



Sustainability in global financial reporting and innovation in institutions

Sustainability in
global financial
reporting

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Elizabeth A. Gordon

Fox School of Business, Temple University, Philadelphia, Pennsylvania, USA

Abstract

Purpose – The aim of this paper is to document the author’s keynote address in Accounting at the 16th Annual Conference on Pacific Basin Finance, Economics, Accounting and Management “Innovation for a Sustainable Future: Visions for 2020”, July 3-4, 2008, Brisbane, Australia.

Design/methodology/approach – In keeping with the theme of the Conference, the paper considers two areas – global accounting and financial reporting, and regulation and institutions.

Findings – As business has become more global and financial markets have developed world-wide, comparable accounting and financial information across countries and companies is a logical step to continue to support and advance business. With this shift, though, the world moves towards a monopoly in accounting standards and standard setting.

Practical implications – The potential costs, problems, and possible solutions need to be considered. Current regulatory environments and institutions offer limited ability to effectively monitor such a monopoly. So innovation must occur.

Originality/value – The paper shows that an infrastructure to support global investor protection and convergence of investor protections and rights can offer such innovation to support and sustain global business.

Keywords Financial reporting, Accounting, Standards

Paper type Viewpoint

Introduction

In keeping with the theme of the Conference, I focus on “Innovation for a Sustainable Future: Visions for 2020.” As we look at where we are in the accounting world today and consider the vision for the future, two themes naturally occur to me – global accounting and financial reporting, and regulation and institutions. In my view, these two are fundamentally intertwined as I explain.

Move to IFRS

Recently, most of the world has passed the point of debating whether or not there should a move to one set of standards and one standards setter. The decision has been made – no more need to debate. Over 100 countries have or have committed to adopting International Financial Reporting Standards (IFRS), among them Australia. In these countries, the benefits of one set of global accounting standards have been determined to outweigh the costs. I have gathered benefits and challenges (or costs) from various sources and lists as follows:

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(1) *Benefits:*

- better financial information for shareholders;
- better financial information regulators;
- enhanced comparability;
- improved transparency of results;
- increased ability to secure cross-border listing;
- better management of global operations; and
- decreased cost of capital.

(2) *Challenges:*

- initial adoption implementation;
- initial adoption costs;
- acceptance;
- training;
- suitability for small and private companies; and
- IT functions.

The costs are primarily short-term: the one-time costs of change. The benefits are lasting.

As we look forward 12 years to 2020, we can also see how far the move to IFRS has come in the last 12 or so years. In 1995, the (then named) International Accounting Standards Committee (IASC) made an agreement with the International Organization of Securities Commissions (IOSCO) to complete the core standards by 1999. On successful completion, IOSCO would consider endorsing IASs for cross-border offerings. A year later, the core standards program accelerated: target 1998. The IOSCO endorsement was received in the year 2000. Many countries and jurisdiction have permitted or required IFRS too.

In some countries, the decision was a matter of the cost of supporting accounting standard setting and efficiencies gained by outsourcing this function. For developing countries with fewer public companies, smaller capital markets, and fewer accountants and auditors, the benefits of this approach outweigh the costs.

In others areas and regions like the European Union (EU), efficiencies gained by reducing information costs through having a common set of accounting standards outweighed the costs. The EU had an organization in place to promote economic development and growth. It wrote common laws and regulations, moved to a common currency, and common accounting standards.

In other countries, it was the decision to adopt the world standard. Again, the benefit of reducing information costs though providing comparable information outweighed the costs to changing standards.

Some will say that the world has moved quickly. Others might say it has been 35 years since the IASC was formed. I worked in the federal government in the USA, audited federal government agencies and departments in Washington DC, where I often saw the slow, bureaucratic pace of change. Even if it has taken 35 years, I am surprised at how quickly the world has made this move. And not mildly surprised. This pace of change has demanded an extreme amount of co-operation and co-ordination.

While many countries have already moved to IFRS, in others the decision has not yet come. I am most familiar with the USA. In the USA, we have not yet lived the transition to IFRS like many of you have. So where is the USA?

