the spirit of accounting

BY PAUL B.W. MILLER AND PAUL R. BAHNSON

To the SEC: Don't throw in the towel by changing FASB to FARSB and creating a FARCE

> "This move would completely marginalize the SEC's influence on standard-setting."

Frankly, we're getting weary writing about convergence, especially the worst kind where the International Accounting Standards Board and IFRS would replace the Financial Accounting Standards Board and GAAP. We thought we had helped put this issue away for good, but the four firms and the American Institute of CPAs keep pushing, seemingly mesmerized with creating artificial demand for something that is at best a lateral move and at worst a big distraction from the real problems that need to be solved.

We've explained how adopting IFRS won't promote higher-quality financial reporting and how switching is infeasible because Congress would have to amend the Securities Acts and Sarbanes-Oxley to hand standard-setting authority to an international body beyond the Securities and Exchange Commission's oversight. We find the constraint created by these statutes to be both binding and fortunate.

Well, the SEC stunned us in late May with a staff paper advocating a dubious backdoor approach to adopting IFRS. After reading it, we get the distinct impression that the staff is encouraging the commissioners to throw in the towel, but it could be the other way around, as implied in June when a call for adoption was proclaimed by lame-duck Commissioner Kathleen Casey, just before her term ended. Whoever is giving up, we speculate it's partly because they're tired of the unrelenting political pressure. More importantly, we believe that they just don't realize how greatly deficient current practice is.

This surreptitious approach, which we dub the "FARSB Proposal," will not help make the markets as efficient as they should be. Indeed, it will create what we call "FARCE."

Above all, we question whether this arrangement is legal and, even if it is, it cannot be a legitimate application of the commission's statutory authority. We're writing to keep this proposal from moving ahead.

FROM FASB TO FARSB

Although the proposal ostensibly describes a continuing role for FASB, it would assign the board much different, and greatly diminished, responsibilities than it presently holds. Instead of letting FASB initiate projects and issue its own pronouncements, the SEC would push it to the distant sideline, where it would lollygag while the IASB sets its own agenda, completes its political process, and publishes standards. When a new international standard comes out, FASB members would stir from their imposed ennui and vote "Aye," slowly but surely replacing GAAP with IFRS.

We call it the FARSB Proposal because it would create the "**Financial Accounting Rubber-Stamp Board**."

Despite the fact that FASB's stamp would be needed to transmutate IFRS into U.S. GAAP, this approach would downgrade the world's unarguably strongest and most independent standard-setting process to being comparable to those in such places as Azerbaijan, Cambodia and Costa Rica. This arrangement would surely devalue, even degrade, FASB's board and staff members. Where they now bring their intellects and experience to bear on crucial accounting issues, the proposal would diminish their duties to merely smiling and nodding.

Condescendingly, the paper claims FASB would remain important because it would retain authority to issue its own standards. If that were true, it would be some consolation, but the paper promptly squashes this glimmer of hope by offhandedly asserting that such "modifications should be rare and generally avoidable." Another section disingenuously suggests FASB could serve "an educational role" in helping Americans comply with IFRS. Surely it could, but FASB is undoubtedly and hugely overqualified for that mundane task.

Despite the paper's claim that FASB would influence the IASB's process, this demotion would actually render it irrelevant.

As a matter of fact, this move would create an intolerable unintended consequence because it would completely marginalize the SEC's own influence on standard-setting.

ABDICATING RESPONSIBILITY

The heart of the issue is that this approach, flippantly called "condorsement," is not merely deplorable but also potentially illegal because it is tantamount to abdicating the SEC's statutory responsibility for creating reporting standards.

Some 75 years ago, Congress authorized the commission to produce accounting standards for public companies, which it has done by relying on the accounting profession's expertise. This de facto delegation of its statutory authority has been justifiable only because the SEC maintains close oversight on the standard-setters and their activities, both to ensure that new standards are suitable and to protect the process against detractors who would compromise its integrity.

In contrast, the FARSB Proposal would take away the commission's powerful status as the "300-pound gorilla in the room" when it comes to standard-setting. Even though the SEC has no explicit formal role in FASB's process, it does monitor and, on occasion, nudge the board through well-established back-channel communications. Having FASB automatically "condorse" everything will deprive the commission of that power and reduce it to being only one of many national regulators with little or no influence on the IASB.

As a result, the commission would no longer be in compliance with its congressional mandate to establish reporting standards.

THE "CARVE OUT" OPTION

With what seems like nonchalant rationalization, the paper suggests that the SEC would retain rights to "modify or supplement" an international standard that it judged unsuitable. In other words, like every other country, the U.S. would be able to "carve out" exceptions, thereby thwarting the alluring but totally illusory quest to achieve international comparability through mere uniformity. Somewhere, the staff's urgent search for palatability caused them to forget why they were making the proposal.

