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The Student Perspective

The Trend of International Accounting Harmonization

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Executive Summary

One of the most important motivators for harmonizing accounting standards is to reduce the compliance costs for companies listed on stock exchanges in different countries, and at the same time to encourage more cross listings on multiple stock exchanges. Moreover, high quality international accounting standards would improve investor confidence, enhance market liquidity, and may ultimately reduce the cost of capital. Global accounting standards are hence rapidly converging.

This article discusses the history, recent developments and likely future trends in the harmonization of international accounting. Specifically being reviewed are organizational efforts toward accounting harmonization, debate over concepts-based vs. rules-based approaches, the obstacles to harmonization, and brief summary of similarities and differences between IAS and U.S. GAAP. The objective is to understand where we are in approaching harmonization; the answer to the questions of when and how the goal can be achieved would be more feasible for bridging the GAAP in converging global accounting standards.

Introduction

Only a few years ago harmonization of accounting standards was viewed by most as an admirable but unattainable goal. As capital markets become more internationalized, there is an increasing need for financial information that is understandable to investors in many different countries. Because the movement toward harmonization of accounting standards should keep up with the increase in international economic activity, there is a consensus that world capital markets want financial reports that comply with a high-quality body of "global accounting standards" that are applied consistently by international and large national businesses with stock market listings.

At this moment, market regulators around the world are considering which standards to use for cross-border listings on stock exchanges (Martin & Udo, 1996; Pownall & Schipper, 1999; Dye & Sunder, 2001; Cheney, 2002; Campbell, 2002; Chawla, 2003; Cornik-Tomaszewski & McCarthy, 2003; Garcia, 2003). For years, U. S. Generally Accepted Accounting Principles (hereafter, GAAP) proponents steadily rejected proposals for shifting to international accounting standards (hereafter, IAS), but corporate scandals in the U.S. have largely undermined their long-standing argument that GAAP is invariably superior to IAS. In face of the recent financial reporting crisis in the U.S. Financial Accounting Standard Board (hereafter, FASB) has realized

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that it does not have all the answers to all accounting issues. There are some areas of U.S. standards that could be improved, generally where international standards seem to be more principles-based and more easily applied (Pacter, 1998; Staff, 2002; Cheney, 2002; Gallardo, 2003; Cornik-Tomaszewski & McCarthy, 2003).

To achieve its current goal of convergence, the International Accounting Standards Board (hereafter, IASB) works closely with national standard setters around the world. The FASB is one of the IASB's most important partners. Therefore, the issue before us is no longer whether we should have a set of high-quality international standards, but when and how this might be achieved. Even though significant national differences exist in the form of economic, political, cultural and social factors, a very strong drive for harmonization will continue. By understanding where we are in approaching harmonization, the answer to the questions of when and how the goal can be achieved would be more desirable (Cornik-Tomaszewski & McCarthy, 2003).

This paper will discuss the history, recent developments and likely future trends of international accounting harmonization. Subjects such as organizational efforts toward accounting harmonization, debate over concepts-based vs. rules-based approaches, the obstacles to harmonization, and the main differences and similarities between U.S. GAAP and IAS are covered in this paper.

The History and Recent Developments of International Harmonization

Prior to 1960, there was little effort devoted to the international harmonization of accounting standards. The International Accounting Standards Committee (hereafter, IASC) was created in 1973 by 16 professional accounting bodies from nine countries, primarily from Europe and North America (Benson, 1976). Companies seeking capital outside of their home markets and investors attempting to diversify their investments internationally faced increasing problems resulting from national differences in accounting measurement, disclosure, and auditing. In response, harmonization efforts accelerated during the 1990s. International accounting harmonization now is one of the most important issues facing securities regulators, stock exchanges, and those who prepare or use financial statements (Choi et al., 2001).
Efforts have been made by a number of organizations to reduce the differences between accounting systems. Although a number of international bodies have been involved in seeking to introduce accounting standards for global use, the most important international standard setter is the IASB, formed in 1973 as IASC but re-named, with effect from April 2001, following a re-structuring (Ei-Gazzar et al., 1999; Choi et al., 2001).

IASC (International Accounting Standards Committee)

The IASC was established in 1973 and headquartered in London by professional accounting organizations from 9 nations (Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and Ireland, and the United States).
As Epstein and Mirza (1997) discuss, the IASC's progress can be seen as taking place within three phases:

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1) 1973-1988: the development of a common body of standards;
2) 1989-1995: the comparability/improvements projects, known as ED32.
3) 1995-current: the core standards project (Danaher & Hunt, 1999).

