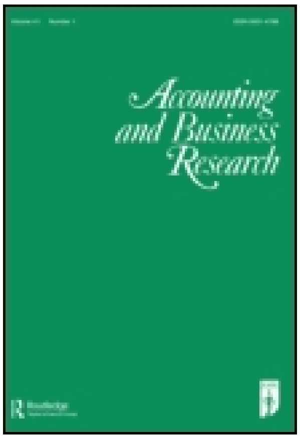

Accounting and Business Research
Publication details, including instructions for authors and subscription information:
http://www.tandfonline.com/loi/rabr20

Discussion of ‘International Financial Reporting Standards (IFRS): pros and cons for investors’

David Damant [a] [b]
[a] Consultative Advisory Group , International Auditing and Assurance Standards Board
[b] CFA Institute
Published online: 28 Feb 2012.

Discussion of 'International Financial Reporting Standards (IFRS): pros and cons for investors'

David Damant*

The following is a summary of the remarks made by David Damant in reply to Professor Ball when he presented his PD Leake Lecture on 8 September 2005. E-mail: David.Damant@totalise.co.uk

Professor Ball has done a great service in emphasising the fact that the introduction of IFRS in the different countries will be variously implemented. Whether we refer to the difference between common law and civil law, or to the very powerful forces which respond to national political imperatives or to local incentives, it would be wise to bear Professor Ball's remarks in mind when observing the different jurisdictions and their stated move towards IFRS. Perhaps a significant proportion of the debates that have arisen when introducing IFRS within the European Union for quoted companies is due to the difference between the common law and the civil law approach. It has been quite interesting to observe how the representatives of these two schools of thought find it difficult to understand how the opposite point of view could be adopted. Nevertheless I would, within Europe and world-wide, take a rather more favourable view of the prospects for IFRS than might be implied by at least some of Professor Ball's remarks.

Throughout his paper, Professor Ball refers first to the internationalisation of financial reporting standards through IFRS, and secondly to the fact that IFRS are based upon transparency and a reflection of economic reality. I believe that the second of these points is overwhelmingly the more important. To put it another way, international standardisation has many virtues, but no virtue as manifest as the fact that all over the world companies are beginning to show in their financial statements something closer to the real economic underlying situation.

Perhaps in some markets where accounting is already orientated on the capital markets the improvement may not be large - as for example in the UK, where already some commentators have expressed surprise that the difference in practical outcome appears small. But for the most of the world the opposite is the case. For those countries which started with very little accounting expertise; or had financial statements which were creditor orientated, or tax orientated; or were economies in transition from socialism and therefore had an accounting framework based upon a no longer existing economic system; for all these and others the change is to a framework which embodies economic reality. The impact will be enormous. Even before we come to positive advances, many billions will be saved by the fact that scarce capital is no longer invested in the wrong places at the wrong prices. And this benefit can spread throughout a country and internationally, producing wealth which can benefit even the poorest people and the poorest countries. It is hard to imagine any other technical device, in the hands of very few specialist professionals, which could have such a widespread beneficial effect on the world as a whole.

The civil law approach has many virtues and may as Professor Ball speculates become more influential in the setting of IFRS. But neither the civil law approach, nor indeed aspects of the common law approach, or national or individual interests, should be allowed to cloud the central aim of improving the efficiency with which capital is employed.

I am, as I have indicated, rather more positive than Professor Ball on the chances of overcoming the adverse forces which he describes and to which I have briefly alluded. I will mention first the international power factors which will operate, admittedly over time. The Basel Committee has influence world-wide, and those jurisdictions which wish to take part in the international financial institutional networks must take note of that fact. Equity and bond investors now commit their funds world-wide on an increasing scale, whether through stock exchanges or in direct investment.

*The author is Chairman of the Consultative Advisory Group of the International Auditing and Assurance Standards Board and a member of the CFA Institute.

