and IASB become account-
ing standards.

Consider, for example, the proposals to change
defined benefit pension accounting rules. Both the
IASB and FASB have indicated an interest in elim-
inating the ‘corridor’ method (IASB) and unrecog-
nised gains/losses as a component of OCI (FASB),
which would effectively result in immediate
recognition in income of plan asset return and ac-
tuarial gains and losses associated with the pension
obligation. Obviously, if some version of these
proposals were to come to pass, firms could face
the prospect of more volatile income, which could
have not only capital market pricing effects – as
investors try to interpret the increase in volatility,
but also, in the case of banks, induce volatility
in regulatory capital. Steps taken by a major bank-
ing company to switch from equities to bonds may
make sense in terms of minimising exposure to
this sort of volatility as well as helping to minimise
the insurance fee they face from the Pension
Protection Fund. Indeed, a current academic work-
paper suggests many UK firms have increas-
ingly taken similar steps.\(^1\) Imagine the
consequences if the full impact of the 2008 plan
asset loss that firms are facing were to be fully
recognised in income. Bearing in mind again the
events of 2008, consider the impact on corporate
balance sheets of the FASB’s proposal for separate
recognition of plan assets and the pension obliga-
tion. Looking at the US, the impact of the double-
barrelled shot gun of the increase in pension
obligations arising from the fall in interest rates
and the dramatic decline in plan assets because of
the collapse in equity and corporate bond prices is
already going to alter dramatically US corporate
balance sheets even under the current rule requir-
ing recognition of the net of plan assets and pen-
sion obligations. Imagine the impact on corporate
balance sheets if each were separately recognised.
How many more firms would have been in techni-
cal default of loan agreements in 2008 than was re-
portedly the case?

As another illustration, consider the exposure
drafts issued by the FASB in the US in September
2008 that proposed modifying existing recognition
and disclosure rules for special purpose entities
(SPEs) and variable interest entities (VIEs) cre-
et by asset securitisations. One major change is
that qualified SPEs (QSPEs) are effectively elimi-
nated. This means that the accounts of most SPEs
will be consolidated with the sponsor-originator’s
accounts. Thus, former QSPE assets and liabilities
will be on-balance sheet for banks, other financial
institutions, and retailers with financing subsi-
diaries. Relatedly, the proposed rules tighten up
consolidation requirements for VIEs, which again
could result in VIE accounts coming on-balance
sheet for sponsor-originators. Another major
change is that the new standards will require a sub-
stantial increase in additional disclosures relating
to SPEs and VIEs. Although the changes in consol-
dation rules would bring US reporting rules more
in line with international reporting rules, imagine
the impact on US bank balance sheets if the con-
solidation rule changes are implemented. As an il-
stration, consider Citigroup, which had $2.187
trillion in assets, $2.074 trillion in liabilities, and
$113.6 billion in equity at year-end 2007, or
roughly a capital ratio of 5.1%. If the $108.1 bil-
ion in managed securitised loan assets were added
to Citigroup’s balance sheet (assuming SPE assets
and liabilities are approximately equal), their cap-
ital ratio would fall to 4.9%. Given the events of
2008, without changes in the way in which regula-
tory capital is calculated, will there be any banks
left standing in the US if securitisations are effec-
tively treated as secured borrowings? Of course,
one has to wonder whether US banks would be in
their present troubled state if such consolidation
rules had been in effect during the past decade –
perhaps the ensuing credit crisis could have been
avoided if bank lending practices had had direct
balance sheet implications. The timelines for the
proposed standards are quarter four 2008 for dis-
closure requirement rule changes, and 2010 for
consolidation rule changes.

Although a case can be made for changes in pen-
sion accounting and asset securitisation account-
ning standards, both of which make sense to me and
which I strongly support, my point in selecting
these two areas of financial reporting is to illus-
trate that changes can be burdensome or disrup-
tive. This does not imply that such changes should
not be made. Rather, it is important that all those
involved in the accounting standard-setting
process articulate clearly the costs and benefits of
proposed standards so that standard-setters can
adopt phase-in policies and extend adoption peri-
ods to give firms time to work with their stake-
holders and relevant regulatorial authorities so as
to minimise contracting and regulatory costs.

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\(^1\) Amir, E., Guan, Y. and Oswald, D. (2009). ‘The effect of
pension accounting on corporate pension asset allocation’,
forthcoming, Review of Accounting Studies.