The IASB issued Exposure Draft 32 in 1989, which led to the revision of 10 IAS, all of which substantially reduce the amount of choice available to companies when choosing which financial accounting practices to follow. The revised IAS include IAS 2, Inventories; IAS 8, Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies; IAS 9, Research and Development Costs; IAS 11, Construction Contracts; IAS 16, Property, Plant and Equipment; IAS 18, Revenue; IAS 19, Retirement Benefit Costs; IAS 21, The Effect of Changes in Foreign Exchange Rates; IAS 22, Business Combinations; and IAS 23, Borrowing Costs (Epstein & Mirza, 1997).

Significant progress has been achieved such as during the 1990s when the IASC have completed Comparability and Core Standard projects, which sought to establish greater standardization in the way in which financial reporting was performed, especially in relation to a targeted number of core issues that were identified as important by the International Organization of Security Commissions (hereafter, IOSCO). The IASC's work has only begun. IASC's core set of standards is not sufficient to meet the needs of the capital markets fully. Significant differences continue between international standards and national standards, leading to a lack of comparability across political boundaries (Pacter, 1998; Hanks, 1999; Casabona & Shoaf, 2002).

IOSCO (International Organization of Security Commissions)

The IOSCO, the association of world stock exchange regulators, consists of the Securities and Exchange Commission (hereafter, SEC) in the U.S. and securities regulators from more than 80 countries. It is the representative body of the world's securities markets regulators, bodies that aim to develop international consensus, exchange information, establish adequate standards of investor protection, and provide mutual assistance for effective surveillance and enforcement (Choi et al., 2001).

The IOSCO identified standards that needed to be improved in order for IASC standards to be acceptable for cross-border offerings. In July 1995, IOSCO and the IASC agreed on a work program to establish core standards for use in cross-border listings in all major countries when the IASC satisfactorily completed a core set of high-quality standards. IASC largely completed that program in late 1998 and in May 2000, core standards of the IASC were approved and endorsed by IOSCO for use in foreign filings on the world's securities exchanges (Pacter, 1998; Hanks, 1999; Anonymous, 1999; Parry, 2003).

The IOSCO endorsement is expected to lead the way to acceptance of IAS in the main capital market countries in which IAS is not already accepted for cross-border listings and offerings and significantly increase the IASC's chances of becoming the global standard-setting body.

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Commission of the EU (European Union)

The position of the European Union (EU) is somewhat different to that of the IASC. The fundamental objective of the EU is the creation of a common economic market which allows free mobility of capital, labor, and enterprises across the national borders of its member countries. To achieve this objective it is necessary that the infrastructure of markets be harmonized; financial accounting is considered to be part of that infrastructure (Choi et al., 2001).

However, EU governments through Directives, and the accounting profession through the IASC, both claim to be seeking to harmonize accounting practices. The EU influences financial reporting via legal directives. Although EU Directives are not standards and variations in interpretation have restricted the level of harmonization, they have at least improved the level of comparability of financial reporting requirements (Carlson, 1997).

Blake and Amat (1994) conclude that the major reasons for seeking to achieve international accounting harmonization include:
1) Serving the need of international investors.
2) Facilitating the work of transnational corporations.
3) Exchanging accounting skills on a global basis.
4) Offering an alternative to U.S. domination of accounting practices.

In fact, the EU and many individual countries and companies look to standards developed by IASC. In June, 2000, the EC has already proposed that all publicly traded companies in the 15-nation EU should be required to present IAS financial statement, rather than under a variety of national codes, by 2005. With less than 300 of the 7,000 listed EU companies currently using IAS, the conversion process that will be required before 2005 will be enormous. Europe's move to adopt IAS has spurred other countries, particularly those that trade heavily with Europe, to accelerate their adoption of IAS (Cairns, 2001; Rouse, 2002; Cheney, 2002; Silvia & Schroeder, 2002; Hofheninz, 2002; Gallardo, 2003; Garcia, 2003).

U.S.'s Progress Toward IA

By 2005, all companies listed on EU exchanges must adopt IAS. Under growing pressure from abroad to revisit the issue of U.S. acceptance of IAS, the SEC continues to consider whether foreign firms should be able to list on a U.S. exchange using IAS. In October 2002, FASB and the IASB jointly issued a memorandum of understanding and announced that they will pursue a joint plan for reconciling the differences between U.S. GAAP and IFRS through a series of projects conducted by both agencies, which marked a significant step toward formalizing their commitment to the convergence of U.S. standards and IAS (Hansen, 2003).

