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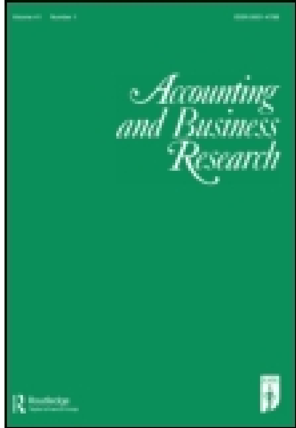

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Issues for preparers when there are changes in accounting standards

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Issues for preparers when there are changes in accounting standards

Academic commentary on the conference

Wayne Landsman*

The conference organisers asked Professor Landsman to provide reflections from an academic researcher's perspective on observations by practitioners made during the conference discussion. Professor Landsman's reflections also provide guidance to policy-relevant questions of interest for future researchers in the field.

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

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Environmental Protection Agency render enforcement actions with energy companies and pharmaceuticals 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 considered by the FASB and IASB become accounting standards.

Consider, for example, the proposals to change defined benefit pension accounting rules. Both the IASB and FASB have indicated an interest in eliminating the 'corridor' method (IASB) and unrecognised gains/losses as a component of OCI (FASB), which would effectively result in immediate recognition in income of plan asset return and actuarial 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 banking 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 working paper suggests many UK firms have increasingly 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 obligation. 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 requiring recognition of the net of plan assets and pension obligations. Imagine the impact on corporate balance sheets if each were separately recognised. How many more firms would have been in technical default of loan agreements in 2008 than was reportedly 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) created by asset securitisations. One major change is that qualified SPEs (QSPEs) are effectively eliminated. 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 subsidiaries. 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 substantial increase in additional disclosures relating to SPEs and VIEs. Although the changes in consolidation rules would bring US reporting rules more in line with international reporting rules, imagine the impact on US bank balance sheets if the consolidation rule changes are implemented. As an illustration, 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 billion in managed securitised loan assets were added to Citigroup's balance sheet (assuming SPE assets and liabilities are approximately equal), their capital ratio would fall to 4.9%. Given the events of 2008, without changes in the way in which regulatory capital is calculated, will there be any banks left standing in the US if securitisations are effectively 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 disclosure requirement rule changes, and 2010 for consolidation rule changes.

Although a case can be made for changes in pension accounting and asset securitisation accounting 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 illustrate that changes can be burdensome or disruptive. 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 periods to give firms time to work with their stakeholders and relevant regulatorial authorities so as to minimise contracting and regulatory costs.

[1] Amir, E., Guan, Y. and Oswald, D. (2009). 'The effect of pension accounting on corporate pension asset allocation', forthcoming, *Review of Accounting Studies*.