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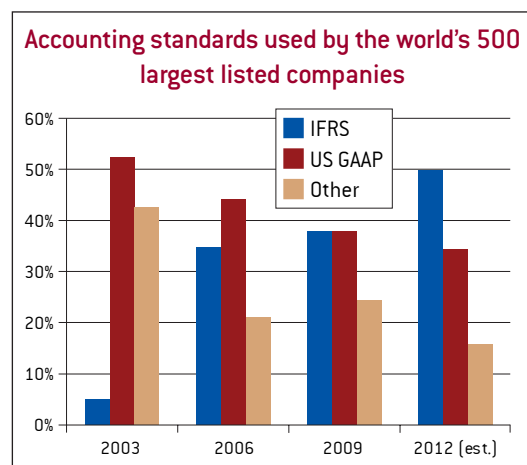
## KEEPING THE PROMISE OF GLOBAL ACCOUNTING STANDARDS

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**THE ISSUE** Accounting provides a fundamental underpinning for capital markets, and the worldwide spread of International Financial Reporting Standards (IFRS) marks one of the most advanced attempts to develop globally consistent financial rules. The financial crisis has generated heated debate on the economic role of fair-value accounting and other IFRS principles. Underlying these controversies are differing views about the mission and governance of accounting standard-setters, and how standards interact with other public policy instruments. Choices are made more difficult by the absence of relevant precedents for the unique institutional features of the global standard-setting organisation, the IFRS Foundation.

### POLICY CHALLENGE

The IFRS's defining promise is cross-border comparability of financial statements, but the aim of global harmonisation will not be fully achieved in the next few years. Given the varying pace and modalities of local IFRS adoption, the IFRS Foundation must focus on standards quality and the integrity of its brand. Standard-setting should serve investors' information



Source: Bruegel, see Figure 1.

needs, leaving other public-policy goals to be met through local assessment by individual jurisdictions. The Foundation's governance and funding framework should become more accountable to the global investor community. Active monitoring of local implementation practices should encourage the gradual convergence of 'IFRS dialects' towards a true single global reporting language.



**ACCOUNTING STANDARDS** are the norms that govern the preparation of financial statements by companies, and as such play a key role in the proper functioning of capital markets. All things being equal, better financial reporting reduces the cost of capital by allowing investors to better assess and compare companies' financial situations and operations, especially for listed companies in which shareholders are dispersed and have no access to inside information. Internationally uniform accounting standards can contribute to a better matching of capital-rich investors and capital-hungry issuers on a global scale, and are therefore an attractive economic proposition.

This explains the emergence and rapid spread of International Financial Reporting Standards (IFRS), the roots of which go back to a 1973 initiative led by Henry Benson, a prominent British accountant. There are currently 38 IFRS standards, intended primarily for use by

issuers of public securities<sup>1</sup>. Since 2001, IFRS have been developed and updated by the International Accounting Standards Board (IASB), a 16-member committee that meets about monthly and is supported by a 110-strong staff based in London. The IASB is appointed and financed by the US-incorporated IFRS Foundation, itself governed by a group of 22 Trustees under a set of rules dubbed its 'Constitution'. In 2009 the Trustees agreed to submit their own appointments to mandatory approval by an ad hoc group of public authorities called the Monitoring Board<sup>2</sup>.

Arguably the most important milestone in IFRS expansion was the European Union's decision in 2000 to require their use by all listed companies by 2005, a decision based on near-total consensus<sup>3</sup>. In its wake, other major jurisdictions have made IFRS or variations thereof either mandatory for replacing pre-existing national accounting standards, or an optional alternative. In