Once IFRS are in place in a jurisdiction investors will exert continual pressure, implicitly and explicitly, in favour of the correct implementation of IFRS. If this is not accepted the investors will require a higher return on their funds, to the detriment of the jurisdiction concerned.

But, in a sense more powerfully on this point, I would say that the genie is out of the bottle. Even if the IASB were to be disappear tomorrow, its ideas are now world-wide and talked about everywhere. The quotation that truth is great and will triumph is not always true, but it has great force and has such in this context.

A further point on which I might differ from Professor Ball is that moving to IFRS is a leap of faith. Of course he is right to say that the amount of research done in this area is small. I have tried over many years to generate research, almost always failing. But I do not think that one needs research to justify IFRS, and in particular to justify IFRS in the context of the second of the two aims which I have mentioned above, that is, the introduction of economic reality. The Framework of Principles established by IASB (and now under review) states clearly that the financial statements exist to enable the user to make economic decisions, and that those economic decisions are based upon a judgment of the ability of the enterprise to generate cash-flows - their size, timing and certainty. I wonder how many people have heard of the Framework of Principles, and of those that have heard of it how many have read it, and of those who have read it how many have agreed with it. But no one should be in any doubt that around the table of the IASB, the Framework contains the basic principles on which all IASB judgments about individual financial reporting standards are made. And indeed, one has to ask, what other purpose could there be in analysing a company, other than to judge its future cash-flows which will enable the user to price the shares, lend money, or decide on future wage claims etc. Thus the logic of IFRS, and the lack of logic and of appropriate aims in the competing systems, makes it unwise to take any other path, even in the absence of enough relevant research

Nevertheless, there are some consequences of the decision-making approach that are not welcome in some quarters. In a way, the Framework of Principles of the IASB sees financial statements as a tool for forecasting. That is not at all the same as the traditional concept of stewardship. For making forecasts, the user needs (for example) fair values, a performance report in the form of comprehensive income, and an unravelling of hedges. I have great sympathy with those preparers who find it extremely difficult to believe that an excellent set of hedges which has achieved great things for the company need to be unravelled in the financial statements. But the difference here is not about accounting for hedges. It is about the aim of the whole process. The stewardship approach wishes to report what has been done. The decision-making approach wishes the company to show figures which will enable the user to forecast what will happen. If XBRL comes to the fore and investors are able to access very many detailed parts of a company's reporting system, the professionals will be able to construct their decision-making accounts for themselves. One might then question what there will be left for the IASB to do: and the answer might very well be to produce stewardship accounts which fulfil other desirable aims, such as understandability by private investors and the public generally.

One thing that should be noted is that, if the two approaches lead to compromise, one will arrive at a logical mess. That is why IAS 39 is so unsatisfactory. I have to confess that I voted for it on the former Board of IASC, but that was because we needed a standard for financial instruments (and particularly for derivatives) in the near term, whereas we believed it would take a long time for the whole question of the fair valuing of financial instruments to be resolved one way or another: and in this decision time has justified our view.

This point about the different approaches to financial reporting, as between decision-making and stewardship, is something which should always be borne in mind. Sydney Smith observed two housewives arguing across the garden wall. 'They will never agree,' he said, 'because they are arguing from different premises.' The Cartesian approach, of looking first at the principles, is the fruitful one in the current debate. Attempting to argue in the British empirical tradition about the practical impact of particular accounting standards will not get very far if any overall difference in aim is not taken into account.

Finally, I will return to the question of the financial reporting chain. Professor Ball discussed several elements in that chain, and there are others to add - IFRS, auditing standards, rules for corporate governance, national regulations etc: and a chain is only as strong as its weakest link. One thing I am sure about is that we should not accept the argument (and I am not suggesting that it is Professor Ball's argument) that because we have six or eight problems to solve there is not much use in tackling a single one of them. We need the best possible IFRS. If subsequently it takes time and trouble in different arenas to get these standards implemented to an acceptable degree then we have to work at that side as well. But at least we have one of the essential building blocks in place.