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Abstract. During the last several decades businesses have experienced an increasingly rapid rate of global and informational change. This transformational pressure has had a significant impact on U.S. accounting regulators, providing a window of opportunity for improving the standard-setting process. This paper argues that an increasingly codependent and interconnected world requires a single, harmonized standard that will provide a common basis for an effective and efficient global marketplace. A transition to a harmonized standard will not be without its own risks and costs, yet the cost of obsolescence and irrelevancy may prove to be the greater threat to the current system.

The purpose of this paper is to provide an overview of the issues related to the harmonization of accounting standards, an investigation of the two major standards in use, followed by a brief illustration of how financial assets would be measured and disclosed under a fair value, principles-based system.

Introduction. During the last several decades businesses have experienced an increasingly rapid rate of global and informational change. The resulting expansion and decentralization of societal and cultural boundaries provides accounting regulators with an opportunity for advancing the standard-setting process. The paper argues that an increasingly codependent and interconnected world requires a single, harmonized standard that will provide a common basis for an effective and efficient global marketplace. As such, two major standards currently in use in key capital markets are investigated. An examination of both standards' strengths and weaknesses demonstrates that a principles-based regime is superior to a rules-based system. Finally, the paper concludes with a brief discussion of how financial assets would be measured and disclosed under a fair value, principles-based system.

The two major standards. Before presenting a roadmap for the harmonization of existing standards, an overview of each of the two major standards is necessary. Although principles-based and rules-based standards are not well defined, the Financial Accounting Standards Board's (FASB) generally accepted accounting principles (GAAP) are commonly considered rules-based while the International Accounting Standards Board's (IASB) international generally accepted accounting principles (iGAAP) are commonly considered principles-based. The following section reviews the advantages and disadvantages associated with the use of a more rules-based standard via GAAP as opposed to a similar examination of a more principles-based standard via iGAAP.

Advantages of GAAP. To a large degree the U.S. accounting profession has been solely responsible for the creation and implementation of GAAP over the last century. A rise in scandals and public criticism during the past 30 years reached a crescendo and the authority to pronounce GAAP was finally removed from the hands of the profession (Zeff, 2003). As a result, many have questioned the ability of what is perceived to be a rules-based system to effectively promote a fair and true financial reporting mechanism. Despite these failures there appears to be two advantages to GAAP. The primary advantage is that GAAP benefits constituents by providing more structure, verifiability, and detail. This advantage then leads to a secondary benefit of increased market confidence. Each is evaluated further below.

Although a "check-box" mentality certainly seems to exist, one primary question is whether this mentality is a result of a rules-based system. Some argue that constituent demand is responsible for creating a perceived system of rules, driven by what appears to be a list of detailed rules and guidance. This appetite for rules and guidance arises at least in part due to desires for clarification, scope extensions, treatment exceptions, and implementation guidance (Financial Accounting Standards Board, 2002; Schipper, 2003). According to Schipper (2003, p. 71) the "…U.S. financial reporting standards are in general based on principles, derived from the FASB's Conceptual Framework, but they also contain elements—such as scope and treatment exceptions and detailed implementation guidance—that make them also appear to be rules-based." Therefore it seems safe to conclude that FASB and Schipper would agree that GAAP is not purely principles-based. However, they would also likely note that the current system provides an advantage to constituents by offering more structure, verifiability and detail than a strictly principles-based regime (Financial Accounting Standards Board, 2002; 2003).

Secondarily, a by-product of increased verifiability is an improvement in market confidence. By increasing market confidence, GAAP provides an adequate response to one of FASB's stated goals: to provide relevant information in order to encourage market confidence (Financial Accounting Standards Board, 2010). In fact, two studies noted no difference in quality of information provided by GAAP vs. iGAAP (Hail, Leuz, & Wysocki, 2010a; Leuz, 2003). This implies that market confidence via verifiability can be retained without sacrificing any informational quality.