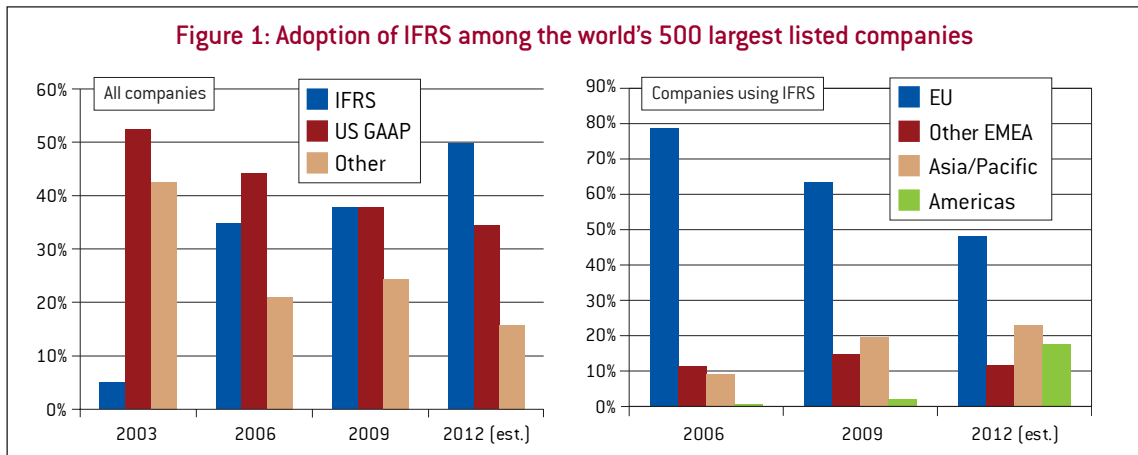
2007, the US Securities and Exchange Commission (SEC) authorised US-listed foreign companies to use IFRS. However, domestic US issuers still have to use the standards set by the US Financial Accounting Standards Board (FASB), known as US GAAP<sup>4</sup>. Figure 1 shows how the IFRS' 'market share' among the world's largest companies has risen rapidly from marginal to dominant, and how the EU has been joined by other jurisdictions that together will soon represent the majority of IFRS issuers.

Accounting standards, like any measurement and disclosure framework, can influence the behaviour of economic actors, even if this is not the standard-setters' intention. This helps explain the occasional intensity of related controversies. Box 1 summarises recent disputes about the fair-value accounting principle, which relies on market prices (or in their absence, valuation models) to determine the book value of some financial assets and liabilities. Moreover,

1. Somewhat confusingly, these are numbered IAS 1 to IAS 41 and IFRS 1 to IFRS 9, as the label was changed from IAS (International Accounting Standard) to IFRS in 2001. Some past standards are no longer in use. To these should be added so-called IFRS interpretations (25 currently in use), which depending on the context can be referred to as part of the collective set known as IFRS. Separately, a standard intended primarily for use by non-listed companies, known as 'IFRS for SMEs', was introduced in 2009.

2. The Monitoring Board includes the chair of the US SEC, the European Commissioner for the Internal Market, the Commissioner of the Japanese Financial Services Agency, and two representatives of the International Organisation of Securities Commissions (IOSCO). Further expansion of its membership is under consideration (Monitoring Board, 2011).

**Figure 1: Adoption of IFRS among the world's 500 largest listed companies**



Source: Bruegel based on FT Global 500 rankings, Datastream. Standards including some variations of pure IFRS, such as in the EU (see page 6), are counted as IFRS in these figures. Estimates for 2012 are based on the 2009 sample of companies, assuming IFRS use in Brazil, Canada, Japan (companies currently using US GAAP), Mexico, and South Korea. EMEA: Europe, Middle East and Africa. The right-hand graph sorts companies by location of operational headquarters.



not all accounting disputes are about fair value. In the US, for example, there were vivid controversies about accounting standards for mergers and acquisitions in the 1950s, leases and conglomerates in the 1960s, oil exploration costs and inflation in the 1970s, pension obligations in the 1980s, and stock options in the 1990s and early 2000s

[Zeff, 2005]. Emissions-trading permits are also likely to give rise to heated discussions<sup>5</sup>.

