In Focus

A Forum on Contemporary Accounting Issues

IASB Vice Chairman TOM JONES

INTERVIEW

Tom Jones, a British chartered accountant, has worked as a preparer for 40 years, including 20 years in executive roles at Citibank and Citicorp in New York. He has served as vice chairman of the International Accounting Standards Board (IASB) since its inception in 2001. He was previously a member of the Financial Accounting Foundation (FAF), which oversees the Financial Accounting Standards Board (FASB), and a member of that organization's Emerging Issues Task Force. He was interviewed at the Pace University Lubin Forum on Contemporary Accounting Issues on April 30, 2009, by Alan Murray, deputy managing editor of the *Wall Street Journal* and executive editor for the *Journal* online.

Banks and Fair Value

Alan Murray: Let's jump into the news of April, which was FASB deciding to ease up on mark-to-market rules. You were quoted a couple of weeks later saying that move was crazy. Why?

Tom Jones: The "crazy" reference was the idea of clowning up the financial reporting by changing rules unnecessarily. It's a lot deeper than just that. The truth is there's a fair amount of judgment permitted anyway. We don't think that the changes that finally were made have such a huge impact.

Murray: But the U.S. stock market took off after that, and there was a sort of "hallelujah" that mark-to-market standards had been eased for banks.

Jones: We went through something like this six months ago when we reacted to pressure from the European Commission to allow people to move between buckets. The excuse was that the U.S. permitted it and we didn't. It's true that bank stocks went up—then they came down again.

The problem is we are not going to improve the situation by misleading investors over time. Investors have demonstrated some real skepticism about bank accounting. I don't think that playing around with the rules—on the basis of individual changes forced by politicians—is going to improve credibility with investors.

Murray: These are extraordinary times. This no longer feels like a recession, it feels like a depression. There are smart people who think that accounting has contributed to cyclicality because banks get into a situation where their market disappears, they have to mark down their assets, they're unable to lend more, and then the situation gets worse. Why shouldn't accounting correct that cycle?

Jones: Because we've seen in the past that what you are describing amounts to putting away money in good times and letting it out in bad times. Or not recognizing real life in bad times, and then catching up later. The Japanese spent 10 years recovering from the 1989–1990 crisis in real estate prices, and it cost Japan 10 years of growth. You cannot use accounting standards or reporting standards to adjust for events. Banks are in trouble because they lent in a very dumb way. Every 10 years, they go through the cycle.

Murray: Does it seem to be getting shorter?

Jones: It is—the turnover's getting quicker and the memory's getting shorter. But you can't use accounting rules to promote financial stability because you defeat the objective of accounting, which is impartial information. I don't think you can use it to protect against bad loans.

There's a lot of talk about these tremendous impacts from having to mark down values. The fact is, huge amounts of bank balance sheets are not on fair value. The percentage of bank assets which are on fair value varies dramatically by the kind of bank. My guess is, on average, it's certainly not 50% and probably not even 30%.

Murray: The bank's argument is there is no market.

Jones: If there's no market, or if there's a transaction which you can show is coerced in some way, then you can ignore that market price. What the FASB has done underlines that. They went to the opposite extreme. They said, "You can assume, in this market, it is always coerced, unless you can prove it isn't." Our rule is very judgmental, but it equally says you can ignore any transaction which is clearly not a market-rate transaction. There's a lot of flexibility.

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Political Pressure

Murray: There's been intense pressure in Europe to get in line. People have threatened the independence of the IASB, saying, "You have to pay attention to your constituencies, or they'll pull the rule-making authority away from you." What has the response been?

Jones: We went through this game last October. There are four ways of measuring assets on the balance sheet. The Europeans wanted more flexibility in moving from one "bucket" to another. We felt they had a pretty fair case. They [threatened us] very clumsily, as you describe now.

On the other hand, they were not wrong, and we made that change. But instead of getting credit for responding rapidly to an issue, we got huge criticism for giving insufficient due process. On the other hand, we also got some criticism from people who didn't believe we did the right thing. What we take from that is you can't have an independent standards setter where the politicians have a habit of holding a gun to your head. We've got to make that point anyway.

Secondly, I think the board voted 14–0 that we were not going to respond. We did volunteer something, though. We're not going to move in the same way the FASB did. But we are going to review [IAS] 39, which is a problem from our point of view, and is equivalent to quite a few U.S. standards. We're going to do a very rapid review, six months, to make some changes that do make sense. They won't be exactly what the FASB did, but they will respond to valid criticisms of that standard.

