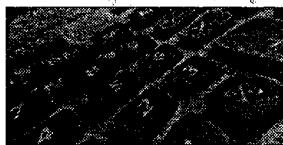


# The headlong rush to global standards

Stella Fearnley and Shyam Sunder suggest a monopoly process may not be most efficient



## THE ACCOUNTANCY COLUMN

Global convergence of accounting standards has been generally accepted by the business community. Proponents claim that written standards improve financial reporting, and convergence will facilitate lower costs of capital and cross-border transactions.

They also claim adoption of International Financial Reporting Standards for listed companies in the European Union is a key step towards both a single European capital market and acceptance by the US Securities and Exchange Commission of IFRS accounts filed by overseas registrants without reconciliation to US Generally Accepted Accounting Principles.

As those preparing and using financial statements in the EU grapple with the realities of the 2005 IFRS conversion, doubts are emerging about the fair value accounting model, the accountability of the International Accounting Standards Board and the strategy to align IASB and US Financial Accounting Standards Board standards. We present arguments that the current course should be reconsidered before the undesirable consequences of these changes emerge.

First, the meaning and the import of accounting numbers depend on the economic environment, including regulatory framework, industry and country where a company

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operates. The equity-based rules for consolidation of businesses in the stock market-driven US economy do not produce meaningful results when applied, for example, to Japanese companies that may be linked to one another through operational relationships.

One-size-fits-all models of financial reporting look good until they are applied in practice, and the differences among the users and uses emerge. The true and fair override is a fundamental aspect of the UK financial reporting framework. Its value, and suitability for global adoption, was highlighted by the recent accounting failures rooted in narrowly defined rules. There are concerns in the UK that its scope could be compromised to gain the supposed benefits of conforming to the IFRS model.

Second, the concept of a company as a competitor in an economic game with the accountant as scorekeeper sets unrealistic expectations of what uniformity in financial reports can deliver. It assumes their complexity can be usefully reduced to a predefined, uniform grid. It pretends that variation is undesirable and must be avoided.

Yet distinguishing one's strategy, products and prices to create local monopolies lies at the heart of managing business. Belief in uniformity has created a costly multilayered industry of interpretation and enforcement. Financial statements must look the same, regardless of the value to users, and regardless of whether the preparer or the user has any interest in the global economic game. Smaller listed companies, trapped in the globalisation-benefits-all myth, are bearing costs that will yield no benefits.

Third, if financial statements are to be useful to non-experts, they must be understandable. Complexity opens the door to misstatements. For example, cash is simple, unambiguous and difficult to manipulate, but financial statements based solely on cash are incomplete. Fair values involve a range of managerial judgments and the inevitable susceptibility to manipulation, making it virtually impossible to combine substance and form.

The supposed relevance of the fair-value model reduces reliability and auditability. How should we value auditors' opinions on the growing number of managers' judgments?

Fourth, a single set of global standards implies no competition. How can we be sure that we have the right model, either for the standards or for the process of setting them, when the door on experimentation with different models is shut? How can we argue that global standards will lower the cost of capital, facilitate cross-border transactions or lead to a single capital market in the EU if we have nothing to compare them with? One leading UK fund manager values the US GAAP reconciliation statements because they highlight the accounting sensitivities. Demise of alternatives will leave an information gap.

Historically, governments established local standard setting monopolies to serve their own legal and economic environments. Standard-setters base their work on analysis, surveys and solicited comments. Since commentators select themselves, and may respond strategically in

their own interests, the consequences of new standards are difficult to assess. A locally grounded process, such as the FASB, is subject to domestic lobbying and is accountable to its government if politically unpalatable solutions are proposed. The IASB serves a wider constituency but has less direct political accountability. It is not obvious that these monopoly processes can jointly or severally deliver an efficient result.

Efficiency could be advanced by making two or more totally independent standard setters compete for fees from companies who choose to report using their standards. Such regulatory competition will enable users to compare the consequences of various alternatives, learn from experimentation and open the possibility of niche standards for specific industries or for companies of varying sizes. Given the recognised benefits of competition among stock exchanges and bond rating agencies, why not have competition in accounting standard setting?

Debate is needed now on alternative models of accounting and standard-setting before the opportunity to benefit from a competitive process is lost for good.

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### FLAWS IN THE SYSTEM

The rush to global standards should be reconsidered for the following reasons:

- The meaning and import of the numbers depend on the economic environment in which a company operates.
- Expectations of what uniformity in financial reports can deliver is unrealistic.
- The move to fair values involves a range of managerial judgments and susceptibility to manipulation.
- A single set of global standards implies no competition and no need or room for experimentation.