Issues in the setting of International Accounting Standards

These notes are intended as a first level introduction to the main issues which arise in setting accounting standards for global use. Therefore, there are only a few references to the academic literature in which these issues are being discussed.

The agency reason for accounting standards

The agency explanation for accounting standards was first made popular in a systematic way through a paper by Jensen & Meckling, Theory of the firm: managerial behaviour, agency costs and ownership structure, Journal of Financial Economics, 1976, 305-360. Essentially, a manger needs to assure shareholders that his/her behaviour will match what shareholders expect.

1. The setting of a simple company

Consider a company with the following long run performance:

Sales	400
cost of sales (including replacement of equipment)	250
Sustainable profit	150

Market discount rate is 10%, and there are 150 shares in the company. The value of the company is

$$\frac{150}{(1+0.1)^1} + \frac{150}{(1+0.1)^2} + \frac{150}{(1+0.1)^3} + \frac{150}{(1+0.1)^4} + \ldots\ldots$$

The sum of this converging geometric series is $a/(1-r)$
where

a = the first term in the series
r = the rate at which the series is declining

$$= \frac{150}{0.10} = 1500$$

2. Perks consumption when the manager owns all the shares

When the manager owns 100% of the shares, then there is only a moderate incentive to consume excessive perks, such as plush offices, company cars and foreign marketing trips. There are a number of reasons why perks are preferred to dividends. For example, the tax rate on perks may be lower than on income. Also it may be a sensitive way in which to take income; employees may expect a rise in salary if they see the managers income is large, whereas they do not have information by which to judge whether the expenditure on perks is a legitimate business expense of simply another way of taking income. The optimum level of perks is likely to be incorporated in to the long run costs of 250.

However, if the manager consumes 20 of extra perks each year, then the long run profit of the company is reduced to 130, and the present value of the company is reduced to 1300. But the present value of the perks to the manager is 20/0.1 = 200. Therefore the fall in value of the company is exactly compensated by the value of the perks taken, and therefore the manager has no real incentive to consume the extra perks. This is shown in Table 1.

Table 1:

Company value based on	**Company value**	**---------- Managers wealth ----------**			
		100% of shares	**Extra perks**	**Cash**	**Total wealth**
Normal perks	1500	1500			1500
extra perks of 20p.a.	1300	1300	200		1500

3. Perks consumption when the manager owns 70% of the shares

In contrast, consider a situation in which a manager owns only a proportion (say 70%) of the shares in the company, as shown in Table 2

Table 2:

Company value based on	**Company value**	**Managers wealth**			
		70% of shares	**Extra perks**	**Cash**	**Total wealth**
Normal perks	1500	1050			1050
extra perks of 20p.a.	1300	910	200		1110

In this case, the manager has a greater incentive than before to consume the extra perks of 20p.a. The monetary benefits of the perks are 200 and this is the fall in value of the company. However, the fall in the wealth of the manager is only 70% of this (140) since he owns only 70% of the shares. Therefore the manager benefits by 60, and this is shown in the total column.

This example shows that when the manager owns only a proportion of the shares, there is a greater incentive to consume extra perks than when the manager owns all the shares.

4. The sale of an owner-manager company

Let's consider a situation in which the manager of a company currently owns all the shares, but wishes to sell 30% of the stock to the public. Let's consider what price he is likely to get for the shares and what wealth he is likely to realise from the sale.

As we have seen above, the incentives for the manager to consume excess perks varies with the % of shares owned. If the stock market is rational it will anticipate that perks consumption will rise after the sale, and this will reduce the price of the flotation. The calculations are given in Table 3.

Table 3:

Company value based on	**Company value**	**Managers wealth**			
		70% of shares	**Extra perks**	**Cash**	**Total**
Normal perks	1500				
extra perks of 20p.a.	1300	910	200	390	1500

When the company is floated, it will not be valued at the pre-floatation value of 1500, but at a value which anticipates the perks behaviour of the manager post floatation. Then the company will be valued at 1300 and the 30% stake will be sold for 390.

The wealth of the manager will then consist of 1500:
the 70% stake in the company (910);
the value of the perks (200); and
the cash received for the 30% stake (390).