Murray: Do you think the FASB was caving to political pressure?

Jones: It's hard for me to put myself in the position the FASB was in. They have one constituency. We have 120 constituencies—every country from Brazil through India and China, through all of Europe and Australia.

Murray: Does that help your independence?

Jones: I think so. In fact, that's one of my key reasons to push the idea that the U.S. should move to international standards—because once it's a three-legged stool, and there's Asia and Europe and the U.S., it is much more difficult for any one group of politicians to hold a gun.

Convergence with IFRS

Murray: Pushing the idea that the U.S. should be moving toward international standards, the last time we were here, that was pretty much a done deal. You had Christopher Cox at the SEC clearly

moving in that direction, but now he's gone. In [new SEC Chair Mary Schapiro's] confirmation hearings, she seemed to raise questions, if not about the direction, at least about the pace at which the U.S. should be moving toward international standards. What's your sense of where the U.S. is headed?

Jones: I think Mary [Schapiro] is pretty open-minded. First of all, there are very few people who believe that the world should have two ways of describing business. We used to have 100 ways. Now we're down to two: the U.S. and the rest of the world. Very few thinking people believe that the U.S. can hold out for its own set of standards, which by the way are highly complex, and have themselves been criticized quite a bit. You're basically talking timing. The U.S. is about the only holdout. Virtually every country, certainly every major economy, is either on international accounting standards or is committed to make the move.

Murray: Just to be fair, there are some people who think competitive standard settings might be a good free-market notion.

Jones: It's a great idea. Investors don't seem to really believe that, but certainly preparers would like the idea of picking and choosing! I exaggerate—I got into this game because I was keeping the books at Citibank when it was a great bank, and it was in 100 countries. And we kept the books 100 different ways, and then tried to reduce it all to one: U.S. GAAP. Having 100 different ways isn't a great thing.

There are a few major differences in principle, and those are important. But most of these differences are very minor. Nine times out of 10, which way you go doesn't matter as long as you all go one way. Accounting is just a language we use to describe transactions. The idea that there should be different results from an identical transaction, because it's in one country versus another, is crazy.

The U.S. is taking an inordinately long time to move. The U.S. started this whole process. When the old IASC was wiped out and the IASB was set up in 2001, the chief accountant and the chairman of the SEC were instrumental, not only in starting that ball rolling, but in the debate as to how it should work.

For us to be sitting around eight years later and talking about 2014 to me seems absolutely nuts, because there's a huge cost to this. Any major corporation in the U.S. has more subsidiaries outside the U.S. on IFRS than they do inside the U.S. not on IFRS. The smaller companies who don't have that issue are dealing with 25,000 pages of instructions instead of two-and-a-half. All around, people are paying a price.

Standards in an Economic Crisis

Murray: This flap over fair value accounting hasn't changed the fundamental [issue]?

Jones: In my opinion, it hasn't. In fact, I think people are coming to realize that we're not kidding anybody by making changes in accounting. The market sees through it. Why do bank stocks sell for less than any value you could ascribe if you believe the numbers on the balance sheet? It's because investors are skeptical.

Murray: They sell for more than they did before April 1. The markets seem to see this as something real, not just hocus-pocus.

Jones: I think it's very difficult to judge why prices change. There may be many reasons. There may have been more reasons to be concerned other than just mark-to-market accounting. We are going to know, because eventually there will be academics who do studies. We'll know to what extent there was any artificiality in the writedowns.

I have to say, I'm very sympathetic to the banks. I was a banker; I have lots of friends in the industry. Believe me, I get a lot of phone calls telling me how dumb we are and what we ought to do. At the same time, when AIG had its first quarter's loss, two or three years ago, and they had to put aside quite a lot of money effectively for mark-to-market, and I think Hank Greenberg [former CEO of AIG] said, "These writedowns are ridiculous. They're totally artificial." Well, $100 billion or so later, it doesn't look so artificial.

I'm prepared to be judged by history. Accounting cannot answer for what people think things ought to be worth, or what the intrinsic value is, or what it will be when this economy picks up. Investors want to know: What's the best approximation today?

Murray: This balance between transparency and dealing with a crisis popped up recently when [Bank of America CEO] Ken Lewis testified that the Treasury told him not to disclose problems with the Merrill Lynch assets, because they were afraid how people would react. When you're trying to balance dealing with the crisis against the demands of transparency, should transparency always win out?

