Response to the IFRS Foundation's Paper for Public Consultation Status of Trustees' Strategy Review

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Introduction

As the IFRS Foundation considers the goal of a single set of high-quality globally accepted high quality accounting standards to be within reach within 18 months (p. 2), this is perhaps a last opportunity to reconsider definitions of the public interest. Evaluating the desirability of the international financial reporting standards project would require, among other things which include political considerations, an investigation of the social (= private + public) costs and benefits. Such a cost-benefit analysis is difficult, if not impossible, and it can only properly be done if we know the intended purpose of IFRSs. The stated purpose of providing information that enables users to make economic decisions does not lead to a measurable outcome that can be evaluated without reference to an underlying purpose.

Decision-usefulness in order to improve the efficiency of product, labour and capital markets would induce the question of what level of efficiency to aim for, given the fact that efficient markets could break down due to a lack of incentives for entrepreneurial activity. In other words, what level of inequality should we aim for (or tolerate, depending on one's ideological position) in our international society. These questions are well beyond the ken of what accountants, financial analysts, investors, and accounting regulators usually consider their area of competence and responsibility.

However, because of the consequences for both the allocation of resources and the distribution of income and wealth, setting international financial reporting standards in the international public interest does come with international social responsibilities. The IFRS Foundation and the IASB need to explore what their international social responsibilities are. Deriving from the IFRS Foundation's Constitution's reference to the public interest, the IASB's social responsibilities stem from the implications for financial accounting and external reporting of globalisation, market and government imperfections, incomplete international accounting theory, and conflicting stakeholder interests in a world where accounting neutrality is impossible.

Response

Mission: How should the organisation best define the public interest to which it is committed?

This depends on which public interest the IFRS Foundation is truly committed to. The IASB is no longer simply responsible for financial reporting standards for multinationals as was the case until about 2005. It is responsible for financial accounting and external reporting standards to be applied in countries with very different levels of capital market and economic development, institutional characteristics, and varieties of capitalism (and in the case of China, socialism). The IFRS Foundation needs to understand that this responsibility does not end with providing standards aimed at providing information useful for economic decision-making, primarily by investors (as providers of risk-bearing capital). In imperfect and incomplete capital, product and labour markets, or in countries where litigation is impossible or too costly, or where the legal system is not independent from those in power, focusing solely on the economic decision-making functions of financial reporting is equivalent to condoning the maximisation of private benefits and the minimisation of private costs of relatively few at the expense of a large social cost which does not get quantified or taken into account.

The IFRS Foundation and the IASB are private organisations claiming to work in the public interest. However, bearing in mind the composition of their trusteeship and board membership, so far the IFRS Foundation and the IASB have not given any indication that they interpret their responsibility as extending beyond the private interests of investors into the social consequences of international accounting standards and of the business and management practices that accounting standards invite. The economic decision-usefulness perspective is too narrow and one-sided to serve as the basis for the IFRS Foundation's mission and the IASB Conceptual Framework. The public interest should be defined as the international general public interest.

Objective

'These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets, and other users of financial information make economic decisions;'

Question 1: Should this objective be subject to revision?

Comment: Yes. I suggest that the objectives will be revised to:

These standards should require high quality, verifiable, reliable, transparent and comparable information in financial statements and other financial **and external** reporting to:

1. help investors, other participants in the world's capital markets, and other users of financial information make economic decisions
2. **enable the protection and reconciliation of conflicting interests in transactions, the determination and enforcement of implicit and explicit contracts**
3. **enable the international general public (including investors and other participants in product, labour, financial and capital markets) to evaluate the economic, financial, social and ecological sustainability of the activities in which business and other entities engage**

NB: From this perspective, the IASB/FASB Conceptual Framework convergence project goes against the IFRS Foundation's Constitution because it is based on a primarily Anglo-American world view. The IASB Conceptual Framework would need to be started from scratch in order to construct a conceptual and theoretical framework that is applicable across the world.