Notice that the new shareholders are simply getting value for money. They are paying 390 for shares worth 390.

I - THE PROBLEM TO WHICH AUDITING IS AN ANSWER

However, this gives rise to a real problem. Who knows what the post flotation perks consumption will be? If investors are prudent they might exaggerate the anticipated amount. Also, the manager may not wish to consume even the extra 20 of perks. He may be tired of foreign trips and expensive lunches and simply want the money to spend on his children's education. Therefore, the manager may want to convince the new shareholders that perks will be limited to a given level and thereby sell the company at a higher price.

In order to be sure that the manager restricts the consumption of perks to the normal level, some monitoring of managerial behaviour will normally be required. This function is associated with auditing. But notice that the manager will only pay up to a certain amount for the auditing. If no auditor hired, then the managers loss is the perks he is "forced" to consume (because this is anticipated in the floatation price). Therefore, the manager will pay up to this amount to get an audit, except .....if the manager can somehow convince investors that excess perks will not be consumed. The point here is that trust is a substitute for auditing.

5. Auditing vs. accounting

The above explanation relates to the need for auditing, to monitor the expenditure of the manager. A similar argument can be made for the reporting of performance. When prospective shareholders are considering buying shares, they will be concerned about not only the profits

that will be made by the company after the share purchase, but also whether or not other prospective investors will be convinced about the level of performance.

Therefore part of the deal with the owner-manager when the shares are initially floated will be that performance of the company is audited & disclosed in order that a market in the shares may develop. If the owner-manager fails to do this, then prospective shareholders will adjust the price they are willing to pay for the shares for the illiquidity of their holding. Therefore the agency explanation for accounting is much the same as for auditing.

Notice here that again there are substitutes for accounting disclosure. If a society already has an effective mechanism for the communication of performance, then accounting will not be so important.

Why regulate the reporting of performance by companies?

The agency explanation for accounting does not require that the audited reporting of performance is regulated, simply that it happens. The reason for regulation is that it is a quicker solution than would be identified by the market mechanism.

If left to themselves, investors would identify good types of reporting practice and companies which did not adopt good practice would be thought of as not reporting at all. This would mean that shares would be purchased by investors *as if* corporate performance were not reported; that is, as we have seen above, the share price would be lower to reflect the illiquidity of the market in the shares.

The problem with leaving the measurement and format of reporting to the market mechanism is that an agreed solution would take a long time to emerge. The advantage of accounting standards is the speed with which measurement and format rules can be achieved.

What is appropriate regulation?

How is it possible for regulators to know the optimal level of regulation? How detailed should accounting rules be?

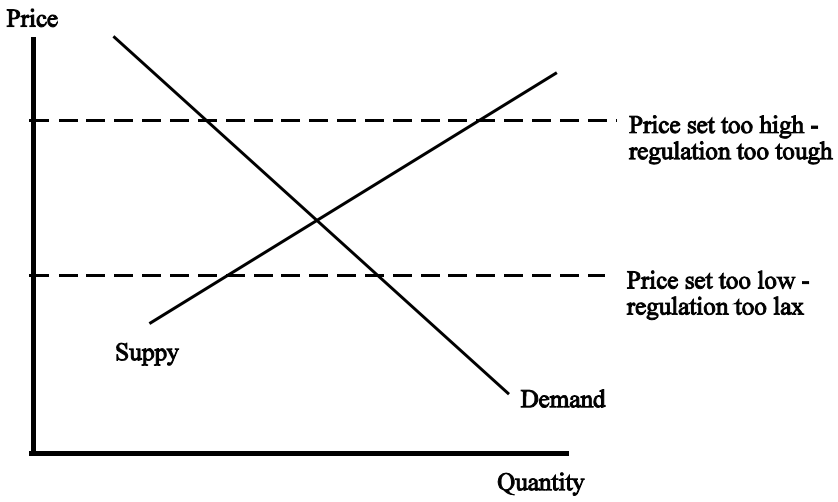
1. The insufficiency of the Jensen & Meckling (JM) analysis

This question is difficult, but the discussion can be informed by the agency justification for accounting and auditing explained above. In the model the manager wants to issue shares to the public, but all the public wants is value for money. Investors do not want to subscribe for shares only to find that the price has fallen because either (i) more perks are being consumed than anticipated, or (ii) the market for the shares is illiquid because the company does not report its performance. In the JM paper, it is managers who are willing to pay the price for the monitoring. They are willing to pay up to the amount they would lose if there were no monitoring or reporting of performance.

