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The Changing Accounting Environment: International Accounting Standards

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Abstract

Accounting provides useful information to decision makers, thus as the business environment has changed so have the accounting standards that govern the presentation and disclosure of information. International Accounting Standards are central to this concept. International standards were first developed in the late 1960's but they have reached their zenith of importance in today's economic and business environment. It is also evident that governments and policymakers recognize this change. This point was made publicly when the European Council of Ministers passed a resolution requiring all EU companies listed on a regulated market to prepare accounts in accordance with International Accounting Standards for accounting periods beginning on or after 1 January 2005. This decisive change was met with great furor in the accounting profession as well as in corporate boardrooms. The International Accounting Standards Board welcomed the resolution; pleased that the EU was among the first major "nation-states" to take the initiative and embrace international accounting standards.

The EU recognized the many benefits of requiring the implementation of international accounting and auditing standards. Moreover, the Securities Exchange Commission (SEC) recently voted on a roadmap that requires U.S. public companies to use International Financial Reporting Standards by 2014. In light of the interests and activities of companies and users of financial information becoming global, the SEC released a statement declaring its involvement and support to develop a globally accepted, high quality financial reporting framework. The benefits of international accounting standards can be financial, economic and political. Preliminary evidence suggests that companies, lenders, and investors would prefer a convergence of domestic accounting standards with international accounting standards to create a quality financial reporting framework.

Keywords: New implementation in enviorment accounting standards

Introduction

Financial reporting has long been guided by the dictates of national standards. The accounting community has always been in agreement as to the importance of official standards to ensure the reliability and relevance of financial information. In addition to

each country's national standards; accounting officials and educators sought the development of international standards. However the international standards have taken nearly 20 years to reach their zenith in the financial world. Only in the past seven years have international standards reached prominence with some countries adopting the international standards in place of their own standards. Historically, the United States has been most adamant about maintaining its own U.S. Generally Accepted Accounting Principles (GAAP), however recently the SEC has agreed to the use of International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS). To best appreciate this momentous decision and its implications one must first understand the differences in how standards developed in various countries, the history behind the development of International Standards, the benefits of international standards, and challenges of implementing international standards within the US, due to major differences between U.S. GAAP and IFRS. (SEC Release 2008)

Development of National Standards

The creation of national accounting standards can be influenced by a variety of factors some of them political, and some of them due to the legal or tax system. Mark Wahrisch identified the following five influential factors: cultural factors, legal/political factors, economic factors, educational factors, and capital market factors. However, Gerhard Mueller identified only four elements: state of economic development, business complexity, political persuasion, and some reliance on a particular system of law. The American Accounting Association's 1975-76 International Accounting Operations and Education committee established eight factors including objectives of financial reporting, clients, and education/training/licensing. Thus even within the accounting field there is no consensus on all the factors---more factors can be identified and the factors can be grouped differently than Wahrisch's or Mueller's grouping. (Wahrisch 2001 and Mueller 1967)

Much research has been conducted to substantiate the link between cultural environment and standard setting philosophy. Kroeber and Kluckhohn's (1952) detailed study of culture defined it as:

Culture consists of patterns, explicit and implicit, of and for behavior acquired and transmitted by symbols constituting the distinctive achievements of human groups, including their embodiments in artifacts; the essential core of culture consists of traditional (i.e. historically derived and selected) ideas and especially their attached values; cultural systems may on the one hand be considered as products of action, on the other as conditioning elements of further action.
Accounting researchers like Bikki Jaggi have used cultural relativism to link cultural

values to the development of accounting standards. Jaggi hypothesized that managers from different countries have different value sets which can impact the reliability of financial information.

Anthropologist Hofstede developed a model for culture in which he outlines four main dimensions. Sydney J. Gray (1988) took Hofstede's model further by identifying four accounting values arising directly from prevailing social values. These points are: (1) professionalism vs. statutory control, (2) uniformity vs. flexibility, (3) conservatism vs. optimism, and (4) secrecy vs. transparency. For example, Gray's research found that societies like those in U.S. or U.K., differed in comparison to Asian societies with respect to point (1) and

(2) . He also identified differences between 'Anglo' culture and Latin American culture with respect to elements (3) and (4). Thus Asian societies' accounting standards emphasize statutory control in part due to the cultural value placed on rules and authority. Yet for the most part, accounting researchers are in agreement that the impact of culture on financial reporting is vague and can be misleading.