Europe's Progress Toward IAS

The unified currency, the euro, represents another important barrier that has been removed. The euro is becoming more influential as a global currency, and this certainly will help

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boost Europe toward superpower status. Furthermore, with all of the 7,000 companies listed and operating in the EU obligated to covert to IAS, now officially called International Financial Reporting Standards (IFRS replace IAS in June 2002), and companies in scores of countries outside the EU converting as well, the beginning of a new era of transparency and cross-border comparability is heralded (Maiello, 2002; Dannhauser, 2004).

Up to year 2003, according to Hansen (2004), some 35 countries require the use of international standards for all domestic listed companies, six other countries require the use of international standards for some companies, and many countries base their national practices on international standards. In 2002, several jurisdictions, including Australia and Russia, announced that they would follow Europe in mandating conversion to IFRS by January 1, 2005 (Anonymous, 2001; Rouse, 2002).

The GAAP Convergence project, a group formed by the six largest accounting firms, surveyed 59 countries in 2003 and found that 95 percent either have adopted, intend to adopt, or intend to converge with IPRS. Three quarters of the countries that intend to adopt IFRS have a formal policy in place for doing so. A majority of these are EU members or countries that plan to join the EU, but convergence is underway in a significant number of nations outside Europe. Countries that trade heavily with Europe will be under even greater pressure to covert (Hansen, 2004).

Concepts-Based vs. Rules-Based Approaches

Since as a practical matter the rest of the world outside the U.S. is moving toward or has already adopted IAS, this option amounts to allowing a competition only between IAS and U.S. GAAP (Pijper, 1998; Hanks, 1999; Schwartz, 2001; Campbell et al., 2002; Leuz, 2003, Garcia, 2003).

Schwartz (2001) summarizes three important responses to the SEC's questions of whether IASC standards were of sufficient comprehensiveness and high quality to be used without reconciliation to U.S. GAAP. Respondents emphasized the following:

1) Deficiencies in quality,
2) Inadequate infrastructure to ensure rigorous enforcement, and
3) Significant conceptual differences between IASB standards and U.S. GAAP.

The IAS principles are fundamentally different from some of the detailed guidance in U.S. GAAP. After the scandals surrounding the disclosure failures and shortcomings associated with Enron and Worldcom in U.S., the attention is likely to eventually turn to how disclosure rules and practices ought to be changed in light of the increasing globalization of equities markets. In its new project, the FASB indicates its intent to evaluate the feasibility of issuing concepts-based standards rather than issuing detailed, rule-based standards with exceptions and alternatives (Pacter, 1998; Staff, 2002; Cheney, 2002; Hofheinz, 2002; Gallardo, 2003; Maines et al., 2003; Cornik-Tomaszewski & McCarthy, 2003;).

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There is the belief that economic substance, not the form, of any given transaction should guide financial reporting and standard setting, and that concepts-based standards represent the best approach for achieving this. Rules-based standards provide companies the opportunity to structure transactions to meet the requirements for particular accounting treatments, even if such treatments do not reflect the true economic substance of the transaction (Hofheinz, 2002; Maines et al., 2003).

Maines et al. (2003) state that it is impracticable, if not impossible, for any standard-setting organization to anticipate and provide for every possible form and type of financial transaction and business relationship. Detailed standards are likely to be incomplete or even obsolete by the time they are published. In addition, such detailed standards provide self-interested managers the opportunity to manipulate the reported results under the guise of complying with the rules. In turn, auditors find it more difficult to thwart such manipulations of reported financial results when detailed rules serve as the managers' justification. Therefore, a concepts-based approach likely will lead to greater agreement in standard setting between the FASB and IASB, and thus promote international harmonization.

However, the primary responsibility for financial reports lies with management. With concepts-based standards, the importance of professional judgment and the desire for unbiased reporting is paramount. Nelson et al. (2002) find that when the standard provides no "bright line" for managers to use in transaction structuring, they are less likely to engage in costly transaction structuring. With such concepts-based standards, managers are more likely to justify earnings management attempts by convincing the auditor of their interpretation of the imprecise rules. Auditors are more likely to permit such earnings management attempts to stand when the accounting is governed by more flexible or subjective standards.

