

## U.S. Switch to IFRS Coming Too Fast in Today's Troubled Economic Times

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Full Text Published by **taxanalysts**<sup>®</sup>

Every solution creates its own problems. In financial reporting, the government risks creating massive new problems as it moves us from our current rules-based financial reporting to the principles-based system used in more than 100 other countries.

In the long run, a switch to the principles-based concept of international financial reporting standards may be both wise and inevitable. But the way we are going about it, and the speed at which the change is proposed, is rife with dangers to the fisc (and to investor wealth).

The problems lie in the timing of the change, the speed of the change, and the lack of real standards for the proposed new system.

We also need to consider the effects of such a fundamental change on Financial Accounting Standards Board Interpretation No. 48, "Accounting for Uncertainty in Income Taxes." When done right, FIN 48 and principles-based accounting can be a powerful tool for tax administrators, giving them a road map to real issues and reducing time wasted in fights over requests for documents from taxpayers. Done wrong, this fundamental change can make it even easier for the dishonest, or merely aggressive, to hide tax cheating.

Central to concerns about changing accounting basics is a simple fact: We are in the middle of a financial disaster. Its effect will surely last for many months and perhaps several years. Indeed, if mismanaged, the meltdown could yet turn into a disaster worse than the stock market crashes of 1929 and 1932.

This is not to deny that our financial reporting standards are failing us and need not just repair, but real reform. They do.

Our existing financial reporting system is so rife with problems that most Americans understand the broad strokes. We have more than a decade of experience now with how finely diced rules can be used to create not reasonable impressions of the financial status of companies, but mirages that cost the government tax dollars and investors their wealth.

FASB's proliferating set of rules is a legacy of the Progressive Era of a century ago, when it was widely believed that if society could get the rules just right, if they could be made so fine that every detail was addressed, then social justice would emerge. Hence rules grow and grow until they often serve not the basic principles of sound construction of financial statements, but draw the eye away to the filigree, just as Doric columns morphed in time into Corinthian columns.

This finer-and-finer frame of mind grew out of the rational approach that began with the Enlightenment, yet in retrospect it suggests almost magical thinking.

To watch a FASB debate in the Coliseum-like loops of seats in its Connecticut headquarters is to see the modern, secular equivalent of medieval monks debating how many angels can dance on the head of a pin. The discussions seem not so much about how to fine-tune our focus on financial reality as how to find rationales to invent unreality.

The principles-based approach to accounting looks in many ways more like the future of the world, a future based on improving the understanding of human nature and how to set broad rules based on holding people accountable for their actions to address the broad effect of their conduct, not the fine details of that conduct.

As Tony Tinker, professor of accounting at Baruch College and a leading critic of the accounting profession, observed, "With principles-based accounting, you will be subject to much stronger common law regulation as fiduciaries and agents of fiduciaries."

But the Securities and Exchange Commission wants us to move much too quickly toward IFRS adoption and perhaps too quickly to adequately protect the interests of shareholders, which is supposed to be that agency's guiding purpose. What hurts U.S. shareholders tends also to threaten the U.S. fisc and to complicate the already difficult work of tax administrators in properly assessing and collecting corporate levies.

Taxpayers, tax administrators, Congress, and shareholders should all be alarmed at the prospect of such a major switch on a fast track when we are in what politicians now routinely call the worst financial crisis since the Great Depression.

The taxpayers have just been tapped for more than \$7 trillion of cash and guarantees to bail out Wall Street, foreign banks, and the automotive industry. Shareholders have lost a quarter or so of their equity in companies, and some have been wiped out. Tax revenues are plummeting as profits and gains become (temporarily) just memories for many companies and individuals. Housing prices are still falling in many parts of the country. The risk of a massive deflation looms, with inflation (maybe even hyperinflation) almost certain in the future as government expands the money supply faster than the economy.

New bailouts seem to be launched almost weekly. We need a well-prosecuted attack on the meltdown, including the faulty financial reporting standards that made it possible, led by financial generals and admirals steeped in accounting and economic principles. But despite their credentials, our top leaders are acting like a bunch of contentious lieutenants and captains who know only tactics, not strategy. How else to explain the lurch from a demand for \$700 billion to buy toxic assets, to deferring toxic asset purchases until after the elections, to injecting liquidity into banks, to rescuing this company and not another?

In the midst of this massive transfer of wealth -- and that is exactly what bailouts are -- the SEC is pushing a whole new system based on principles rather than specific rules.

This is madness.

We have already gone mad with the bailouts and guarantees, which now equal about 60 percent of a year's gross domestic product and approach the value of all residential mortgages in the United States. A single company, Citigroup, has been given more than 2 percent of GDP.

Government leaders are acting as if there is not just a money tree in Uncle Sam's backyard, but a vast grove growing greenbacks as fast as we can pluck them.

Switching the basics of financial reporting in the midst of a continuing bailout would go beyond simple madness to qualifying for straightjacket treatment.

Changing financial reporting standards at the most basic level, the level of principle, will make it nearly impossible to ever figure out what really happened. Worse, it would make it easier for the less-than-scrupulous to hide anything it wants, be it more toxic assets or where the public's money really went.

The record shows plenty of cause for these concerns.