The economic impact of accounting standards has major implications. Standard-setters are generally accounting professionals by background and see their role as intrinsically technical, namely finding the best

measurement and disclosure principles for financial statements to give investors the information they need. But corporate issuers tend to view them like policymakers, and often attempt to influence them accordingly. Auditors also have special interests in the process, especially in those cases where the wording of the standards may affect their future legal liability. Governments can have multiple and sometimes conflicting public-policy objectives beyond the efficiency of capital allocation, such as using accounting standards to influence corporate behaviour, or leveraging their control over the standard-setting process for their own information needs for tax, regulatory or statistical purposes. There is also the possibility of the occasional capture of governments by private special interests which can be facilitated by the arcane content of some accounting discussions. These diverging perspectives imply that the 'quality' of accounting standards can only be considered in reference to a specific group of stakeholders, rather than in absolute terms. They also explain why the most intractable policy debates about IFRS relate to the governance of the standard-setting process, ie to which stakeholders it effectively gives priority.

The second half of 2011 will be particularly important in shaping the future of IFRS, with:

- Adjustments to be made to the IFRS Foundation's governance,

#### BOX 1: THE FAIR VALUE CONTROVERSY<sup>6</sup>

At the start of the financial crisis in 2007-08, many financial executives called for the suspension of fair-value (also known as mark-to-market) accounting, claiming that the sudden disappearance of liquidity from markets, such as those for US mortgage-based securities, had made market price references for the value of their assets meaningless. At the height of the crisis in October 2008, EU policymakers strong-armed the IASB into hastily amending their IAS 39 standard on financial instruments to allow financial firms to retroactively reclassify assets in order to escape the requirement to mark them to market prices, at a high cost in terms of perception of the IASB's integrity<sup>7</sup>. Separately, in April 2009, the US FASB loosened its standard on financial-asset impairments, and the IASB later adopted a new financial instruments standard (IFRS 9) that redefines the scope of fair-value accounting.

Nonetheless, numerous subsequent studies from public authorities and academics [Escaffre *et al*, 2008; SEC, 2008b; Novoa *et al*, 2009; Coval *et al*, 2009; FCAG, 2009; Huizinga and Laeven, 2009; Laux and Leuz, 2010] concluded against blaming fair-value accounting for accelerating the crisis, as they generally recommended 'prudential filters' in regulatory capital calculations to mitigate the effect of short-term accounting volatility on capital requirements. Dissenters (eg Bezold, 2009; Marteau and Morand, 2009) fail to provide any empirical evidence for their harsh assessment of the fair-value principle. More to the point, the 2007-08 decline in market price of mortgage-based securities and other assets, which financial firms had blamed on 'fire sales', eventually appeared to be justified by fundamentals. The possibility of a bias in financiers' perceptions is illustrated by the point that the leading US advocate of suspending fair-value accounting in early 2008 was Martin Sullivan, then CEO of AIG<sup>8</sup>. Even so, many leaders still view fair-value accounting as a negative factor in the crisis, particularly in Europe (see eg French President Nicolas Sarkozy's speech to the 40th World Economic Forum in Davos, 27 January 2010).

3. The key corresponding legislation, Regulation [EC] No. 1606/2002, was adopted by 492 votes in favour out of 526 by the European Parliament, and unanimously by the Council.

4. Generally Accepted Accounting Principles.

5. The IASB has started discussion on a standard on Emissions Trading Schemes in 2009, currently on hold but expected to restart later in 2011.