THE WRONG PREMISE

Near as we can tell, those who support dumping FASB have a deeply flawed premise to

See SPIRIT on 19

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Spirit

FROM PAGE **18**

the effect that they erroneously believe that nothing is fundamentally wrong with today's financial reports and standards.

In their eyes, all that's needed is a few tweaks here and there before etching the status quo in stone, slapping the IASB seal of approval on it, and leaving it untouched for generations to come.

We hold out hope that the commissioners don't subscribe to this view, because heretofore we've seen only perfunctory and lukewarm support for adoption in official releases and speeches. Perhaps they've succumbed to either political pressure or an idealized fantasy that GAAP and IFRS produce useful information. Or both.

Bottom line, if the staff paper is a trial balloon to test an idea for embalming current standards, we think it's made out of lead.

WHY PROGRESS IS NEEDED

Space keeps us from explaining the many flaws in the status quo with any detail, so here are quick summaries of the four biggest:

- **Assets and liabilities:** Under GAAP and IFRS, these items' reported amounts are determined six different ways: cost, book value, impaired value, market, realizable amount, and present value. Instead, they should all be reported at market values all the time.
- **Earnings:** GAAP and IFRS artificially smooth reported earnings by spreading revenues, systematically allocating costs, and excluding unwanted items, leading to totally imaginary manipulated results. Instead, they should be based on empirical measures, namely observed changes in market values. Further, all income items belong (where else?) on income statements.
- **Cash flows:** Practitioners cling to the indirect method that obscures more than it reveals. Instead, it's slam-dunk obvious that cash flows are best reported as gross inflows minus gross outflows.
- **Reporting frequency:** The New York Stock Exchange mandated quarterly reporting 80 years ago, and the SEC made it mandatory 40 years ago. Who can think this anachronism should still be in place despite the obvious benefits from staying informed? Instead, managers should satisfy today's enhanced hunger for knowledge by applying 21st century technology to implement continuous reporting that publishes information weekly, daily and even more frequently.

The consequences of implementing these true reforms would be less uncertainty, risk and market volatility, leading to lower capital costs and higher stock values. In other words, they are desperately needed.

FROM FARSB TO FARCE

Here's our point: Even though current GAAP and IFRS might be the best existing standards, they do not produce high-quality financial statements and must be replaced with new standards that produce rational and useful information.

Therefore, this move to neutralize FASB will not lead to significantly more useful financial reports. Instead, it will produce a condition we call FARCE: "**Financial Accounting and Reporting Cannot Evolve**."

Subjugating FASB to "condorsing" IFRS is a questionable, even contemptible, end run around long-standing statutory protections for U.S. markets. It will not achieve progress because it will preserve today's incomplete and grossly inadequate financial statements in suspended animation.

This dismal future is not worth pursuing.

THE SEC'S TO-DO LIST

What should the SEC do to stand firm, instead of throwing in the towel?

First, it must acknowledge that its authority extends only to regulating U.S. capital markets. Thus, it cannot legitimately try to make global markets more efficient. While strengthened non-U.S. markets might help the U.S. economy, that goal lies beyond the SEC's statutory mandate and regulatory jurisdiction.

Second, the SEC must comprehend that its only constituents who matter are the people of the United States. Yes, that's all the people, not just investors, because the capital markets help drive the economy's health and efficiency. Clearly, the SEC's constituents do not include residents of other countries and their politicians, especially the oft-quoted G-20. The same is completely true for big CPA firms and the AICPA; as entities regulated by the SEC, their views should get scant attention, if any.

Third, the SEC should encourage and enable FASB to be more independent, reform-minded and forward-looking, so that it can apply bold new solutions to old problems and stop applying ineffective old solutions to new problems.

Fourth, the SEC should challenge its international counterparts to push to re-orient the IASB to become a force for genuine progress, instead of a bastion against substantive change.

Rather than settle contentedly into the status quo like it's going to last forever, the SEC and its staff should dare the entire U.S. reporting community to emulate the rest of today's commercial world, which remains viable only through continuous, even radical, innovation.

If the IASB wants to follow that lead, so much the better.

Alas, this FARSB Proposal would do just the opposite by abolishing the world's most potent organization for creating real reform.

We're alarmed because it threatens to impose inferior reporting practices on the world and mummify them for who knows how long. The results will be inefficient and irrational capital markets, just the opposite of the glowing (and exaggerated) claims made by the IASB and its supporters.

The SEC and responsible members of the accounting profession must surely agree that this dismal future is not worth pursuing.

No problem can be solved by throwing in the towel and implementing an illicit and potentially illegal scheme to create a rubber-stamp FASB. AT