Competition required to reduce standards complexities

Accountancy
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Good financial reports are essential for efficient markets and making directors accountable. But HSBC's recent annual report had 454 pages and weighed three pounds. Who will read that?

Increasing complexity means there is a desperate need for alternative ways to communicate financial information. One way to find them is to introduce competition to accounting standard setting.

The Financial Accounting Standards Board has had a monopoly in writing US accounting rules for 34 years. And in the European Union the International Accounting Standards Board has had a monopoly since its International Financial Reporting Standards came into force across the region in 2005.

Both monopolies are proving problematic. The complexity of the resulting standards has been criticised in the US as well as Europe. Accounting for financial instruments remains particularly controversial. Auditors and companies demand endless "clarifications" of both sets of rules, while bankers devise new schemes to defeat their intent, generating even more rules. The US regime obviously did not prevent, and perhaps even encouraged, the Enron accounting abuses.

Yet in spite of the problems with the monopoly model of standard-setting, the FASB and IASB remain determined to converge their standards instead of compete.

There was no public consultation on the 2002 convergence decision. And legal differences among countries on directors' accountability to shareholders, and on shareholder rights to remove directors from office, raise serious doubts about the feasibility and desirability of achieving a single conceptual framework for global financial reporting.

Some UK investors already question if IFRS 8, a new standard on the way companies report performance by region and product line, is compatible with EU law. More recently the US Securities and Exchange Commission has announced consultation plans on releasing foreign registrants from a requirement to file a reconciliation to US GAAP (a small saving for a small number of big companies) and on allowing US domestic companies to use IFRS.

But under a convergence model, and without competition for royalty revenues from companies choosing their respective standards, the SEC proposal tightens the grip of the monopoly. In the end, the prevailing doctrine will be beyond challenge or correction.

The IASB, which some say has disproportionate North American representation, has adopted the FASB's model of a full-time board that includes individuals with long careers in standard-setting, who are isolated from current accounting practice.

The IASB and FASB have adopted similar structures and processes. They actively co-ordinate activities. This leaves little room for variation, innovation, competition and finding better ways of doing accounting. If we stay on this track, we may soon wish for the days when the financial reports weighed only three pounds.

The introduction of supervised competition could reduce complexity and simplify accounting. The SEC and EU could permit companies to choose from two or more sets of financial reporting standards set by bodies that are independent of each other.

Major accounting firms could be allowed to compete by offering their own respective brands of standards, subject to regulatory approval.

Royalties from companies who choose to use their standards would be the sole source of revenue for the standard-setting organisations.

Competition is the best-known catalyst for efficiency, innovation and keeping things simple. Standard-setters would have to consider the effect of increased complexity and clarifications on its royalty revenue stream. In a monopoly regime, rule-makers cannot learn from the mistakes of others or the consequences of alternatives.

Competition thrives among stock exchanges and credit rating agencies. So why think multiple standards will cause confusion in securities markets? After all, technology makes it relatively easy to convert financial reports from one regime to another.

Regulators and auditors may argue that competition among standards would make their lives too complex. But their role is to serve the needs of business, investors and other stakeholders, not their own convenience.

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