First, the set of IFRS that the United States is considering adopting hardly constitutes a global standard. Right now, what one country calls IFRS is what another calls unacceptable. There are "as adopted" variations of IFRS as well as national and regional variations; so many that now IFRS arguably comes in more flavors than Baskin-Robbins ice cream.

The word "standards" is also drawn into question by a statement from the International Federation of Accountants warning that while someday IFRS will make financial reports more comparable, "consistency will not be achieved overnight. It will take some time for all market participants to be familiar with IFRS, and the usual forces for consistency -- peer pressure and regulatory enforcement -- will not act in the usual way at first. Also, consistency does not mean uniformity. The IFRS standards are principles-based and require judgment to apply them. In some cases the standards allow for the use of alternatives. And every company has different facts and circumstances. Consistency means an acceptable interpretation in every case -- it does not mean an identical application and interpretation in each case."

Maybe we should refer to the NIFRS, the Nascent International Financial Reporting Standards.

Then there is what Charlotte Jones, managing director and global head of accounting policy for Deutsche Bank, told the SEC at an August hearing. (Keep in mind that Deutsche Bank played a central role in the tax shelters that have bedeviled government and relied on hiding the facts.)

"IFRS is still less mature than U.S. GAAP [generally accepted accounting principles]," Jones said. "There isn't so much of a track record and guidance there."

She was speaking specifically about those off-books assets and liabilities that have been at the heart of so many of our financial woes in recent years, vehicles that keep secrets from shareholders and all but the savviest of tax auditors.

When Deutsche Bank switched to IFRS, she testified, "what we found at the point of conversion was that the very much more rules-based approach that we had followed under U.S. GAAP did require a lot of revisiting and indeed, a lot of different answers when we moved to IFRS."

Revisiting how assets and liabilities are measured is a good thing. But it was where Jones ventured next that should raise eyebrows.

"To give you an idea," she said, "we consolidated an additional 200-something vehicles on conversion to IFRS, compared to our U.S. GAAP results. Part of that was driven by the very specific QSP [qualified special purpose entities] rules, which were there around the securitization activities."

And when we dig through the mess that caused the bailout, what will we find? Lots of securitizing of mortgages and other assets that created a false sense of their value, combined with fleets of those special purpose vehicles that kept dubious assets off corporate balance sheets but did not banish them from reality.

"We were on IFRS for real, it created more work, in that you could never rely on any specific rule to give you a yes-or-no answer," Jones continued. "We needed to fully understand what was going on in the vehicle, or the suite of vehicles, and the assets and liabilities transferred to them in order to reach that judgment. So it was more difficult, more work. But I think on balance it gives a more realistic answer of what's going on."

On the surface, requiring a close reexamination of off-books entities seems like a strong argument for IFRS. The problem is that in the transition, in the context of the bailout, it will open vast opportunities to hide and obfuscate, vexing tax administrators.

Tinker, the accounting critic, noted in an interview that with IFRS, "the emphasis is to leave much more to the discretion of accountants and reporting entities and hewing more to the spirit than the letter of the rules." Yet what the meltdown has revealed is that the accounting profession did not do its duty under the Sarbanes-Oxley Act of 2002 to "attend to the systems of internal controls. They broke down, which showed that there was no proper adherence to the Sarbanes-Oxley provisions," he concluded.

Why would we expect there to be any better conduct during a switch from one set of accounting fundamentals to another?

Consider what happened in Europe in 2005 when companies that had not already adopted IFRS did so. Companies engaged in a host of troubling activities, according to research by Vedran Capkun, Anne Cazavan-Jeny, and Thomas Jeanjean -- three French business scholars -- and Lawrence A. Weiss of Georgetown University's McDonough School of Business.

They analyzed statements of publicly traded companies, controlled for a host of factors, and concluded that there was solid evidence of earnings management, a polite term for what the SEC calls "misleading investors," and what the rest of us think of as cheating.

Their paper should give more than just pause to tax administrators and investors: The level of enforcement of accounting and other rules did not affect earnings management.

That is a chilling observation, one that should make tax administrators and investors alike insist on a long list of reasons why we cannot slow down the transition to IFRS until the current financial crisis has passed and the facts have all flowed into the record, right down to the last few drops buried in the footnotes.

It was from the fine details in Enron's financials that journalists revealed the company was a house of cards. In breaking the story that Enron did not pay taxes, I relied on the fine print of its Form 10-K annual reports. Knowing what we know now about Enron -- and WorldCom and Countrywide and Wachovia and on and on -- why would we expect anything but game playing? And why in the world would we even consider a system that could mean less disclosure of the fine details that expose rot and wrongdoing?

Requiring companies to engage in both book and tax accounting has created vast opportunities to game the system that far too many companies have embraced, some gleefully. Remember that Enron labeled its tax department a "profit center," though it was not the first to do so behind closed doors.

We should be concerned that the transition to IFRS will be used to play tricks on tax authorities and investors alike. Transition to IFRS will create more opportunities to obscure and hide.

Tax administrators, speak up. Tell the politicians how much more difficult it will be to properly levy taxes if we switch from rules-based to principles-based financial reporting, instead of waiting before the meltdown is over and the red-hot ink flowing everywhere has cooled.