Legal and political factors provide a much more substantial influence on standard development and implementation than cultural values provide. Throughout the accounting literature exists a variety of standard setting models grouping countries based on legal/political similarities. Most of these models seek to divide countries based on whether or not they are common law or code laws states. The models also include the variations of tax law, and whether the countries focus on socialism or capitalism. Although this division is not perfect it does yield a model that loosely groups similar countries. For example, 'common law' countries such as England, United States, Canada, Australia and New Zealand are in one group; whereas 'code law" countries such as France, Germany, Egypt and Taiwan form another loose group. It is important to note that even within these groupings most models provide for further divisions. Accounting researcher Nobes (2006), is one of many, who has noted that most developing countries follow the legal and political systems of their former colonizers and this reflects in each nation's accounting practice. The legal differences between the various groupings are relatively easy to identify. For example in the United States, as a common law country, accounting rules are not laws but standards or recommendations; whereas in Taiwan, accounting practice is part of the legal system. Also the size and magnitude of regulatory authorities is a differentiating factor. Thus the U.S., England and Australia, as similarly grouped countries, have a proliferation of these authorities whereas in France and Germany these authoritative bodies are not as numerous. For example:

The United Kingdom presents a good example of accounting as an 'independent

discipline'; of pragmatic accounting; of accounting based on the judgment of 'fairness'. West German accounting, on the other hand, is held up as an example of detailed prescription (by company and tax laws) of formats, measurement rules and disclosure; of accounting which seeks correctness and legality (Nobes 1999 p.139).

In 'civil or code law' countries the accounting system relies entirely on a legalistic approach. Thus obeying accounting regulation is synonymous with obeying the law. Moreover, tax law has a unique impact on accounting standards and regulations. In some countries, notably the U.S., the tax law is a distinct and separate code of regulations from general accounting practice. In other nations, the tax law and accounting regulation are the same. This is important because tax law has a significant influence on how businesses and individuals behave. (Washrisch 2001)

The political environment naturally segues from the legal environment. Accounting literature is in agreement that the political environment specifically stability and extent of Journal of Finance and Accountancy freedom can and does influence accounting doctrine. For example the level of freedom and civil liberties in a country has a direct influence on the extent of financial information disclosure; evidence shows that less free countries have less extensive disclosure. People that do not have the freedom to choose their own government and support or oppose business policies will not have the necessary tools or resources to establish transparent accounting. Although these statements are logically sound, significant empirical evidence is still being sought by researchers to further support the validity of these statements.

Economic factors along with the availability and variety of capital markets also impact the national accounting profession. Obviously nations differ in their economic systems, some are categorized as capitalist, or capitalist-statists, while others are capitalist-socialist or socialist (Gastil 1978). Economic development includes growth as well as the social and structural changes that accompany it. A more developed economic system requires an accounting structure that captures the necessary relevant information about the productivity and performance of various sectors. This is clearly evident as the most comprehensive accounting systems are present in countries with the greatest extent of economic development. For example, it comes as no surprise that Australia, with a well developed economy, has well developed accounting practices whereas Libya, with a stagnant ill-defined economy has little accounting regulations or guidelines. Another aspect of the economic factor that is especially significant is the structure of capital markets. Much research has been done to study the effect of capital markets on accounting standards. Capital formation be it through public financing, private investment or foreign private investment are necessary ingredients for economic development. All the relevant

financial information to motivate private investment or validate public financing relies on accounting data. Accounting data is pivotal in creating a level of confidence for working capital market structure. Thus the structure of capital markets influences the nature of accounting standards in different countries. For example in Germany, most of the financing for capital markets came from creditors, mainly banks, this is reflected in it accounting goals. The main purpose of financial reporting in Germany is protection of creditors and capital maintenance. However, in the U.S., where the capital market is equity based, the main purpose of financial reporting is the protection of investors. The dominance of equity financing in the U.S. created an accounting structure concerned with fair presentation and full disclosure but in Germany, accounting is concerned with calculating distributable income, i.e., making sure creditors get their payment.

International Standards

Different countries with different accounting practices is an accepted situation, however it is not without its disadvantages. As the idea of global corporations and markets without borders began to become a reality, members of the accounting profession realized the need for international standards. In 1971, the International Accounting Standards Committee (IASC) was formed. It was a loosely formed committee at the behest of accounting boards from Australia, Canada, France, Germany, Japan, Mexico, Netherlands, and U.K. It had a similar framework to that of the US Financial Accounting Standards Board (FASB) as well as the British and Australian frameworks. At about the same time the international professional activities of accountancy bodies from different countries organized under the International Federation of Accountants (IFAC). The IASC and IFAC operated tangent to each other. However IFAC members were automatically members of IASC. With this structure, IASC would have autonomy in setting international accounting standards and publishing discussion documents relating to international accounting issues. From the 1970's the IASC issued roughly forty standards; that went largely unused by most large corporations and countries with already established accounting systems. Its greatest progress was in Europe and with developing or newly industrialized countries. For example in the 1990's Italy, Belgium, France and Germany all allowed large corporations to use International Accounting Standards (IAS) for domestic financial reporting.

Benefits of International Standards

Most of the various national financial regulatory and standards setting bodies agree that there are numerous concrete benefits to implementing international standards. The SEC explicitly stated this as far back as 1988, in a policy statement that reads "all securities regulators should work together diligently to create sound international regulatory frameworks that will enhance the vitality of capital markets"(p2). Capital

markets are one area that can benefit greatly from uniform standards. Currently companies desiring to issue stock via capital markets in different countries must follow the different rules of each country. This creates significant barriers to entry because meeting the varied financial reporting requirements leads to considerable increased costs. For example, in 1993 Daimler-Benz spent $ 60 million to prepare financial statements adhering to U.S. GAAP, and expected to pay between $15 and $20 million Journal of Finance and Accountancy each subsequent year to meet U.S. GAAP (Doupnik 2007).