6. See also Véron (2008) for a more in-depth analysis of arguments over fair value.

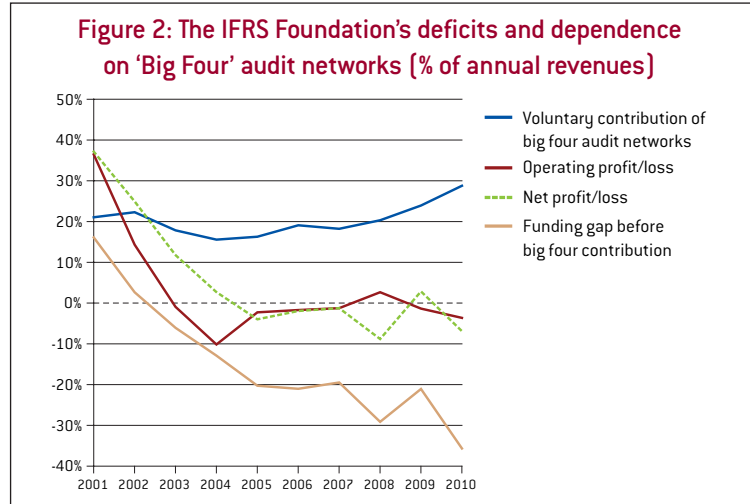
7. The IASB's chairman was widely reported as having come close to resigning on this occasion. See David Jetuah, 'Tweedie nearly quit after fair value change', *Accountancy Age*, 12 November 2008.

8. See Francesco Guererra and Jennifer Hughes, 'AIG urges 'fair value' rethink', *Financial Times*, 14 March 2008.



in the context of a recent gradual loss of trust by key constituencies, including global investors, particularly since the IAS 39 amendment of October 2008 [see Box 1]. The Trustees have published a 'Strategy Review Report' that proposes important parameters for future development (IFRS Foundation, 2011), and the Monitoring Board has launched a parallel public consultation (Monitoring Board, 2011);

- Financial strains and the Foundation's increasing reliance on voluntary funding from the 'Big Four' global accounting networks<sup>9</sup>, as illustrated by Figure 2, which raise concerns about independence and the medium-term viability of the current funding model;
- A commitment by the SEC to decide in 2011 on the adoption of IFRS by the US (SEC, 2008a). Harvey Goldschmid, an influential Trustee, has argued that a negative outcome or further delay "would likely have tragic consequences" (Goldschmid, 2010). Even with a less dramatic assessment, this is potentially as important for IFRS as the EU endorsement decision was a decade ago;
- Major changes of leadership at all levels: the IASB's chairman for its first decade, David Tweedie, was replaced on 1 July by Hans Hoogervorst, a former Dutch finance minister and securities regulator; the Trustees's chair has been vacant since the death of



Source: Bruegel based on IFRS Foundation's Annual Reports (2002-09) and presentation on Financial Position (April 2011, available on [www.ifrs.org](http://www.ifrs.org)).

Tommaso Padoa-Schioppa in late 2010; and the Monitoring Board, initially chaired by Mr Hoogervorst, must also give itself a new head.

#### ACCOUNTABILITY AT THE CORE: A CONSISTENT GOVERNANCE FRAMEWORK

Global organisations tend to fall into one of two main categories. Those in the public sector, such as the United Nations (UN) or the International Monetary Fund, generally have a state-based governance model which holds them accountable to individual governments. Those in the private sector generally have a stateless governance model that involves either accountability to a community of stakeholders not defined by nationality (such as corporations vis-à-vis their shareholders, or global partnerships vis-à-vis their partners), or no formal accountability mechanism other than reputation (as in the case of many charities, NGOs and foundations, which are

essentially self-governed).

The IFRS Foundation started as a self-governed organisation under a stateless governance model, embedded in its Constitution as initially adopted in 2001. However, the Foundation subsequently made two major steps towards a state-based model. First, in 2006 it adopted a new funding strategy based on 'non-voluntary contributions' calculated for each country (and the EU) in proportion to GDP. This now partly implemented scheme makes the Foundation dependent on the support of each relevant government, which has a monopoly on legal coercion to pay. It is thus functionally equivalent to voluntary funding by governments, which gives them significant potential leverage. Second, the 2009 creation of the Monitoring Board, to which the Trustees granted the control of their own selection and reappointments, established this state-based group, composed of representatives of individual

9. Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers.



governments (and the European Commission), as the *de facto* highest governing body of the IFRS Foundation, a major change the consequences of which are gradually unfolding<sup>10</sup>.