This is a simplification because it assumes that managers are in a weak position. The JM analysis assumes that managers have no alternative but to raise funds on the stock market; and in particular, that investors will not invest unless they get value for money. But investors want to invest just as much as companies want to raise capital. What would investors do if companies did not want to borrow their money? Alternative ways in which funds can be invested might give rise to even larger risks (for example, investing in art). The point here is that the sharing of the costs of monitoring are determined by the aggregate forces of supply and demand, just as are interest rates.

2. Regulation should mimic the market solution

The level of monitoring and accounting performance measurement in a market solution will depend on the forces of supply and demand for funds. For example, in a company where the shares are owned entirely by the employees, there would be significant non accounting sources of information about its performance, and consequently, there would be little demand from investors for accounting information. However, if investors were far removed from the company the demand for accounting information would be substantial. Therefore it is the function of regulators to mimic in, accounting standards, the solutions that investors would have devised for themselves.



One illustration of this is that in the UK there is complete set of accounting standards for small companies, *Financial Reporting Standards for Smaller Entities* (the FRSSE). This is an attempt by UK regulators to acknowledge that small companies may not have such severe agency problems as larger ones. That is, for small companies, there may be non accounting information about the performance of the company available to investors; and this reduces the amount of accounting information that a smaller company needs to disclose to its investors.

The situation may be likened to a regulator trying to fix the competitive price for an industry. If the price is set too high by the regulator, then supply will exceed demand. If the price is set too low by the regulator, then demand will exceed supply.

If the regulator makes accounting standards for quoted companies too tough, then although investors will find it attractive to invest, companies will find the funding too expensive and seek alternative sources, such as from banks and family members. Similarly, if accounting standards for quoted companies are too weak, then although companies will find it attractive to fund

projects from the issue of public shares, investors will find it unattractive to invest because of the risks, and will invest in other markets.

The acceptability of International accounting standards

As business becomes more global, there is a demand for an international accounting language so that performance can be measured reliably by a single set of measurement techniques. This is the objective of the International Accounting Standards Board (www. iasb.org.uk) who set International Accounting Standards (IAS). The idea is that such standards would be used to report performance on all the major stock exchanges in the world (New York, London, Frankfurt ....). The standards are being assessed by the leading security commissions (or their equivalent) through the world; this group is called IOSCO (International Organisation of Security Commissions).

There are a number of legitimate reasons why national accounting standards may vary, and this gives rise to situations in which there are difficulties for IASC in agreeing a standard that is suitable for all.

1. Different standards arising from different cultures

The problem with IAS is that different regulators want IAS to reflect what they already do and to reflect the balance of interests between investors and companies in their own economies. This is not surprising, since the adoption of IAS in a particular economy may upset the current balance between investors and companies.

For example, in the US, there is a strong tradition of bureaucracy. In other countries such as the UK, the economic environment is less litigious and therefore a far less defensive attitude is taken to financial reporting. This may explain why in the US, assets are valued at historical cost and revaluation is not permitted. Historical cost is accurate and defensible, whereas market values are by their nature imprecise and sometimes subjective.

2. Different standards arising from different economic environments

Financial reporting is supposed to represent the economic substance of the company's performance. Therefore it is to be expected that reporting will be different if the economic substance is different. A good example of this is accounting for research and development.

The issue is whether expenditure on research development can be treated as an asset. In the example below, 50 has been spent on R&D. Should this be treated as an asset or charged to the P&L of the period?

Balance sheet of a company

Assets (Dr)			**Financing (Cr)**		
Fixed		100	Creditors (long term & short term)		200
R&D	50 ?				
Stock		300	Owners interest		
Cash		150	*Previous periods*		350
	-50		*This period (p&l)*	-50 ?	
Total		500	Total		550

One factor which will determine this is how well patents are protected in a country. If patents rights are not well protected by easy access to the courts, then it might not be appropriate to classify the expenditure as an asset.

