Accountants unchained

Instead of slavishly following international standards, external auditors should be allowed to exercise their professional judgement, says David Myddelton

IN THE LAST TEN YEARS the quantity of accounting law and regulations has risen by 150%, from about 800 pages to more than 2,000. The 20 new Financial Reporting Standards since 1991 have averaged 85 pages each; and the March 2004 volume of *International Financial Reporting Standards* comprises 2,250 pages. In contrast, in the good old days when I was training as an accountant, long before there were any compulsory accounting standards, all we had was 26 pages in the Companies Act 1948.

No single model of accounting satisfies everyone: preparers, auditors and users may have somewhat different aims. In law, annual accounts reporting to all shareholders about corporate performance and financial position are not prospectuses inviting individuals to invest. Nor do balance sheets purport to "value" enterprises. Probably the least imperfect approach is the orthodox stewardship model emphasising consistent disclosure and based on recoverable historical cost, prudence, matching and realised profits. It is fairly objective, it evolved gradually over many years and it has proved able to satisfy the main purposes of accounts for companies of all sizes.

New approach

But accounting standard-setters, who all accept the US Financial Accounting Standards Board's "conceptual framework", are now attempting to impose a system based on "decision-usefulness", prescribing measurement rules as well as disclosure. This aims to change accounts from being a report on past performance into an instrument for predicting future cash flows. But the top six accountancy firms disagreed with many key elements in the Accounting Standards Board's revolutionary Statement of Principles in the 1990s. So those principles are certainly not "generally accepted".

There are at least two serious problems with the new approach (which most standard-setters, if few others, accept). First, it will lead to much greater volatility in the annual (interim) accounts of many companies, which in the long run will make it harder to understand what is happening. Second, it is based on the flawed notion that it makes sense to use current "market" values even when there is no genuine market for the assets and liabilities concerned.

We must remember that it is very ambitious to aim to present the complex affairs of large companies in three summary financial statements, even with many pages of notes. In a going concern, many transactions are incomplete at the balance sheet date, so to a great extent the annual accounts have to contain estimates rather than definite facts. But in making estimates about the uncertain future there are few

➲ uniquely "correct" answers and competent people may honestly hold different views. Moreover, many important aspects of business cannot be quantified at all, such as employee morale, customer satisfaction and management expertise.

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Much of the impetus behind standards comes from the quest for "comparability" between the accounts of different companies. But there may often be more than one possible way to account for transactions. We are entitled to expect each reporting entity to say which method it has chosen, and to stick to it consistently. But comparing the accounts of different companies is likely to be far more difficult, if not impossible.

Reader beware

The first rule for company accounts should be: "Caveat lector" – let the reader take care. Every company has its unique features, and at best accounts can give only a very approximate impression of performance and financial position. There is bound to be a substantial margin of error, and we should not exaggerate the extent of possible precision. My favourite example is the accounts of General Motors, which actually went *to the nearest dollar* as recently as 1975 – though I doubt if they could possibly have been accurate to better than the nearest million dollars!

The existence of standards may legitimise bad accounting practices. The Last In First Out method of valuing stock has been permitted in the US for many years, even though it is really just a tax dodge and can lead to very misleading balance sheets. And when Beecham took over SmithKline in 1989, deducting goodwill from reserves meant that the new group accounts showed negative equity – which was absurd.

Equally important, standards may prohibit good accounting. The powers-that-be blocked the constant purchasing power method of accounting for inflation during a period when the value of money in this country fell by about 75%. That was unhelpful interference. And the standards require accounts to write off spending on research as an expense, even though it often creates an economic asset.

The stimulus for accounting regulation has often been so-called "scandals". Yet there is little evidence to show that misleading disclosure has caused losses to investors. Recent accounting scandals, in the US and elsewhere, are said to have damaged confidence in the accuracy of company accounts. If so, that is indeed good news! The existence of "standards" leads people to expect far too much from accounts, so reducing overconfidence may help to limit ultimate disappointment. Perhaps each set of accounts should carry a health warning, like packets of cigarettes?

But the Sarbanes-Oxley Act 2002 was rushed through, in a classic knee-jerk reaction, to "tighten up requirements" in the US (at enormous expense to companies). As so often when regulation falls short of what it promises, the "solution" is to reinforce failure by more of the same. Accounting scandals have always been with us, and always will be. Anyone who thinks over-regulation is the answer is ignorant of history.

The path to so-called "international harmonisation" (or "global monopoly", as I prefer to call it) is by no means straightforward. It seems quite possible that the European Commission will fail to endorse all the International Accounting Standards. I find myself unexpectedly in sympathy with President Chirac, whose banking constituents object to IAS 39. This is not a technical accounting issue, but a highly political one: should accounting principles be "generally accepted" by the accountancy profession or should they be imposed by a body of experts?

Capital cost

People sometimes argue that if all companies were to produce accounts in accordance with a single set of accounting standards, that would reduce their cost of capital. If this were true, there would be sufficient incentive for companies to fall in line of their own accord, *with no need for compulsion*. But as far as I am aware the evidence does not support this plausible sounding excuse. In any event, as Warren Buffet says: "The business world is simply too complex for a single set of rules to effectively describe economic reality for all enterprises."

The set-up of the new International Accounting Standards Board (IASB) is hardly satisfactory. Only a bare majority – eight votes out of fourteen – are required to impose a new standard. This allows for a much larger degree of disagreement than most standard-

setters. In other words, it is quite possible that future International Financial Reporting Standards won't enjoy "general acceptance" even within the IASB itself!

At least two of the reasons for the growth in compulsory accounting standards relate to external auditors: possible lawsuits for negligence and client companies threatening to shop around for more congenial audit opinions. Sir David Tweedie, the Chairman of the IASB, has said he'd prefer to issue shorter standards, but auditors want the details spelt out to protect themselves. As for shopping around, or "competition" as it is often called, that can be discouraged by making the standards compulsory – in spite of the 1989 Dearing Report's recommendation that accounting standards *not* be mandatory.

It has been suggested that, like the professional outside director, the welfare of the external auditor depends largely on "reputation". If auditors merely tick boxes to record compliance with standard rules, they cannot easily distinguish themselves by the quality of their judgement, in which case perhaps a reputation for *competence* hardly matters. But the awful example of what happened to Arthur Andersen underlines what can happen if an auditing firm's *independence* comes into question. (Presumably this can also be a problem for internal auditors.)

Deception

It is unlikely to be in a company's long-run interests to deceive its own members, though directors might take a shorter-term view. Setting up audit committees comprising only non-executive directors attempts to guard against this. Nor probably would external auditors gain in the long run if they abetted any such attempt. All this does not guarantee the complete absence of short-term deception in accounts; but it is doubtful whether any other approach could do so either.

Accounting does need rules. But rules can emerge and win general acceptance and change over time without any committee designing or imposing them. The very expression "as a rule" implies there can be exceptions. All we need is a single sentence in the Companies Act requiring accounts to give "a true and fair view" of financial performance during a period and financial position at the end of it. That would leave accountants and auditors free again to exercise their own subjective professional judgement. They would no longer be reduced to ticking boxes.

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