Unfortunately, this increasingly state-based model jars with the IFRS Foundation's mandate. The purpose of public financial information is to correct information asymmetries to the benefit of dispersed investors, an aim that has been confirmed by both the Monitoring Board (2009) and the Trustees' Strategy Review Report. This calls for a stateless governance model that would make the IFRS Foundation accountable to the global investor community, as investors do not act on the basis of territoriality, and their interests cannot be properly represented by individual governments – which typically tend to favour the more powerful countervailing interests of corporate issuers – or national securities regulators, which are ultimately accountable to their respective governments. Indeed, in most advanced economies, governments have come to the conclusion that high-quality accounting standards requires an independent standard-setter with dominant input from the private sector<sup>11</sup>. A purely state-based model is bound to gradually transform the IFRS Foundation into an 'accounting UN' which would permanently seek compromises between different understandings of the public interest (including the multifaceted concept of 'financial stability') in different

jurisdictions, and would find it practically impossible to deliver standards that serve investors' information needs properly. The corresponding deterioration of the quality of IFRS may eventually result in the emergence of competing standards preferred by investors, possibly causing a

new episode of fragmentation.

Conversely, the significant economic impact of accounting standards implies that a purely stateless governance model would be unrealistic. Therefore, the IFRS Foundation has to invent an innovative hybrid of

#### BOX 2: A TENTATIVE PROPOSAL FOR INVESTOR REPRESENTATION AT THE TOP OF THE IFRS FOUNDATION

The IFRS Foundation would put in place a global Investor Consultation Network, using internet-based tools to be able to directly consult individuals who are professionally involved in investment activities, with an appropriate process of voluntary registration and checking. This would serve as a sounding board to validate appointments of investor representatives, which would only become effective after a sufficient number of Network members (representing a suitable quorum) have endorsed them. The Trustees would appoint an Investor Representative Selection Committee of, say, 15 individuals who command trust from the global investor community. Following this initial appointment the Committee would renew itself by cooptation, with all initial and subsequent appointments subject to validation by the Investor Consultation Network. The Investor Selection Committee would nominate Investor Representatives to the Monitoring Board (also subject to validation by the Network), whose number would gradually increase and eventually represent the majority of the Board.

Investing entities (such as asset management companies, investment funds, sovereign wealth funds, family offices, etc) would be encouraged to contribute to the IFRS Foundation's financing on a voluntary basis. This voluntary funding scheme would be more sustainable than the one adopted by the IFRS Foundation in the past, as investors' interests are more directly aligned than those of issuers with the IFRS Foundation's mandate. Naturally, such a voluntary funding mechanism, which would take significant time and resources to establish, could only gradually replace the Foundation's current funding model.

The Constitution would be amended to make the Monitoring Board an integral body of the IFRS Foundation, rather than an external group as it is now, and introduce qualified-majority voting rules for Monitoring Board decisions. The Constitution would also make it a condition that Trustees could only be appointed if their past experience gives credence to their commitment to high-quality standards that serve the needs of capital providers.

10. The name of the Monitoring Board is a misnomer, as its powers already go well beyond monitoring and can be expected to further expand in the future (Monitoring Board, 2011) – even though the Memorandum of Understanding between the Trustees and members of the Monitoring Board, that establishes this transfer of power, can theoretically be revoked.

11. For example, in Canada, Japan and the US, public authorities have less direct control over national accounting standard-setters than the Monitoring Board has over IFRS Foundation Trustee appointments.



12. The CFA Institute and the International Corporate Governance Network have a claim to represent global investors, but arguably not sufficient to be formally embedded in the IFRS Foundation's governance framework (note: the author sits on committees in both of these organisations).

13. For more detail, including a proposal for jurisdictions' respective voting power within the Monitoring Board, see the author's responses to recent public consultations (Véron, 2011a and 2011b).