Dye (2002) provides support for Nelson et al. (2002) by stating that rigid standards will increase managers' ability to manipulate financial reporting outcomes opportunistically, and thus weaken the effectiveness of the standard.

The Obstacles to Harmonization

Differences in accounting and financial reporting are a product of a variety of longstanding environmental factors of an economic, political, and cultural nature. Culture is often considered to be one of the powerful environmental factors affecting the accounting system of a country. Additionally, nationalism leads to an unwillingness to follow other countries' accounting practices and to give up sovereignty. These national variations in accounting standards create vast inefficiencies, impede the flow of capital and complicate cross-border transactions at the most basic levels (Asheq et al., 1996: Brusca & Condor, 2002).

Rich traditions exist among many EU members. Cultural values frequently become embedded in law, resulting in barriers cross-border business. However, the reduction of travel and currency exchange barriers is helpful to the goal of economic unification. The tax-driven

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nature of national accounting standards makes it difficult to adopt IFRS. The scope for local interpretation of accounting principles provides further opportunity for confusion (Asheq et al., 1996; Blake, et al., 1997; Blake, et al., 1998).

Doupnik and Salter (1995) provide the most comprehensive empirical study using three principal categories to determine a nation's accounting development: the external environment, cultural values, and the institutional structure. Using this framework, they test environmental measures for 1) the legal system, 2) the nature of the relationship between business enterprises and providers of capital, 3) tax laws, 4) inflation levels, 5) level of education, and 6) level of economic development. Their results show that the legal system is very important variable and suggest that it is an institutional indicator that influences not only how accounting rules are promulgated but also the content of the rules.

While both the EU and the IASB pursue the objective of harmonizing national accounting practices, major differences between the approaches to national accounting standards remain. Internationally, and particularly within the EU, a major distinction in national accounting systems is between those companies which accept and those which reject a comprehensive binding link between tax rules and accounting rules. Two countries, Germany and the UK, can be seen as leading distinctive and contrasting accounting traditions in the EU. UK accounting practices have developed separately from tax law whereas German accounting has been significantly affected by tax rules. Therefore, albeit tax influences may be an important factor in some areas of accounting policy choice (Blake, et al., 1997).

Overall, obstacles to accounting harmonization in the EC include:
1) Differences in the regulatory framework in each country limiting the influence of the accounting profession in supporting IASB;
2) The "true and fair view"; the fundamental principle on which EU harmonization is built, varies in its interpretation;
3) A binding tax accounting link ties accounting practice to national tax rules rather than international norms (Asheq et al., 1996; Blake, et al., 1998).

Likely future trends of accounting harmonization

The convergence of IAS and national accounting standards is, and always has been, one of the IASB's key objectives (Cairns, 2001). In order to respond to these and other related concerns, there is a desire to move toward harmonizing international accounting standards by reducing the number of accounting alternatives that exist today. Three basic future roles exist for the IASB:

1) Producing standards for those countries that have no standards of their own.
2) Assisting in the reduction of diverse national practices.
3) Acting as an umbrella organizing for national standard setters who will be working together on developing issues to produce common principles which could then be returned into international standards by the IASB (Schweikart, 1994).

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On the other hand, U.S. GAAP consists of more detailed rules than IAS. The philosophical difference between the two is not easily bridged. The goal of one set of high quality global accounting standards is high on the priority list of the IASB and it has already built significant bridges with the U.S. standard setting body, the FASB. The IASB's ongoing project with FASB will continue to achieve convergence or harmonization between IAS and GAAP standards (Pownall & Schipper, 1999; Hofheinz, 2002).

Implications

One can conclude that IAS and U.S. GAAP are more similar than dissimilar and the movement toward harmonization is bringing them closer and closer. Campbell et al. (2002) state that many believe a precondition for a single set of high-quality, international accounting standards is convergence between U.S. GAAP and IAS. The key to this convergence lies in the conceptual frameworks that underpin each set of standards. To the extent that the frameworks are consistent, convergence should be easier (Crofts, 1998; Campbell et al., 2002; Buchanan, 2003).

As Dye and Sunder (2001) suggest, the economic map of the world has changed and it continues to change. If we assume that certain standards are useful for promoting commerce, cross-boundary commerce requires cross-boundary standards. Because accurate social cost-benefit analyses are difficult to conduct, accounting rules actually implemented may be inappropriate. Whether to depend on either the FASB or the IASB standards then could be decided if one set of standards is deficient relative to another; competition will eliminate the former.

