Called to account

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Seen from the windows of 30 Cannon Street, in London, where the International Accounting Standards Board (IASB) has its offices, the world looks a wonderful place. In less than five years, the board has won endorsement of its International Financial Reporting Standards (IFRS) by the European Union, Australia, China and many other countries.

Canada, South Korea, Japan and other jurisdictions are also likely to require IFRS from listed companies. And the US is considering IFRS recognition as an alternative to its own Generally Accepted Accounting Principles (GAAP). Is this, then, a tale of unqualified triumph? Not quite. The IASB’s success in promoting IFRS should not mask awesome current challenges. Start with the grumbles of early adopters. Corporate executives and their representative bodies across Europe have expressed dissatisfaction about “abstract” standards.

John Browne, the outgoing chief executive of BP, was quoted by the Financial Times as saying: “What IFRS actually does is make our results more difficult to understand.” Investors are unconvinced, which is a worry, seeing that the standards were tailored specifically for their use. A sense of exasperation was palpable in a recent reaction by investors’ groups. These included the UK’s Investment Management Association and the National Association of Pension Funds, which were both dismayed by the IASB’s rash adoption of a new standard on segment reporting (IFRS 8). Earlier criticism, raised during the consultation phase in 2006, was disregarded. The politicians and public agencies who gave IFRS their legal currency in the EU are hardly more enthusiastic. France fought a battle in 2003-04 against the IAS 39 standard on financial instruments and has been distrustful of the IASB ever since. Senior European Commission officials privately express disappointment about the direction taken by Cannon Street since its governance overhaul in 2001. The European Parliament has been vocal in its criticism of the IASB’s lack of accountability.

The standards’ implementation has raised a separate set of concerns. As every practitioner knows, the content of the standards is only one part, though a crucial one, of the wider accounting framework. Since IFRS is principles-based, leaving considerable scope for company judgment in preparing financial statements, there is a risk that the promise of comparability is not going to be fully kept. If such were the case, a reason for adopting IFRS in the first place would be invalidated. This is true in jurisdictions such as China where enforcement is difficult. But it is also true in the EU. Even though adoption is too recent to produce a clear picture, (an Institute of Chartered Accountants study commissioned by Brussels is due in August), there are signs that IFRS implementation in the Union’s 27 countries is less than homogeneous. The IASB has no powers to enforce consistent implementation. However, its self-given mandate is to promote not only the standards’ use but also their “rigorous application” (IASC Foundation Constitution, Article 2). One tool for this is the International Financial Reporting Interpretations Committee (IFRIC), also a denizen of Cannon Street. But the IFRIC delivers its wisdom slowly and has until now refused to take a stance on most of the questions it has been asked. Therefore, market participants will inevitably look for guidance from other sources of authority.
regarding legal issues. The present arrangements, despite efforts by the Committee of European Securities Regulators, do not pass the test of subsidiarity and may lead to persistent national divergence. Europe should reinforce its ability to ensure consistency of IFRS implementation, possibly by setting up an EU-level accounting agency to guide national regulators’ decisions. But it is also the IASB’s responsibility to monitor local implementation much more than it does today. This is bound to involve costs but is integral to the standard-setting entity’s mandate. On implementation, however, the IASB will always play second fiddle to national (and regional, in the case of the EU) authorities.

On the standard-setting process itself, by contrast, it has primary responsibility. The IASB should ask itself tough questions about its legitimacy as a global setter of accounting standards that have piercing effects on economies that adopt them. All national accounting standard-setters, including the FASB in the US and the UK Accounting Standards Board (ASB), are accountable to their national authorities. But the IASB has no such links. If reform is needed, it can only come from the board itself or from its overseeing foundation, not from governments. Therefore, Cannon Street must take the initiative to strengthen its accountability and legitimacy, which are too limited to ensure continued reliance on them by most of the world’s economy. What form could such an initiative take? Some reforms are easy to implement and should be considered in the short term. One is full financial disclosure: the IASC Foundation is still insufficiently transparent about its funding, including support from accounting firms. Another is a process that would better enable observers to understand what is behind each new standard. It is the IASB’s responsibility to make its debates understandable to the public. In the same spirit, the IASB should make all its standards, interpretations and related information freely available to the public on its website, as does the FASB, while continuing to sell printed copies. The standard-setting entity would also help itself by adopting a proper name as an umbrella for its mosaic of convoluted acronyms such as IASB, IFRIC and IASC.

Other necessary changes are bound to be more controversial. One is the pace and philosophy of convergence between IFRS and GAAP. The IASB’s current focus on endorsement of IFRS by the SEC makes it ready to publish less-than-satisfactory standards modelled on American rules, such as IFRS 8 which replaces the arguably better IAS 14 standard on segment reporting. It also induces it to delay work on long-needed standards, such as on insurance liabilities or the (in)famous “performance reporting” (now known as “financial statement presentation”), the completion of which is integral to the whole IFRS project. The focus on convergence with GAAP tends to validate widespread concern that the IASB, while appropriately independent from EU political pressures, as was illustrated in the battle over IAS 39, is more subservient to US interests. If not combated vigorously, this perception could prove lethal to the whole international standard-setting enterprise, whose premise is that no single political entity, however mighty, can direct the IASB’s decisions.

Last but not least, the IASB should not wait before tackling the lack of ultimate accountability that rests at the core of its legitimacy problem. Despite recent changes, the 22 trustees of the IASC Foundation still form an entirely self-appointed group, which is not answerable to external interested parties. This is not a sustainable governance arrangement. Of course, there is no such thing as a global democratic constituency to whose oversight the IASB could submit itself, in the same way as the FASB is indirectly monitored by Congress. But the IASB knows its stakeholders: users of financial information (first and foremost), preparers of
accounts, auditors, and public agencies such as securities regulators. In order to ensure its long-term survival and the enduring success of its standards, it should organise these constituencies and give them appropriate powers and voice, not of course in the standard-setting process itself but on governance and especially on the appointment of trustees.

As always, funding concerns are bound to be the drivers of change. Financing the IASB is inherently difficult, even though the budgetary requirement remains limited at no more than €30m ($40m) per year in the foreseeable future. The Internet Corporation for Assigned Names and Numbers, which is one of the few global private-sector policy-making entities with which the IASB can be compared, has a natural stream of revenue in fees from internet registrars. Cannon Street has no equivalent resource and is aware that the current framework is untenable. Contributors are mostly large listed companies, which are unlikely to shoulder the burden for long. The big four audit firms are reliable contributors but their IASB budget share is already large and, if anything, should fall to ward off suspicions of influence. Cannon Street is trying to raise funds on a national basis in co-operation with each government and has made progress in several jurisdictions such as the UK and the Netherlands. But this endeavour will stay fraught with difficulty as long as it essentially asks for a free lunch, with no voice in governance given to funders. A more legitimate IASB is indispensable if the advances of the past few years are to become a lasting achievement. To acquire such legitimacy, Cannon Street needs not only good standards but sounder governance.

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