The USA and IFRS

The USA is not there yet but the Financial Accounting Standards Board (FASB) and Securities and Exchange Commission (SEC) have committed to one set of high-quality accounting standards and convergence. Not so long ago, a common view was the one set of high-quality standards would be US GAAP and convergence would be towards US GAAP. This view has changed. The Enron debacle, other scandals, the Sarbanes-Oxley Act of 2002 all pushed the USA towards IFRS. Still, even today, about 45 percent of companies in the world (by market capitalization) use US GAAP.

The IFRS and FASB

With the Norwalk agreement of 2002, the FASB and International Accounting Standards Board (IASB) have committed to convergence. The aim of both is a commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. The two standard-setters are working in many areas, including joint projects being conducted, short-term convergence project, liaisons and monitoring of projects, and explicit consideration of convergence potential agenda decisions. They have worked together on improved standards on inventory, nonmonetary transactions, share-based payments, segment reporting, and the use of a fair value option to simplify financial instrument accounting. Recently, new standards on business combinations were jointly issued by both standard setters.

On June 16, 2008, the Financial Accounting Foundation and FASB hosted the forum High-Quality Global Accounting Standards: Issues and Implications for U.S. Financial Reporting, seeking input from various constituencies (www.fasb.org/forms/Convergence_forum.shtml). The forum is an initial step toward the creation of a national transition plan to IFRS in the USA.

IFRS and SEC

The ultimate decision of whether US companies will be allowed to use IFRS rests with the SEC. Very recently, we have seen much more discussion and decisions made that move the USA in this direction. Last November, the SEC discontinued the requirement to reconcile net income and shareholders equity to US GAAP for IFRS reporters (foreign private issuers). The decision to discontinue the reconciliation has been years in coming. In 1997, Arthur Levitt the (then) Chairman of the SEC gave his speech titled The Importance of High Quality Accounting Standards (www.sec.gov/news/speech/speecharchive/1997/spch176.txt). More recently, the SEC issued its 2005 Roadmap committing to make a decision by 2009, noting it could be before then (www.sec.gov/news/speech/spch040605dtn.htm).

In Levitt's 1997 speech, he laid out three key objectives for international standards to gain acceptance:

- (1) The standards should include a core set of accounting pronouncements that constitute a comprehensive, generally accepted basis of accounting.

- (2) The standards must be of “high quality” – they must result in comparability and transparency and they must provide for full disclosure.
- (3) The standards must be rigorously interpreted and applied.

When the decision was made, it was made quickly and in effect almost immediately. While the SEC stated reconciliations would not be required after March 2008, it later allowed earlier January filers not to include the reconciliation.

In August 2007, the SEC also issued a Concept Release, “Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards,” soliciting response on 35 questions on the possible use of IFRS by US public companies, effectiveness and effects of convergence, views of investors and other market participants, implementation matters for auditors and educators, views of and issues foreseen by companies, views of and issues foreseen by auditors, regulation and integrations with current rules and processes, and transition and timing (www.sec.gov/rules/concept/2007/33-8831.pdf). In December 2007, the SEC held two days of public roundtables regarding whether US issuers should be allowed to use IFRS (www.sec.gov/spotlight/ifrsroadmap/ifrsround121707-agenda.htm). Whether and how the USA will allow IFRS is still open.

As the world moves to IFRS, the USA could be considered a hold out. A lone country standing, going its own direction. In this the USA, though, has been performing a valuable function. The USA is a viable competitor in providing the competition in standard setting. The adoption of IFRS by the USA would move us to a monopoly in accounting standards and standard setting; the costs of a monopoly need to be considered also.

Competition versus monopoly in standards and standard setting

With a USA move towards IFRS, we will move from competition in standards and standard setting towards a monopoly. Such a move raises many questions: are accounting standards and standard setting where we expect or want a monopoly? Do common problems (and costs) of a monopoly apply? Do the common solutions apply?

Is standard setting where we expect or want a monopoly?

The case is being made that one world-wide set of accounting standards and one standard setting process offers the desired benefits at lower costs than many standards and standard setting bodies. These benefits we have mentioned. In deciding that, these benefits outweigh the costs, we are deciding that a monopoly in both standard setting and standards is desirable.

