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ACCOUNTING

The future of accounting principles

BY PAULINE RENAUD

The events of the last few months have shed light on accounting principles and the role they might have played in prolonging the current market turmoil. Fair value accounting, in particular, has been accused, by some professionals and officials, of being at least partly responsible for the current financial troubles. Furthermore, the increase in cross-border transactions is highlighting the differences in regional accounting practices and the problems such disparity can create. As a result, a number of experts are calling for International Financial Reporting Standards (IFRS) to replace all other existing practices, including US Generally Accepted Accounting Principles (US GAAP). But issues of enforcement and efficiency are a matter of concern for most analysts. Events in global markets could mean that 2009 will be a critical year for accounting principles.

Fair value and the financial crisis

Following the downfall of Lehman Brothers in 2008 and its ripple effect on financial institutions worldwide, many began to investigate the reasons behind what has been an extensive crisis. Subsequently, some officials and analysts have laid the blame on fair value accounting, also known as mark-to-market accounting, for crushing market confidence. They believed that if companies had been allowed to report financial assets at higher values than the then current market ones, confidence would have returned to the markets and banks would have started lending again. However, this may overstate the power of fair value accounting.

Indeed, most experts agree that this valuing system revealed the crisis much earlier than other measurements would have, but was definitely not the cause of the current difficulties. "Blaming fair value accounting for the financial crisis is akin to blaming your report card for the fact that you couldn't graduate," asserts Steve Henning, a partner at Marks Paneth & Shron. "Fair value accounting simply provided investors with more current and relevant information, enabling them to make well-informed decisions on how to allocate their capital. The trouble is more attributable to bad lending and investment decisions than to the accounting rules that made poor asset quality more transparent."

Consequently, several experts have called for an investigation into the real underlying reasons for the turmoil, rather than blaming accounting standards. D.J. Gannon, a partner at Deloitte, is one of them. "The challenges facing policy makers and standard setters in dealing with the fast-moving developments in financial markets are significant. Policy makers should undertake a constructive review of the root causes of the credit crisis. Understanding the root causes will help in determining any necessary reforms, including those that go beyond accounting and financial reporting," he explains.

In general terms, asset values saw widespread declines because investors across the globe were confronted with unexpected losses, and swiftly moved to withdraw their money to save further losses. As such, some analysts argue that fair value accounting provided investors with higher visibility and more current, relevant information, helping them to make better decisions. This is why, despite recent criticism, it is believed that fair value is here to stay. The accounting standard even received support from the US Securities and Exchange Commission (SEC), with a recent report concluding that, "Fair value accounting did not appear to play a meaningful role in the bank failures that occurred in 2008. Instead, the report [an SEC review of fair value accounting] indicated that bank failures in the US appeared to be the result of growing probable credit losses, concerns about asset quality, and in certain cases, eroding of lenders' and investors' confidence."

Some experts even predict there might be an increase in use of fair value. "If anything, I think we're more likely to see the expansion of mark-to-market accounting rather than its contraction," notes Scott Ehrlich, managing director of Mind the GAAP, LLC. "If all financial assets were marked-to-market, companies would not need to perform 'other than temporary impairment' tests under GAAP or look for loss events under IFRS – areas that are giving preparers fits at the moment." He adds, "I do acknowledge that if we increase the use of fair value accounting, the income statement would have to clearly separate mark-to-market adjustments from realised gains and losses. But standard setters are already working on this issue." Other benefits of mark-to-market accounting include the greater transparency and accuracy it provides. In addition, some analysts believe that a change in fair value could have a negative impact on investor confidence and increase market volatility. Indeed, Yan Zhang, a director at Eisner LLP, believes fair value is easily the most competent accounting standard. "I think the concept of mark-to-market accounting is the

only correct answer. Any changes should only be made in terms of providing practical guidance and benchmarks to aid valuing the hard-to-value securities," she recommends.

US GAAP vs. IFRS

However, alternative methods, such as historical cost or mixed-model, can be preferable to fair value in certain cases. Both IFRS and US GAAP will occasionally require the use of mixed models, depending on the type of assets involved. "Not all amounts on a balance sheet should necessarily be at fair value. A mixed attribution model may make sense, whereby certain longer-term items used in the normal course of business are reported at cost, depreciated cost or at an impaired value, thus matching cost with future benefits to the business," explains Richard Stokes, a co-founder of GAAP Seminars. Yet, he maintains that fair value is suitable in most situations. "Mark-to-market is by no means perfect, and it clearly is more difficult to apply in illiquid markets, but it gets as close to reality as possible, even though reality is sometimes difficult to face," he says.