Disadvantages of GAAP. As globalization continues to encourage international interconnectedness there is greater resistance from factions both within and without the U.S. to abandon the current standard-setting system in favor of iGAAP. These constituents believe that GAAP is inherently flawed in several ways. First, there is a perception that a rules-based approach encourages compliance rather than judgment. Second, the bright-lines associated with GAAP encourage earnings management. Last, GAAP fails to reflect the economic realities of certain transactions. These shortcomings are discussed below.

While a more rules-based approach might offer increases in structure, verifiability, and detail, it can also encourage a "compliance" mentality which begins to impair the informational value afforded by GAAP. Even Schipper, a proponent of GAAP, acknowledges that the current GAAP system fosters "…an alleged current 'check-box' mentality, that is, in the view of some, an open invitation to financial structuring and other qualities that subvert high quality financial reporting (2003, p. 61)." Worse yet, a focus on compliance encourages form over function; i.e., sacrificing the essence of an accounting standard in order to adhere to the required rules. This discourages the use of professional judgment by replacing it with policies and procedures.

Additionally, the specification of bright-lines inevitably encourages earnings management via "transaction structuring" (Nelson, 2003, p. 100) and "financial engineering" (Benston, Bromwich, & Wagenhofer, 2006, p. 185). Indeed, earnings management is often actually increased by tighter, more precise reporting standards associated with rules-based systems (Ewert & Wagenhofer, 2005; Nelson, 2003). As a result, some suggest that a move away from GAAP towards a more principles-based system that is imprecise enough to avoid safe harbors is the only antidote to aggressive reporting (Nelson, 2003).

As noted earlier, by definition rules-based systems tend to promulgate specific and narrow guidance that suppresses professional judgment. This suspension of professional judgment becomes problematic in certain circumstances, such as the application of fair value techniques in accounting for financial instruments (Linsmeier, 2011). The use of fair value under a GAAP regime would ultimately lead to a prescriptive, mechanistic application of rules and computations. By contrast, a fair value method coupled with a principles-based system would marry the richness of professional judgment with the imprecision necessary to exercise and report on that professional judgment.

Advantages of iGAAP. Many of the disadvantages of GAAP become advantages under iGAAP, and vice versa, and do not need to be repeated in detail. By way of summary, two key advantages to iGAAP which have been previously discussed include: (1) the encouragement to exercise professional judgment (Schipper, 2003) and (2) the ability to curb aggressive reporting (Nelson, 2003). There are three additional, and perhaps more critical, advantages to iGAAP as follows below.

First, and most importantly, iGAAP would lead to an improvement in comparability (Hail, Leuz, & Wysocki, 2010a). As globalization continues to increase competition for scarce capital resources, the importance of comparability will become more critical. Under current standards it is difficult to compare GAAP vs. iGAAP firms, and this in turn limits an investor's ability to allocate resources to the most efficient and profitable entity. Furthermore, Hail et al. (Hail, Leuz, & Wysocki, 2010a) note that iGAAP would not either increase or decrease information quality, suggesting that even a modest comparability benefit would be desirable.

Second, research suggests that principles-based standards can be both flexible and clear when written precisely (Nobes, 2005). In fact, according to Nobes (2005), the failure to base standards off of appropriate principles can lead to an overreliance on rules. Although a reduction of rules might also lead to a reduction in verifiability, Nobes (2005) seems to believe that the benefit of reduced complexity, increased flexibility and increased clarity offset such costs.

Finally, multinational firms will experience recurring future cost savings after a one-time transition cost (Hail, Leuz, & Wysocki, 2010a). Although this benefit is limited to a subset of all firms, anecdotal evidence suggests that even small U.S. firms are experiencing international growth due to rapid changes in technology and the continued "flattening" of our world. Assuming this trend continues, it seems inevitable that other firms will eventually benefit from a global standardization of accounting principles.

Disadvantages of iGAAP. One danger of moving towards a principles-based system is that professional judgment will not be exercised appropriately, resulting in biased reporting. Maines et al., (2003) note that principles-based accounting is more difficult to implement and enforce because of the level of agreement and effort required jointly by management, the board of directors, and auditors. As a result, "the importance of professional judgment and the desire for unbiased reporting is paramount (Maines et al., 2003, p. 81)."