Some would say that this is a natural evolution. As business has become more global, as companies operate across borders, as financial markets have developed and grown world-wide, comparable information across countries and companies is a logical step to continue to support and advance global business. One set of accounting standards to be used for global investing and financing decisions, global M&A, managing worldwide operations. A common set of standards, increases comparability, improves transparency and decreases cost of capital.

Some critics assert that IFRS do not meet the unique needs of each country, align with institutions, or reflect history. IFRS is laid over a structure and set of institutions developed by each country to meet its needs. There is a mismatch – the right pieces are not put together. However, the objectives of the IASB are clear. And, adoption by

country, jurisdiction or market is voluntary. The IASB is not forcing any country or jurisdiction, or market. The IASB is seemingly devoid of national ties and removed from political influences. But, it does espouse an economic perspective, one that most countries are moving towards.

One set of accounting standards and one standard setter is not, though, a natural monopoly in the sense that there are economies of scale in production like a utility. The monopoly is being created in a normative decision-making process where competition in standards and standard setting is prohibited.

Do the common monopoly problems apply?

With standards and standard setting we do not have a clear analogy to some common problems of monopolistic profits, like where monopolists charge a higher price than marginal cost leading to distortions in the economy. What is much clearer is that we will not have the benefits or discipline of competition. Without correction by market forces or even the possibility of correction, the foreseen benefits of one set of high-quality global accounting standards could disappear before they even materialize.

The concern of a monopoly – no competition – is where we see the intersection with regulation and study of institutions. One solution to a monopoly is regulation.

Numerous national regulators and standard setters have voluntarily given the power to the IASB to set standards. They have no effective control over the IASB and even limited input. The IASB is self-regulated. If the national regulators and standard setters are not in agreement with the standard setting process or standards, they have few choices. They can threaten to stop using IFRS in hopes of the acquiring some desired outcome or concession in standard setting process. They can totally opt out of the standards and create their own; then we are back to domestic GAAPs. They can allow divergences or differences from the standards; then countries are not following full IFRS. Each of these is costly; costly to companies, to investors, to markets[1].

The “if national regulators and standard setters are not in agreement” is not such a big “if” or big stretch. We have already seen the IFRS being tested: with improving the standards, with improving the structure, and with standards being applied as issued. We can foresee the time when even more pressure is put on the IASB.

We are in a difficult spot. The progress we have made moving towards one global set of accounting standards could have only been made free from national ties and politics. As we move towards a monopoly though, we have no mechanism to discipline the monopolist. There is a need for innovation.

Before discussing needed innovation, I would like to next move to the standard setters and standards, and then other forces.

The standards setters and standards

Over the last 12 years or so, we have seen major changes in the international standard setting organization – from the IASC to the IASB in 2001. The IASB has distinct advantages; a relatively small board, full-time members, memberships from throughout the world, a structure of accountability with the IASC Foundation and trustees, the ability to be responsive with the International Financial Reporting Interpretations Committee and Standards Advisory Council, and its open processes.

The IASB has conducted “business” in a more objective and neutral manner than standard setting had been done previously in some countries. Still, some areas need improvement:

- *Funding* – the need for adequate, reliable, and sustainable sources of funding.
- *Interpretations* – the need to be responsive to issues raised.
- *Implementation* – the need for further guidance and examples.
- Free access to pronouncements/literature for companies, auditors, and educators.

The standards themselves have dramatically improved over the last 12 years or so. The core standards project was the beginning. The IASB has continued with the commitment, based on their first objective:

[...] to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world’s capital markets and other users make economic decisions.

When we compare IFRS to US GAAP, there are still differences. Some are areas that IFRS have not been addressed. Some are problems with US GAAP, others are where the method that best matches underlying economics is just not known and a decision could have been made either way.

If the issues mentioned above are addressed, the IASB’s structure and processes are in a sound position to move forward. In moving forward, being innovative and sustainable, it needs to continue to be responsive in addressing issues raised and concerns of companies, users, investors and analysts, national regulators, national standard setting bodies over process and standards.

We see some evidence of this in the recent roundtable on Constitution Review, organized by the International Accounting Standards Committee Foundation (IASCF), which included discussion of the creation of an IASCF Monitoring Group composed of public authorities (www.iasplus.com/pressrel/0802iascfconstreview.pdf). The IASCF Monitoring Group should provide for organized interaction between authorities like the SEC and IOSCO. This is improved oversight but still not regulation with teeth.