Jones: The crisis was caused by some pretty extreme lending. This is not a crisis brought about by anything other than the banks having gone way beyond any rational measure. First of all, you have to deal with the real cause, not with the symptom, which is the numbers. Second, in the case you mentioned, he must have been in a very difficult situation because a regulator's instructions don't overcome the law. If the law says you have to disclose, and the regulator says you can't disclose, you're between a rock and a hard place. But I don't think you're exempt from the law.

Can you ever trump transparency to protect the system? I don't think you can, because you're already in trouble. Once people know you can cook the books, it's off.

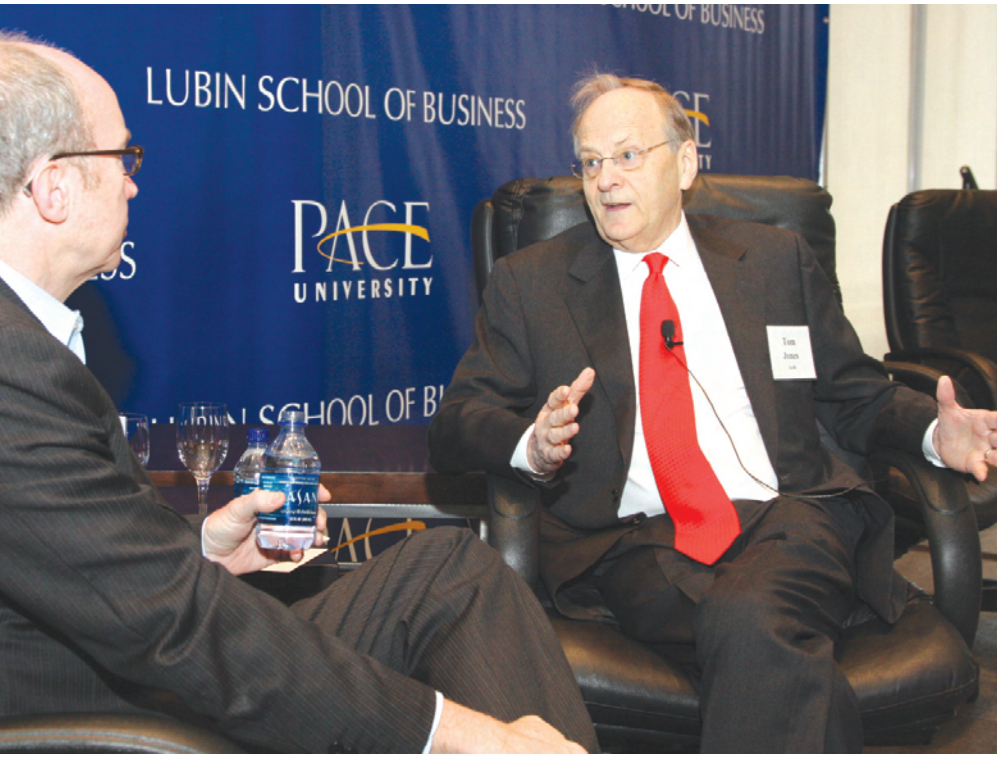
Questions from the Audience

Kaustav Sen, Pace University: Why just have mark-to-market? There have been some papers written by folks from Wharton and Chicago which argue that you should have both cost and mark-to-market. For banking and insurance industries particularly, mark-to-market may lead to a catastrophic effect.

Jones: People are perfectly at liberty to disclose cost as well. I don't believe many investors take much notice of cost when they're looking at a balance sheet, but there's no reason people can't do that.

With regard to the catastrophic results in the banking industry, I think those are the results of reality. I don't think they're the results of accounting. The balance sheet is the balance sheet as of the day you draw it up, and the value is whatever it is. If I'm selling my house, I don't want to know what I paid for it 20 years ago, I want to know what it's worth today—fair value.

The insurance reference is interesting because insurers, in fact, are allowed much more leeway than banks. They have risk margins. If I was a banker, I'd be making the argument that I need a risk margin for credit on a 10-year loan. The difference is that it's visible, it's disclosed, and the risk margin is known.



Murray: A year ago, you said the insurance accounting system is broken. Is it getting any closer to being fixed?

Jones: The quick answer is no, because we haven't issued a standard yet. Until we do, there won't be any common standard in the world. Every country's insurance accounting is different. I think that's already a problem. In addition, insurance accounting is couched in such obscure terms that even an expert accountant who isn't an expert in insurance accounting can't follow it.