3. Different standards arising from different agency situations

Another reason why standards are different across the world is that there are different agency situations. For example, in the US, investors are far removed from the companies in which they invest. Therefore, US GAAP is tough; and there are many rules to limit the discretion of managers in reporting their performance. For example, borrowing costs are required to be capitalised for particular assets, whereas in UK and IAS GAAP capitalisation is permitted, but not required.

The drivers behind the IASB

One of the main forces behind IAS is US GAAP and this is shown in the conservative nature of financial reporting.

1. Elements of international financial statements

The elements of IAS GAAP are as follows:

assets
: rights to economic benefits

liabilities
: obligations to transfer economic benefits

ownership interest
: assets less liabilities

gains & losses
changes in ownership interest, not resulting from contribution from or distributions to the owners.

contribution from owners
initial funding or retained earnings

distribution to owners
dividends

These elements seem sensible, but they have important implications, as we discuss next.

2. Recognition in financial statements (how US GAAP is winning)

the building blocks of financial statements are
assets
liabilities

the process of recognition of assets and liabilities is
initial recognition
subsequent remeasurement
derecognition

An important point to notice is that a transaction cannot be recognised unless it is an asset or a liability. This will determine if expenditure is charged tp P&L or is recognised as asset, but there is also another consequence, relating to provisions. Provisions can be made only if a liability can be justified, that is if the company is obliged to transfer economic benefits? This can be seen from the following example.

Balance sheet of a company

Assets (Dr)		**Financing (Cr)**		
Assets	320	Creditors		80
		Provisions	Provision +20	40
		Owners interest		
		Previous periods		200
		This period (p&l)	Provisions -20	
Total	320	Total		320

A company may wish to make a provision for an anticipated expense (the failure of a machine). It may know from experience that a machine fails every 3 years. The establishment of the provision will allow the firm to build up a balance to which the repair cost of machine may be charged. This enables the profit and loss to be charge with 20 each year instead of the 60 every

three years. The P&L is then a more effective measure of sustainable performance.

This practice is prohibited by IAS 37 unless the company can shown that the provision is a liability, that is the company is obliged (either legally or commercially) to pay the money. For the machine repair, this condition is not satisfied since there is no reason why the company MUST stay in business. Therefore the 60 would have to be charged to the P&L every 3 years, as the breakdown occurs.

Even if the company were obliged to repair the machine when it breaks down (because it has a contract to produce goods and there are severe penalty clauses for non performance) the company may still not make the provision. This is because at the time of the first provision, the machine has not yet broken down, and therefore currently the company is not obliged to undertake the expenditure.

This means that reporting assets and liabilities is more important than reporting performance. From a valuation point of view this is controversial, but it seems to stem from the excessive concern with the desired objectivity of financial statements, a characteristic which is highly regarded in the US.

The future of International Accounting Standards

1. The effect of US GAAP

It is likely that the US influence on IAS GAAP will be significant. This will mean, in effect, that emerging economies will need to comply with US GAAP. Since these economies do not have US style agency problems and US style economic and cultural environments, the standards will not be suitable for all companies. For those that wish to raise funds in the US, it will be fine. For others it will be overkill, but this is the price to be paid for universal accounting standards rather than standards to suit the economic, legal and cultural conditions in an economy.

2. The decline in the importance of accounting information

Fortunately, this influence of US GAAP will be offset by accounting standards becoming less important in financial markets. The value of a company consists of two components:

> the value of what the company does now (ie the value from sustainable profits from the existing capital base); and
>
> the value of what the company will do in the future (ie the present value of excess profits from future investment).

The former component is the one for which accounting information is relevant. However, it is the latter which is becoming more important in the global economy. This means that discursive statements in the annual report and accounts are becoming more and more important. For example in the UK, companies are encouraged to provide an Operating and financial review of the existing and future activities. There is some discussion that the full annual report and accounts will be available only on request and that a summary report will the main way by which the company communicates with its shareholders.

3. The quality of auditing

As the US gets it grip on IAS, it will also be concerned about the quality of auditing. It has

already started to raise issues about how managers and auditors interpret and implement international accounting standards. It has called for a body similar to the US SEC (Security and Exchange Commission) which will monitor how companies and auditors implement IAS.