Infrastructure to support investor protection globally

Beyond a well-structured and responsive global standard setter for one global set of high-quality, understandable and enforceable global accounting standards to be sustained, is an adequate infrastructure to support investor protection globally. This will help provide a check on the monopoly, and needed enforcement. We already see certain elements of the infrastructure in place. They may need to be shored up. Others will be innovations.

Auditors are at the front-line of investor protection. They provide the needed assurance that financial statements are prepared in accordance with accounting principles, whatever principles they are. There are concerns about the rigor and comprehensiveness of global auditing standards; concerns about whether global accounting firms truly audit the same throughout the world.

National regulators and stock exchanges in many countries and jurisdictions are the enforcers, ensuring that IFRSs are applied and interpreted consistently. In many places they are the effective enforcers. In others they are not. Unless IFRSs are applied and interpreted consistently across companies and countries, a single global accounting standard will not be achieved.

In considering the infrastructure, other information intermediaries will continue to consider other forces that will still act as checks on the system. Institutional investors, analysts, bond rating agencies, and other capital market participants will continue to perform their important functions of financial and information intermediaries. In fact, with common accounting standards, they may become more effective.

Clearly, we are moving towards convergence of accounting standards so investors worldwide can read comparable financial statements and use them to make better investment and financing decisions. Creditors can use them to make better lending decisions. We can read the financial statements, understand them, compare them, and make decisions based on them. But investors and creditors do not have the same rights or protections. The next step to sustain global business is convergence in investor protections and rights.

With differences in legal systems and institutions, this will be more challenging. Convergence in accounting standards may seem like a “piece of cake” compared with this next step.

How can convergence in investor (and creditor) protection and rights be achieved? Changes in laws and regulations? Changes in legal systems? Changes in stock exchange regulation (enforcements)? A super national legal body? Perhaps, an international business court system for companies, where both accounting standards and shareholder rights can be tried? Each investor (and creditor) would have a voice, regardless of where they are or where the company is. They could raise an issue, lodge a complaint, have it heard, and decided on. I do not have the answers. But, innovation will occur.

Side note: innovation in other laws and regulations

One set of principles-based accounting standards will highlight differences in rules and regulations across countries. Think of different consumer protection laws across countries or heavily regulated industries. A principles-based set of standards should report substance over form. Legal restrictions and requirements though, can drive the substance. Having numerous countries reporting under one accounting standard helps to identify some of the differences and could give rise to convergence in other laws and regulations.

Final note: where’s the biggest innovation?

Companies will be the biggest innovators. All faced with reporting under the same set of standards, companies will be able to further distinguish themselves through their voluntary disclosures, investor relations, and corporate governance choices. They will be able to go beyond those IFRS and national requirements. With the content, transparency, timing, tone, and frequency of other disclosure channels, like press releases and web sites, they can provide additional and supplemental information or present it in different ways. The governance choices they make also solidify commitment to stakeholders.

Conclusion

Skipping politics, the words of the USA's former Secretary of Defense Donald Rumsfeld come to mind at times:

The Unknown

As we know,
There are known knowns.
There are things we know we know.
We also know
There are known unknowns.
That is to say
We know there are some things
We do not know.
But there are also unknown unknowns,
The ones we don't know
We don't know
(February 12, 2002, Department of Defense news briefing).

So, what do we know about where we are and where we are going with global accounting and financial reporting, and regulation and institutions?

(1) Know:

- moving to IFRS;
- one standards setter;
- one set of standards; and
- no competition.

(2) Unknown:

- regulatory environment and institutions strong enough, agile enough; and
- legal rights and protections of shareholders and creditors support global business.

But, as we know in Philadelphia, through hard work, fair play, and good collaboration with our global colleagues we cannot just pursue the knowns and unknowns, we also can chalk up a few wins along the way.

Note

1. Of course, many of them had monopolies in their home markets before, but those monopolies were checked through other legal and regulatory arrangements.

Corresponding author

Elizabeth A. Gordon can be contacted at: egordon@temple.edu

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