Question 2: To what extent can and should the two perspectives be reconciled?

Financial reporting standards and public policy (in particular financial stability) do not represent two evidently different perspectives on the public interest. Although some people do not consider standard setters to be regulators, this perspective ignores the fact that standards setters enjoy delegated authority from national and international regulators, who, in turn are subject to the insurrection constraint, that is, they have to balance a variety of interests in order to stay in power. In some countries staying in power means being re-elected, in other countries this means not being overthrown by a military coup or some other means, or lynched by an angry mob. The tension between private standard setters and public regulators arises because of the tension between the relatively narrow interests of the constituents of the private standards setters and the wide range of interests which public regulators must serve to survive.

On the one hand there are the interests of informed international investors, speculators and other capital market participants, and on the other hand there are the interests of the general public such as fairness, equality, full employment, ecological sustainability, sustainable and steady economic growth, stable interest rates, stable required rates of return, security and stability of the financial system and the financial institutions such as retail banks holding the savings of the general public. The extent to which they can be reconciled is a function of each side's political power. It is in essence the trade-off between incentives (risk and return) and equality (stability) from the textbooks on micro-economics. In capitalist societies, the two perspectives on this trade-off on either side of the ideological divide are:

1. What level of equality do we need to have the maximum short-term incentives without the system collapsing due to social unrest?
2. What level of inequality do we tolerate in order to have the minimum incentives without the system collapsing due to lack of inventive and entrepreneurial activity?

When international financial reporting is seen as instrumental in preventing international financial and capital markets from breaking down, the private benefits are on the side of the investors, speculators and other capital market participants and the public costs are on the side of the international general public. The consequence will be increased incentives for risk taking and the pursuit of private profits, leading to increased inequality of income and wealth. This may ultimately cause economic, social and political instability. When external reporting is seen as instrumental in making capital and other markets as efficient as they can be, the private costs are on the side of the investors, speculators and other capital market participants, and the public benefits are on the side of the general public. Decreased incentives for the pursuit of private profits may lead to slower economic growth and less inventive activity. In countries where companies rely much less on direct financing (most countries in the EU and most countries in the world), the role of financial accounting and external reporting is much more aimed at accountability and the protection and reconciliation of conflicting economic interests. Reliability and neutrality (in the old-fashioned sense, not in the statistical sense) are then more important than decision-usefulness.

Reconciling the two perspectives can be done by:

1. recognising and reconciling the different perspectives of the functions of limited companies in society. On the one hand, there is the proprietary perspective (the purpose of a limited company is to increase its owners' wealth by maximising private benefits and minimising private costs). On the other hand, there is the entity perspective, or social perspective (the purpose of a limited company is to contribute to society through specialisation and risk sharing, providing goods and services, and providing employment and incomes to large numbers of people including shareholders).
2. incorporating estimations of both private costs and benefits as well as public costs and benefits in financial and external reporting
3. reconciling the asset/liability approach with the revenue/expense approach to income determination
4. moving away from general purpose financial statements to providing information based on multiple measurement bases at the same time so they can be compared and analysed by users
5. measuring and reporting value added, economic, financial and ecological sustainability, and social consequences.

<u>Governance: How should the organisation best balance independence with accountability?</u>

Question 3: Does this three-tier structure remain appropriate?

The question is, appropriate for what purpose? The answer depends on what definition of the public interest the IFRS Foundation adopts. If it recognises its social as well as its economic responsibilities, its governance structure and membership need to support accountability to the international general public. Therefore it needs to be more representative of the countries with different institutional characteristics, and should be more inclusive of those who are mindful of social consequences and more responsive to the interests of the general public. It also needs more input from people who are multi-disciplinary and multi-cultural, and who have a thorough knowledge of the historical development of accounting practice and accounting theory.

Question 4: Are further steps required to bolster the legitimacy of the governance arrangements?