With regard to the main accounting standards, the reality is that things may be changing. The financial crisis may have raised questions about fair value accounting, but it has also thrown the shortcomings of US GAAP and IFRS into sharp relief. Furthermore, the increase in cross-border M&A during the last few years had also begun to highlight those same shortcomings. Take US GAAP, for example. These principles were introduced following the stock market crash of 1929, and are a combination of authoritative standards and commonly accepted ways of recording and reporting accounting information. "GAAP is seen by most accountants worldwide as a more rules-based framework, aimed at prescribing a specific accounting treatment for every economic situation. While US GAAP contains general principles, it also provides volumes of specific rules and bright-line tests, much of which comes from volumes of implementation guidance," explains Mr Henning. Because it provides detailed guidance, covering many industries and different transaction types, investors have a certain level of consistency in the financial statements they use when analysing companies. However, the level of detail and the specifically US context can make it difficult to apply. Mr Henning continues that "while a rules-based framework may work well in a static business environment, it is less flexible and less transparent in a dynamic business environment."

IFRS, on the other hand, leaves some space for judgement by providing fewer specific standards. Adopted by the International Accounting Standards Board (IASB) increasingly in collaboration with the Financial Accounting Standards Board (FASB), these standards and interpretations are accepted as comprehensive by many professionals, if rather condensed. Also, in contrast to US GAAP, IFRS standards are specifically designed for worldwide financial markets. "IFRS are better suited to be the global set of accounting standards," says Mr Stokes. "They have been developed over the past few years, based on a framework of principles to be applied globally across industries, using judgement of how to account for transactions faithfully rather than setting specific rules for particular transactions." Consequently, IFRS are said, unlike US GAAP, to reflect the economic substance of transactions that may be unique to certain industries.

Despite its many positive elements, some people argue that a principles-based system might lead to irregularities exactly because of a greater reliance on personal judgement. It is also believed that IFRS is weaker than US GAAP in certain areas, such as lease accounting, principles of revenue recognition and accounting for the insurance industry. Drawbacks aside, there are more and more calls to establish a global standard based on IFRS, largely due to the fact that the globalisation of capital markets is making it increasingly difficult to work with separate standards. "There will soon be a set of accounting standards used by all the world's major economies, with the pace of adoption rising in the next three or four years. The global economy will simply not countenance anything less, as significant differences in accounting standards unnecessarily increase the cost of doing business around the world and add irrelevant cost and confusion," analyses Mr Stokes. With a single set of rules, experts hope that quality and transparency will be enhanced, thereby restoring and reinforcing investor confidence.

Achieving a global standard

While a new global standard could be created from scratch, IFRS are already in use in many regions of the world, including the European Union, Australia and Russia. In total, more than 100 countries permit IFRS reporting and 85 of them require IFRS reporting for all domestically listed companies. Furthermore, several emerging economies are expected to adopt IFRS in the coming years. Clearly, it is well on the way to becoming the sole accounting framework, and is fast gaining political support. "The notion of a single set of global accounting and financial reporting standards has been debated for many years," recalls Mr Gannon. "They're now becoming a reality. The leaders of the G-20 countries recently noted 'key global accounting standards bodies should work intensively toward the objective of creating a single high-quality global standard'."

To this end, the SEC issued a 'road map' that could allow IFRS to be introduced to volunteer companies in the US as early as 2009. "Consistent application of international accounting standards will help the two-thirds of US investors who own foreign securities to understand and draw better comparisons among investment options than they could with a multiplicity of national accounting standards," says Christopher Cox, the former SEC chairman. Ms Zhang agrees, asserting that it will vastly simplify the entire process. "Having a single accounting standard will definitely ease the burden of practitioners and users of financial statements in terms of having one less set of standards to comprehend. It will enhance comparability for recurring transactions that involve less judgement. Given the globalisation of trade, it is imperative that business around the world speaks one language," she says.