An intrinsic benefit of harmonization is that it does not force the elimination of national standards, which could be met with significant nationalistic opposition. Harmonization through the use of global standards will enhance the comparability of financial statements across borders; thus providing a better quality of information for investors and creditors. However, some developing countries are hesitant to embrace harmonization for fear that accounting standards will be dominated by standards from developed countries specifically U.S. GAAP(Nobes 2006).

US Implementation of IFRS and Major Differences

In light of the significant developments made with IFRS the SEC decided to adopt IFRS. It is important to note that the SEC and FASB were never against adopting international standards; however both bodies wanted to make sure that the international standards were high quality and provided information similar to that of U.S. standards. The SEC further clarified that quality of accounting standards plays a vital role in the development of high quality financial reporting structures. Thus SEC's announcement of its intent to adopt IFRS came after lengthy preliminary measure instituted by FASB. However to best understand the FASB/IASB convergence effort, it is important to understand the main differences between U.S.GAAP and IFRS.

Recognition Differences

Recognition differences are an area of significant divergence. Recognition can refer to whether or not an item is recognized or not; when to recognize it, and how to recognize it. Research and Development (R & D) cost provide a good example of the differences that arise Journal of Finance and Accountancy between U.S. GAAP and IFRS with respect to recognition. U.S. GAAP required all R & D costs to be recognized as expenses in the year incurred with an exception for computer software meeting certain specifications; whereas, IFRS allows the capitalization of R & D meeting specific criteria.

Presentation & Disclosure and Format of Financial Statements Differences

As mentioned earlier, financial reporting in the U.S. is focused on fair presentation and this is reflected in the presentation and disclosures in the financial statements. Presentation and disclosure disparities arise due to the differences in the information presented in the financial statements, and what is disclosed in the accompanying notes. For example U.S. GAAP requires extraordinary items to be presented as such on the financials but IFRS does not allow this distinction. A more significant difference lies with IASB's *IAS 1: Presentation of Financial Statements. IAS 1* provides guidelines for specific presentation, disclosure and format issues; there is no equivalent to this standard in U.S. GAAP.

Measurement Differences

Often different amounts will be recognized for the same type of activity under U.S. GAAP and IFRS mostly due to the measurement amounts or methods applied. The different methods allowed for measuring inventory cost provide a comprehensive example of this phenomenon. U.S. companies can use a variety of inventory costing methods, including LIFO; but IFRS does not allow the use of LIFO. Thus a foreign company that lists in the U.S. can use , LIFO but it would have to restate is financials to meet international standards. Other measurement issues can arise from differences in the market cost used in *lower of market or cost method* to restate the value of inventory and the use of fair values as opposed to cost in measuring assets.

In spite of formidable and numerous differences, FASB worked with IASB in the early 2000's to develop a convergence plan. In the 2002 Norwalk meeting the two bodies agreed to combine efforts towards achieving compatibility as soon as practicable and to extend efforts to maintain the newly achieved compatibility.(FASB-IASB memorandum). The plan was based on six initiatives: (Doupnik, Hoyle & Schafer, 2007)

Short term convergence project focuses on differences between U.S. GAAP and IFRS in which convergence can be easily achieved in the short-term by selecting the higher-quality standard.

Convergence research project involves the FASB staff researching all the differences between IFRS and U.S. GAAP; and then grouping these differences based on resolution measures.

Monitoring IASB requires the FASB to monitor IASB projects based on the interest level generated by the project. This provides an efficient method of identifying those international standards that generate the most debate, thus helping the FASB identify

any differences and convergence opportunities early.

Joint Projects initiative combines the efforts and resources of the FASB and IASB staff on a congruent time schedule.

Liaison IASM member on site at the FASB offices facilitates quicker meaningful discourse and coordination between the two bodies.

Explicit consideration of convergence potential in board agenda decisions ensures the FASB considers opportunities for convergence when discussing or considering new measures.

In 2002 when these initiatives were revealed the FASB explicitly stated that the Norfolk Agreement did not mean U.S. acceptance of IFRS but instead represented an exchange of views. Nonetheless this endeavor was met with much approval from the IASB and the EU. It was interpreted as a positive measure that could lead to some level of acceptance. This proved true in 2007, when the SEC with the support of FASB revoked its requirement that multinational entities listed on U.S. exchanges reconcile their IFRS compliant financial statements to US GAAP.

Conclusion

The adoption of global or international accounting standards is an idea that has patiently waited in the wings for decades. The increasingly global nature of the business environment coupled with the complexity of financial dealings propelled global accounting standards into the limelight. The EU nations and many other nations have adopted IFRS; at the same time others are working towards such a goal. Yet this climate of progress and camaraderie does not mean opposition in nonexistent. The greatest opposition to IFRS is largely political but many proponents of IFRS see this obstacle as easily diffused. Indeed, leaders from the G20 countries have established their support for developing a single set of high-quality global accounting standards. The FASB/IASB convergence plan has been one of the greatest advantages in helping IFRS gain a foothold. U.S. GAAP and IFRS are the prominent and most widely used accounting standards.

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