Because of the degree of professional judgment required, a second issue arises under iGAAP. Principles-based systems inherently afford a wider range of alternatives than do rules-based systems. One drawback to a larger range of alternatives is the lack of clarity if provides auditors when assessing management judgments. For example, a study by Trompeter (1994) indicates that a more specific, rules-based regime is likely to limit a firm's ability to influence auditor judgment. As a result, it seems likely that an increase in standard flexibility would correspond to more alternatives being available for management to affect auditor judgment.

While these are two of the more serious disadvantages to iGAAP, there are other potential problems. For example, researchers have revealed that acceptance of a single global standard would award and promote monopoly status for the standard-setter and therefore stifle innovations in accounting practices (Hail, Leuz, & Wysocki, 2010b; Jamal et al., 2010; Sunder, 2009). Likewise, Hail et al., (2010b) also note that a switch to iGAAP would not improve reporting quality which obscures whether any benefits gained would exceed the one-time switching cost and on-going compliance costs. Finally, Hail et al., (2010b) describe other complications related to standard creation and enforcement and funding of the standard-setting body. While some of these issues are not directly related to the success or failure of an accounting standard per se, the problems of implementing and executing such a principles-based system still affect the overall success of the regime.

Why iGAAP is a preferable approach. At this moment in history two things seem abundantly clear: today is an era of information and globalization. Businesses, countries, and people groups are no longer isolated from each other. Technology, the great enabler, binds these entities together, both informing and joining disparate parties at a pace that seems to increase each day. In this context it seems likely that the international movement of human capital and goods will only continue to increase. These movements will require a common language to ensure fair and true trade. Just as English is now the common medium of business communication, a common regime of accounting standards is now necessary to measure global business exchange. This harmonization will facilitate the effective and efficient use of financial information by all stakeholders. Which regime will provide the best avenue for global harmonization? I believe that a principles-based regime offers our best chance at success. My defense of this selection follows.

A primary concern with harmonization is whether the quality of the standard will be impacted by the type of regime. Fortunately there is research evidence that neither a rules-based nor principles-based regime significantly affects the overall quality of financial reporting (Hail, Leuz, & Wysocki, 2010a). Not only will quality be retained, but other evidence shows that neither approach, as employed today, significantly alters the incentive or ability of management to report aggressively (Maines et al., 2003). However, when principles-based standards are worded more precisely then there is evidence that aggressive reporting practices can be somewhat mitigated (Hronsky & Houghton, 2001; Nobes, 2005). Additionally, there is recent evidence that suggests that reporting quality might actually be improved when both preparers and auditors use the same principles-based system (Jamal & Hun-Tong Tan, 2010). This suggests that concerns over the quality of a principles-based regime and its ability to mitigate earnings management are unwarranted, especially when all stakeholders utilize a common system. Indeed, it appears that a principles-based system will retain the same level of reporting quality while affording the opportunity to improve a standard's effectiveness of reducing opportunistic reporting behavior.

It appears then that reporting quality is high for either regime, and therefore irrelevant for a decision to adopt one over the other. Indeed, the ideal of comparability in an increasingly globalized world rises in importance. Hence a key question: which system best ensures global comparability? Although there is recent evidence that iGAAP has already increased comparability between GAAP versus iGAAP preparers, differences between the two systems still remain (Barth, Landsman, Lang, & Williams, 2011). If these differences continue to exist they will likely continue to hinder true comparability, and outcome that seems unacceptable in an increasingly interconnected world. It is also true that both structures are susceptible to political lobbying (Zeff, 2002) yet recent evidence demonstrates that iGAAP is likely to provide modest comparability gains (Hail, Leuz, & Wysocki, 2010a). There are also critics who note that comparability benefits are unrealistic and overstated, yet most of the concern seems targeted at the issue of a standard-setter receiving monopolistic power in a one system regime (Jamal et al., 2010). It is ironic that competition in standard setting only seems important when considering nations, yet the FASB and Securities and Exchange Commission ("SEC") enjoy monopolistic powers within the U.S. It seems reasonable, just as it occurs in the U.S., that if there are enough stakeholders involved in the standard-setting process, then monopolistic power will be greatly mitigated by the internal and external forces applied by those stakeholders.

