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Article

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NATIONAL ACCOUNTING RULES IN A GLOBALISED WORLD

PRO: AN ALTERNATIVE TO A SINGLE SET OF ACCOUNTING STANDARDS FOR THE WORLD

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The corporate accounting scandals in the United States during 2002 have strengthened calls from around the world for having a single set of accounting standards. Current Generally Accepted Accounting Principles (GAAP) in the United States, it is claimed, have been a major part of the problem. The reason: because the principles are so detailed, they virtually invite clever accountants and attorneys to skirt the intent of the rules by carefully circumventing their precise contours. One widely discussed solution is for the United States to follow the many other countries that have embraced or, like the European Union are about to adopt, International Accounting Standards, which are written in broad principles instead.

There is a case for having a single set of accounting standards – as shortly argued – but it does not and should not rest on the recent accounting failures in the United States. In virtually all of the highly publicized cases – Enron, Worldcom, Xerox, and AOL/Time Warner, to name a few – the problems (alleged or documented) grow out of the failure to enforce U.S. GAAP, specifically rules on revenue and expense recognition, and not out of some flaw in GAAP itself. The one apparent exception, Enron's failure to consolidate many of its off-balance sheet "special purpose entities", in fact does not support an indictment of U.S. GAAP. Even in Enron the main problems were failures by the company and its auditor to disclose contingent liabilities of the SPEs, not consolidation per se.

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Moreover, there are drawbacks to the broad principles-based approach embodied in IAS, which leave ample discretion to management and auditors on how to report a variety of transactions. Can one be easily assured that the same managements that were so willing to skirt the detailed rules of U.S. GAAP suddenly would follow conservative accounting if they were given the freedom or license to do so? Skepticism about the answer is a major reason why the U.S. standards have been driven by regulators and litigation toward detailed rules.

A far better argument for a single set of reporting standards worldwide is to ensure that investors, wherever they may reside, can easily understand and compare the financial accounts of companies headquartered in different countries. This has become an increasingly important objective as investors expand their portfolios to contain ever larger fractions of foreign securities, while exchanges from different countries are merging or forming cross-border alliances. A global capital market seems to cry out for a global set of reporting standards.

The world's two main accounting standards-setters, the Financial Accounting Standards Board (responsible for U.S. GAAP) and the International Accounting Standards Board (which sets international standards), formally recognized this imperative in September 2002 by announcing their intention to eliminate major differences between the two sets of standards by 2005. In essence, the two bodies intend to set a single world standard although the two standards-setters presumably would continue to co-exist.

Therein lies at least one of the reasons to be cautious about the joint effort. For one thing, bridging the large philosophical difference between the details of U.S. GAAP and the broad principles of IAS will not be easy. More fundamentally, even if the two bodies initially agree to a single set of stan-



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dards, it is far from clear whether that outcome will be stable over time. Pressures are certainly likely to arise in the United States and elsewhere for “interpretations” of the single standard. Are the two bodies going to coordinate their responses to every one of these inquiries or pressures, or more likely, are they going to go their separate ways? If the latter, then multiple interpretations over time will lead right back to different standards, thus defeating the objective of a single global standard. If the two bodies instead seek to coordinate their responses, the outcomes are likely to be very slow in coming. The repeated attempts by the Basel Committee, over many years now, to refine bank capital standards, a much less complicated task than setting and maintaining a comprehensive list of accounting standards, provides a clear example of how even one body can find it very difficult to adapt to changing market conditions.

In short, achieving and maintaining a single set of accounting standards is likely to prove very difficult, if not impossible. It is not too late to consider an alternative paradigm, one based on true *competition* between the two standards – that is, one where exchanges are permitted to recognize reports under both standards, or the exchanges themselves are permitted to compete in different countries.

Under competition, standard-setters have much stronger market-based incentives to respond to investor pressures for sound standards, and to do so more quickly, than is the case when standard-setters seek to compromise for the sake of achieving uniformity, or if the two standards-setting bodies collapse to a single organization (most likely the IAS). To be sure, there would be less uniformity with two standards, but market pressures over time should also encourage companies to provide sufficient information for analysts to compare financial results of companies under either standard.

Sometimes the perfect can be the enemy of the good. Such is the case with the quest for a single set of global accounting standards for all time.