14. Simultaneously, financial regulatory bodies such as the Basel Committee should further develop prudential 'filters' to mitigate the geographical distortions and procyclical impacts that may be induced by their capital and leverage standards if these are too directly based on IFRS accounting.

15. In early October 2010, the last time all three positions were permanently filled, they were all held by Europeans (respectively Hans Hoogervorst, Tommaso Padoa-Schioppa, and David Tweedie).

state-based and stateless models, reflecting its unique global policymaking position in the absence of a global government that could play the same role as governments do in national environments. The scattered nature of the investor community, which has hindered the emergence of organisations that would represent it at global level<sup>12</sup>, represents an additional difficulty, which the Foundation can overcome only by taking a proactive role of 'community organising'. Not enough thought has been given so far to possible corresponding options. Box 2 describes one imperfect, tentative scheme, to which more debate could certainly bring improvements.

Other steps should also be considered to improve the IFRS Foundation's governance, particularly in terms of geographical balance<sup>13</sup>. The Monitoring Board's public-sector membership should be expanded to major emerging economies, and the EU should be represented by the European Securities and Markets Authority (ESMA) rather than the European Commission, as securities regulators are generally best placed among public authorities to understand and support the IFRS Foundation's mission to serve the information needs of investors<sup>14</sup>. The Trustee level should be reinforced by making the Chair of Trustees a full-time position, and by more clearly

separating their secretariat from the IASB's staff. This secretariat could be located in the Americas, and the Monitoring Board's secretariat in Asia, or vice versa. Geographical balance should also be sought among the chairs of the Monitoring Board, the Trustees and the IASB<sup>15</sup>.

*'The IFRS Foundation must invent a hybrid of state-based and stateless models.'*

**ADAPTABILITY ON THE GROUND: ACCOMMODATING THE WORLD'S DIVERSITY**

Full global accounting harmonisation is the promise of IFRS and should remain the long-term goal. But it will not be achieved any time soon. China, India and Russia have made significant steps towards IFRS but appear in no mood to renounce the option of keeping some of their standards different. At the time of writing, the US seems likely to adopt an approach colloquially known as 'condorsement' (blend of convergence and endorsement), under which some US standards would only gradually converge towards their IFRS equivalents, while others would be replaced by IFRS outright (SEC, 2011). Japan is widely expected to cautiously follow the steps taken by the US. Even the EU, in spite of its past pioneering approach to IFRS, has often appeared to disagree with the IASB in recent years and may not endorse all its standards in the future<sup>16</sup>. At least for some

*'The IFRS Foundation needs to organise the investor community.'*

time, there will be several 'IFRS dialects', some close to 'pure IFRS' (all standards as adopted by the IASB), some only remotely comparable.

As discussed in the previous section, IFRS standard-setting should be focused on the information needs of investors, and the IFRS Foundation cannot itself integrate multiple and occasionally divergent views of the public interest around the world. This makes it legitimate that individual jurisdictions should be able to opt to not endorse all IFRS standards, if they believe they have valid public-interest reasons not to. In the EU, Regulation (EC) 1606/2002 states that only standards that 'are conducive to the European public good' should be endorsed. Most other jurisdictions have similar safeguard clauses or can be expected to introduce them. However, this discretion should not be abused. Comparability of financial statements across borders is a global public good that depends on maximum harmonisation of accounting standards<sup>17</sup>.