There are some very valid questions about insurance, like the one I mentioned. We're going very slowly because we have a status quo; every country is using its own preexisting insurance accounting. It's a very important industry and we certainly don't want to screw it up. That insurance standard is due out in the next 12 months or so, then we'll see.

Deepak Doshi, Anchin Block & Anchin: Why do you think IFRS is going to be the panacea in the U.S.? What about the downside of IFRS, which is that it's based on principles and has a lot of judgment involved?

Jones: What you describe as a downside, I regard as an upside. I think a simpler standard, which is based on a principle, is not only better from the preparer's point of view and the user's point of view, but is also easier to defend in a court of law. A lot of people in the U.S. say, "Well, how can these standards possibly apply in a country as lawyered as the U.S.?" And the answer is, we've been through that transition in other countries. There are other countries with extremely rigorous legal systems, and they've managed quite well. I regard that issue as a strength, not as a weakness.

You asked why would it answer all the issues in the U.S.—I don't think it does. The U.S. has a very long-established, deep set of accounting standards. No one could really say that the U.S. is deficient in accounting. But it is costly, because the standards are so complex and there's so much material that you almost can't encompass the whole thing. You can pick and choose right through the standards. I think that's a huge weakness. The folks who really study this don't believe that our system would give them more freedom or flexibility.

Murray: Are there any areas where U.S. GAAP is better [than IFRS], in your view?

Jones: I've tried to make comparisons. They're so different that it's very hard to even feel you're being honest in terms of better and worse. I see very few differences now. In those last few reconciliations that were done for the SEC by foreign registrants, the differences were becoming very minor. In broad principle, we get to about the same result; the question is how painful is it to get there.

By the way, the real answer is, if there was a standard that was significantly better than ours, we'd use it. If there was any country in the world which had an insurance standard that we said is terrific, we'd use it. We've done that many times. In fact, we stole the financial instrument standard from the U.S. But it wasn't such a good one, so we weren't so happy.

Murray: Are there ever situations where the principles become so hazy that you're better off with a rule?

Jones: If it happens, we'll take care of it. We don't see that now. There was lots of doom and gloom eight years ago about the fact that we said we're not going to have massive amounts of interpretations. If a standard needs interpretation, we change the standard. I think on average, we've only issued two or three interpretations a year. It's very exceptional. I think that's a strength.

Mary-Jo Kranacher,* The CPA Journal*: There have been some concerns with regard to the source of funding for the IASB and how it might affect independence. How would you respond?

Jones: It was possibly a risk once. We've actually switched: Most countries now operate a levy system, which is pretty much what the U.S. does for the FASB. A surprising number of countries, when they realize that our critics were using that as an excuse to attack, switched to a levy system. Many European countries are on a levy system, as with most of the world.

The way we're set up, the trustees deal with funding and the board deals with the technical work. The trustees, they reacted quite aggressively, even though it meant reversing where we'd already made arrangements.

In real life, it's not an issue, but it's still used as an excuse to criticize. Our biggest problem today is that the funding is heavily from Europe and Asia. The U.S. is the only country that isn't using the standards, and yet we have a closer relationship and broader partnership with the FASB than with any other country. And that's very heavily criticized outside the U.S. People are saying, "If we're going to have this forever coming closer but never quite getting there, why are you wasting all this time in the U.S.? Why not serve the countries that use the standards, the rest of the world?"

That's a real problem because there are many people in the U.S. who think that a permanent convergence for the next 10, 15 years is a great idea. It isn't, because the rest of the world won't let us do that. They'll insist that we break away, if it's obvious the U.S. isn't going to be seriously involved.

Rudy Jacob, Pace University: What is so unique about a global standards-setting process to ensure you don't just end up with more detailed rules?

Jones: I've read people's comments who say IASB isn't less detailed, it's just younger. My real answer is, we're absolutely determined not to—we have had eight years of experience showing that we won't do it.

Interpretation is very often required because people are doing things they really shouldn't be doing. We don't interpret, because every time you put in new words, smart people can get around those words. So we just say the answer's in the standard. At one stage, we were pointing out where the answer is, and we don't do that anymore.

I think you've got to assume that we're going to carry on as we have so far, and eight years is already a decent kind of test. The other criticism was the standards weren't tested. But by now, so many countries have moved. We have plenty of critics. One or two countries are clearly in total opposition. But in general, the standards have passed the test. They've held up. ❑