An extremely valuable benefit of harmonization would be the increased usefulness of financial statements to global investors. Financial statements prepared in accordance with harmonized accounting standards would be far more comparable than those currently relied on by global investors (Parry, 2002). The report called GAAP 2001 by PricewaterhouseCoopers surveyed world standards; the brief summary of differences and similarities between U.S. GAAP and IASs (details for Figure 1) presented may provide a direction in achieving genuine harmonization.

Conclusions

The demand of international capital markets helps to drive harmonization and the increasing importance of IAS is evidenced by the growing list of countries that recommend them or accept their use. To achieve, and possibly accelerate its harmonization goals, the IASB has become more cognizant of the need to work with national standard setters. By bringing national standard setters into membership of IASB, it may be possible to eliminate the differences between national and international standards if the major standard setters agree to work together towards that aim. The current agreement could then be viewed as the first step in a much longer process. The IASB must view the IOSCO's endorsement as an early achievement and continue

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the difficult task of working with other standard setters to achieve international accounting harmonization. The unification of the regulatory environment in Europe has effectively reduced the number of parties that must now agree on international standards to two. Once the U.S. and the EU agree, the rest of the world will follow.

Appendix

Figure 1: Summary of similarities and differences between IAS and U.S. GAAP

Subject	IAS	U.S. GAAP
Financial statements		
Reporting currency	Requires the measurement of profit using the measurement currency, however, entities may present financial statements in a different currency.	Use a functional currency. Does not specify the concept of a presentation currency.
Components of financial statements	Two years' balance sheets, income statements, recognized gains and losses, cash flow statements, changes in equity accounting policies and notes.	Similar to IAS, except three years required by SEC for all statements except the balance sheet.
Balance Sheet format	Does not prescribe a particular format, however, certain items must be presented on the face of the balance sheet.	Similar to IAS, items presented on the face of the balance sheet are generally presented in decreasing order of liquidity.
Income statement format	Does not prescribe a standard format although expenditure must be presented in one of two formats (function or nature). Certain items must be presented on the face of the income statement.	Present as either a single step or multiple step format. Expenditure must be presented by function.
Exceptional items	Does not use the term, but requires separate disclosure of items that are of such size incidence or nature that require separate disclosure to explain the performance of the entity. Disclosure on the face of the income statement or in the notes.	Similar to IAS, but disclosure on the face of the income statement.
Extraordinary items	Are very rare, limited to events outside control of the entity.	Similar to IAS. Gain or loss from extinguishing debt must be classified as extraordinary.
Statement of recognized gains & losses	Give statement of recognized gains and losses as either separate primary statement or highlighted in primary statement of changes in shareholders' equity.	Disclosure total comprehensive income, either combined with income statement, or choose one of the two alternatives as for IAS.

(Continued)

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Subject	IAS	U.S. GAAP
Financial statements (continued)		
Cash flow statements – format & method	Standard headings, but limited flexibility of contents. Use direct or indirect method.	Similar headings to IAS, but more specific guidance given for items included in each category. Use direct or indirect method.
- definition of cash (equivalents)	Cash includes overdrafts and cash equivalents with short-term maturities (less than 3 months).	Cash excludes overdrafts, but includes cash equivalent with short-term maturities.
- exemptions	No exemptions.	Limited exemption for certain investment entities.
Changes in accounting policies	Either restate comparatives and adjust prior year opening retained earnings, or include effect in current year income statement and provide pro-forma comparative in the notes.	Generally include effect in current income statement. Disclosure pro-forma comparatives. Retrospective adjustments for specific items.
Correction of fundamental errors	Either restate comparatives or include effect in current year income statement with pro-forma comparatives in the notes	Restate comparatives.
Changes in accounting estimates	Reported in income statement in the current period.	Similar to IAS.
Revenue Recognition		
Revenue recognition	Based on several criteria, which require the recognition of revenue when risks and rewards have been transferred and the revenue can be measured reliably.	Four key criteria. In principal similar to IAS. Detailed guidance for specific transactions.
Construction contracts	Accounted for using the percentage of completion method. Completed contract method prohibited.	Similar to IAS, completed contract method permitted.
Expense Recognition		
Interest expense	Interest expense recognized on an accrual basis. Effective yield method used to amortize non-cash finance charges.	Similar to IAS, effective yield known as interest method.

Source: Price WaterhouseCoopers, Sep. 2001

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