To avoid a harmful proliferation of IFRS dialects, there should be proper incentives for convergence. First, jurisdictions that choose not to endorse a standard should explain why. Second, if they endorse a standard with modifications, they should not keep its IFRS name – for example, the 'carved-out' version of



IAS 39 in the EU should be given a different, EU-specific, name to avoid confusion. Third, translation into local languages should be subject to stricter control and validation by the IFRS Foundation<sup>18</sup>. Fourth, issuers should be clear about which set of standards they are using, whether ‘pure IFRS’ or the locally endorsed ‘dialect’, and auditors and regulators should not tolerate fuzziness – IOSCO has made efforts in that direction but more needs to be done. Fifth, all jurisdictions should allow the use of ‘pure IFRS’ as an alternative to the local ‘dialect’, and make it compulsory for cross-border listings, possibly with limited ‘reconciliation requirements’ as the US has long required from foreign issuers. The IFRS Foundation cannot impose such practices but could encourage their adoption and monitor compliance, naming and shaming free-riders and thus discouraging companies and countries from claiming adoption of IFRS when they only ‘speak dialect’. More generally the Foundation should produce more detailed jurisdiction-level data on the status of IFRS endorsement and use by various categories of companies, as part of an expanded research capacity (including on the economic effect of IFRS), which the Trustees’ Strategy Review Report rightly calls for.

In the case of the US, the fifth proposal would mean the coexistence of two sets of standards,

with some US companies using pure IFRS, and others using the modified US GAAP under the ‘condorsement’ approach, in other words the US IFRS dialect. Past and present examples including Germany, Japan and Switzerland suggest this would be manageable<sup>19</sup>. Also, the SEC should endorse most IFRS standards early on, and adopt the ‘convergence’ approach only for the handful of really contentious cases. This would create trust and a sense of commitment, and would also encourage constructive approaches in other jurisdictions.

Flexibility will also be needed to determine which companies should report under IFRS, beyond the large listed issuers whose use of IFRS generates most of the benefits in terms of cross-border comparability. At least for some time, local accounting standards could remain in use for non-listed and even possibly smaller listed companies<sup>20</sup>, and for single-entity (as opposed as consolidated) accounts which are embedded in local corporate and tax law and whose shift to IFRS can generate mismatches<sup>21</sup>. Finally, comparability depends crucially on how the standards are implemented and enforced. The Trustees’ Strategy Review Report’s proposal that “the IASB will work with a network of securities regulators, audit regulators, standard-setters and

other stakeholders to identify divergence in practice” is a welcome initiative in this respect. This may not preclude enforcement authorities, such as the SEC, from issuing local guidance on IFRS application, as long as such guidance does not contradict IFRS. This amounts to local ‘accents’ that do not threaten the integrity of the IFRS ‘language’, even though the IASB may gradually amend its standards to reduce corresponding regional differences. In the EU, any guidance should be issued by ESMA, which should also strongly coordinate IFRS enforcement at EU level. Such regional and global efforts are necessary complements to standards harmonisation in order to maximise the economic value of IFRS adoption.

The vision of full global harmonisation of financial reporting appears increasingly ambitious as the world gradually discovers the ramifications of IFRS adoption. Its ultimate success is not guaranteed. But the prize, a globally unified accounting language that can contribute to reducing the cost of capital across the world, remains well worth the effort. With the right combination of clarity of purpose, institutional creativity, and flexibility on the ground, the IFRS promise can be brought ever closer to fulfillment.

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*‘For some time, there will be “IFRS dialects” alongside “pure IFRS”.’*

*“Pure IFRS” should be allowed as an option everywhere.’*

16. There is already one case of such divergence, as the EU ‘carved out’ (deleted) part of the IAS 39 standard on financial instruments when endorsing it in 2004.

17. As numerous studies have established, harmonisation of accounting standards is not a sufficient condition for cross-border financial reporting comparability, which also depends on cultural and institutional factors including audit quality and public enforcement. But it is a necessary condition nevertheless.

18. For example, the French translation of IFRS used in Canada has been validated by the IASB, but the translation that has binding status in France is a different version produced by the EU’s translators.

19. A similar proposal is made in Laux (2011).

20. See Kevin Reed, ‘Allow small listed firms to duck IFRS’, *Accountancy Age*, 18 May 2011.

21. See Rose Orlik, ‘IFRS critics see momentum gathering’, *Accountancy Age*, 9 June 2011.



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