However, the new SEC chairwoman Mary Shapiro recently indicated that she "won't feel bound" by the IFRS roadmap, citing the costs associated with switching rules. This has been interpreted as a warning that the move towards international accounting standards might be slowed down. Other hurdles could also make the implementation of IFRS more complex or just slower, starting with national differences that may persist and the fact that countries might want to add their own 'flavour' to the general principles. "The most significant IFRS application issue is a cultural one," notes Mr Gannon. "In the US, we are used to dealing with specific requirements in standards and practice that oftentimes involves arbitrary bright-lines. With IFRS, companies, auditors, and regulators will need to adapt to a financial reporting framework that requires less reliance on details and bright-line tests. The challenge is to ensure that while different outcomes may exist in the ▸▸

application of IFRS, such outcomes are within the context of one's view of the underlying economics of the transaction, and are transparent in the financial statements," he adds.

Nonetheless, IFRS leaves a lot of room for interpretation, and this could, in some cases, affect comparability. "While IFRS contains robust accounting principles, there is relatively little guidance on how to apply those principles in practice. It is therefore inevitable that companies will account for similar transactions in different ways – not intentionally, but simply because IFRS allows more judgement than GAAP," explains Mr Ehrlich. Comparability could even be affected within a single jurisdiction. Local, privately held companies might not want to adopt global accounting standards designed to be more relevant to international companies. As a result, public and private companies might end up being less easily comparable than they were in the past.

In addition, the adoption of a single set of accounting standards would force some companies into completely overhauling their procedures – a difficult and expensive process for many. Ms Zhang lists a number of potential problems. "Anything that has to do with national sovereignty rights, long-established industry practices or special interest groups will be difficult to reconcile by the accounting standard setters. Inventory costing methods and related income tax implications, for example, can be an area that generates a lot of heated debate for manufacturers who have been using the last-in-first-out (LIFO) method for their income tax returns in the US for decades. The energy and natural resource industry is another example where all information and data gathering processes and systems have been evolved around GAAP," she adds.

Regulators may be avoiding areas that are widely thought to be among the most difficult to reconcile. "GAAP and IFRS have different models for testing long-lived assets – such as property, intangibles, and goodwill – for impairment," according to Mr Ehrlich. "The boards previously tried to reconcile their respective models, but to no avail. I suspect this will be one of the last areas the boards try to converge. Both boards seem to think that their own impairment model is better than the other's, and neither board has given any indication that it will budge from its respective position."

Therefore, to avoid unnecessary complexity and confusion, harmonisation between IFRS and other accounting standards should be prolonged, before switching to a new set of rules on a specific date. Companies, investors and shareholders would then have the time to adapt to a single set in a smooth manner. But for this to be achievable, the process needs a shift in mindset across the board. Also, most experts seem to agree that implementing a single global standard cannot be achieved without a single enforcement body. But for the moment, there is no global regulator instance that ensures that IFRS are interpreted and enforced in a uniform fashion. "While IFRS may help us get closer to a single accounting standard, a true global accounting standard will not exist as long as the enforcement agencies are country-specific, such as the SEC in the United States," explains Mr Henning. "Enforcement agencies may interpret accounting rules for their particular jurisdiction or even disallow or carve out certain accounting options available in a standard," he adds.

The SEC, in its November road map, stated that by 2014 all US companies could be using international rules to file their financial statements. But the Commission also said that it will only decide in 2011 whether to stick to that timetable. Furthermore, the various criticisms of specific accounting requirements and the numerous obstacles faced in implementing a single set of standards are likely to slow down the process. However, it cannot be postponed forever. The process will be long and arduous; but the increase in worldwide M&A, coupled with the financial crisis has intensified the market's need for an efficient, global set of accounting standards, and it is no longer acceptable to cling to tradition in the face of that need. ■

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Mind the GAAP provides training and consulting services on the application of U.S. generally accepted accounting principles ("U.S. GAAP"), Securities and Exchange Commission ("SEC") regulations and International Financial Reporting Standards ("IFRS").

Scott A. Ehrlich is the founder and Managing Director of Mind the GAAP, LLC. Scott oversees the company's day to day operations, but his primary responsibility is serving clients. Scott personally leads every engagement, and enjoys sharing his technical expertise and passion for training. Scott has designed, developed, and delivered hundreds of customized training courses for Mind the GAAP clients, and has presented to groups ranging in size from three to 300. Scott also provides consulting and advisory services to entities ranging from Fortune 50 companies to regional accounting firms.

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