Finally, Demski et al. (2002) suggest that accounting is an information medium that encounters market and nonmarket interactions.

This implies that we need to take care to properly encode financial information in a manner that enables it to interact in a global environment yet remain consistent and comparable. But in order for this to occur each firm or nation state would need to accept a common method for encoding that information: a harmonized standard-setting system. It appears that a principles-based system is the best, and only, way forward that will help achieve this reality. The selection of a system should therefore be based on ideal criterion without being influenced by secondary concerns of enforcement, funding, and standard-setting. In summary, the regime that best meets the ideal criterion and the needs of our globalized, information saturated environment today, and in the future, is a principles-based system.

A principles-based approach to fair value. Fair value measurements have recently been under increased scrutiny due to many high profile bank failures. As a result, this accounting topic seems relevant and appropriate as a basis for developing a principles-based approach. Interestingly, the FASB and IASB completed a fair value measurement project in 2011 with the aim of developing a common set of guidance. Below I will briefly describe how I would define, measure, and disclose financial assets using fair value under a principle-based regime. In general, I would adopt a system that is similar to that used by the FASB and IASB, especially after the recent 2011 update and convergence (much of the content below is adapted from IFRS 13 and ASU No. 2011-4).

Summary objective. This objective of this principle is to provide a standard that explains how to measure fair value of financial assets for financial reporting. It does not require fair value measurements in addition to those already required or permitted by other principles and is not intended to establish valuation standards or affect valuation practices outside of financial reporting.

Scope and Definition. This principle applies to all financial assets that require fair value measurements. In brief, fair value is measured using observable transactions or information from the asset's principal, or most advantageous market, when available (this is Level 1). This generally infers quoted market prices for identical assets. If Level 1 inputs are not available, inputs that are derived from observable transactions or information from a similar asset's principal, or most advantageous market should be used (this is Level 2). If both Level 1 and Level 2 inputs are unavailable, inputs that are derived from the company's own unobservable data, adjusted for market assumptions, should be utilized (this is Level 3). There would be no scope exceptions or exclusions.

Measurement. Initial and subsequent measurement should be based on the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date under current market conditions for that asset's principal market. Level 1 inputs must be used if available, followed by Level 2 and Level 3 inputs, in order of preference. When measuring fair value a reporting entity shall take into account the characteristics of the asset if market participants would take those characteristics into account when pricing the asset or liability at the measurement date.

Required disclosures. This principle requires the preparer to provide disclosures necessary for understanding the source and amounts of reported fair value measurements for financial assets. The underlying assumptions are essential to obtain such and understanding. Accordingly, these disclosures must include but are not limited to:

1) The financial assets should be categorized according to risk and clearly labeled on the face of the statement of financial position
2) The financial assets should be further categorized as either operating assets or financing assets on the statement of financial position according to the model presented by Dichev (2008)
3) Footnote disclosure of both the historical cost and fair value by Level of financial asset according to the model presented by Barker (2004)

4) All valuation techniques and inputs used to develop fair value measurements
5) For fair value measurements using unobservable inputs (Level 3):
    a. The effect of fair value measurement on earnings or other comprehensive income
    b. A quantitative sensitivity analysis and its various effects on earnings or other comprehensive income
    c. A narrative providing an explicit rationale for the choice of a Level 3 valuation over Level 1 or 2

Conclusion. A move towards a principles-based system will not be without its own risks and costs. However, the even greater cost of obsolescence and irrelevancy threatens the current system. Despite a great history of financial and capital market dominance, the U.S. risks losing its influence and status by failing to seize an opportunity to help shape what has already become the majority world's de facto standard in iGAAP. The process of globalization is not likely to reverse or decelerate. The best chance therefore awaits us with complete harmonization into a single, unified iGAAP structure.

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