As above, the question is, legitimate for what purpose? If the IFRS Foundation sees its responsibility as limited to the interests of investors in risk-bearing capital, why would it seek legitimacy from the international general public? Otherwise, the answer to question 3 applies.

<u>Process: How should the organisation best ensure that its standards are high quality, meet the requirements of a well-functioning capital market and are implemented consistently across the world?</u>

The IASB should start from a Conceptual Framework that does not choose sides but explains and theoretically reconciles all the different perspectives on accounting and reporting issues. As Watts and Zimmerman[1] pointed out a long time ago, positive accounting theories can only describe and predict managerial choices and the actions of stakeholders in lobbying for accounting standards, but cannot prescribe what the purpose of accounting standards should be, or what accounting standards are fit for purpose. Normative accounting theories have often been discredited on the basis of self-interest. Having an impartial Conceptual Framework would not be the solution for each standard setting problem. It would merely be the starting point for finding solutions in each new case.

Question 5: Is the standard-setting process currently in place structured in such a way to ensure the quality of the standards and the appropriate priorities for the IASB work programme?

It would be in the international general public interest to have a theoretical and conceptual framework that integrates the economic and the social functions of accounting and reporting because, for one, it would make accountants and accounting standard setters more accountable to the (international) general public. Second, accountants could no longer use the complicated structure of transactions and economic reality as an excuse for making accounting exceedingly technical and therefore difficult to understand by the untrained, whilst at the same time preparing general purpose financial statements that should be understandable to the investing public (without specifying the level of training needed to be able to use financial statements). The Conceptual Framework needs to be priority number one, and it should be completely new, not a revised version of the FASB Conceptual Framework.

Question 6: Will the IASB need to pay greater attention to issues related to the consistent application and implementation issues as the standards are adopted and implemented on a global basis?

Yes.

1. Standards need to be as simple as possible.

[1] Watts, Ross L. and Zimmerman, Jerold L. (1979), 'The Demand for and Supply of Accounting Theories: The Market for Excuses', *The Accounting Review*, Vol. 65 (2): 273-305.

2. They need to be designed with an understanding of how transactions are structured and carried out for different purposes in different markets and institutional environments.
3. Standards need to be designed with sufficient understanding of the variety of capital and other markets around the world.
4. Standards need to be designed with a view to the financial statements and external reports being audited reliably, efficiently and cheaply.

<u>Financing: How should the organisation best ensure forms of financing that permit it to operate effectively and efficiently?</u>

Question 7: Is there a way, possibly as part of a governance reform, to ensure more automaticity of financing?

This depends on which public interest the IFRS Foundation intends to serve and to which public it intends to be accountable. The IFRS Foundation needs to be clear about whose interests it serves and make a case for obtaining funding from them. That is, if it wants to remain a private standard setter, the IFRS Foundation must lay out the costs and benefits of the individual standards and the total of IFRSs and convince its intended public that they are getting value for money. If the IFRS Foundation wants to serve the general public across the world, it will need to convince the governments across the world that it will genuinely serve the general public interest in their countries with the Conceptual Framework, IFRSs and other pronouncements in order to be able to collect contributions.

<u>Other issues</u>

Question 8: Are there any other issues that the Trustees should consider?

Yes. The IFRS Foundation and the IASB would do well to consider:

1. Clearly communicating what the limitations of financial accounting and reporting are in order to make sure that people aware that financial statements do not represent an objective economic reality, but that they are based on judgements and interpretations without which accrual accounting would not be possible or presumed useful.
2. Multidimensional reporting, because general purpose financial statements need to be supplemented by information on alternative measurement and recognition bases in order to be both useful for making economic decisions and enabling the reconciliation of conflicting stakeholder interests in different institutional environments.
3. Triple bottom line and value added reporting.
4. Clarifying the IFRS Foundation and IASB's moral philosophy and explaining how this informs individual accounting standards and international financial reporting standard setting in general.