International Accounting Standards -- 1973 – 2003: Where Do We Go From Here?

Background

Almost 1,200 foreign companies list their stocks on exchanges in the United States (US). Worldwide, there are more than 2,000 companies that list their stocks on exchanges outside their home countries. When foreign companies raise funds on stock exchanges around the world, the issue of the understandability and reliability of their financial reports comes to the forefront.

The US Securities and Exchange Commission (SEC) requires that foreign companies prepare financial statements in accordance with US generally accepted accounting principles (GAAP) or with another comprehensive body of accounting standards including those of the International Accounting Standards Committee (IASC). However, a foreign company using accounting standards other than US GAAP must provide an audited reconciliation to US GAAP.

The purpose of this paper is to evaluate changes in the international accounting standard-setting process from 1973 to 2003 during which time the objective of establishing one set of global accounting standards for multinational entities has evolved from harmonizing standards in countries around the world to the convergence of national standards with international accounting standards. The objective is to identify areas of needed change to improve the comparability and usefulness of international financial report information.

Establishing International Accounting Standards

In 1995, the IASC entered into an agreement with the International Organization of Securities Commissions (IOSCO) to complete a "core set" of international accounting standards (IAS) by 1999. The potential affect of this agreement on establishing one set of international accounting standards is significant. It means that one set of financial statements, properly prepared in accordance with IAS GAAP, would automatically be acceptable for listing purposes without amendment and without any reconciliation to national (i.e., local) GAAP on each and all of the world's important stock exchanges.

The core standards project was completed in December 1998. The IASC's Strategic Working Party issued a report "Recommendations on Shaping IASC for the Future," that suggested changes needed to be made in IASC's structure in order to prepare for an enhanced role as a global accounting standards-setter.

IOSCO's Review of Core Standards

In May 2000, IOSCO announced completion of its assessment of the accounting standards issued by the IASC. IOSCO reviewed 30 IAS and related interpretations described as the IASC 2000 standards. Its recommendation was that IOSCO members should permit incoming multinational issuers to use the IASC 2000 standards to prepare their financial statements for cross-border offerings and listings, as supplemented where necessary by one or more of three supplemental treatments of reconciliation, disclosure and interpretation.

Reconciliation means requiring reconciliation of certain items to show the effect of applying a different accounting method, in contrast with the method applied under IASC standards.

Disclosure means requiring additional disclosures, either in the presentation of the financial statements or in the footnotes.

Interpretation means specifying the use of a particular alternative provided in an IASC standard or a particular interpretation in cases where the IASC standard is unclear or silent.

IOSCO's position leaves considerable discretion with the separate market regulators and securities commissions that are the members of IOSCO to decide whether to accept the IOSCO recommendation and whether to apply supplemental treatments. In particular, if the SEC in the US were to continue requiring reconciliations to US GAAP there is a risk that foreign registrants on US stock exchanges would regard this as too costly and troublesome and would apply US GAAP in preference to IAS.

International Accounting Standards Board

The IASC recommended a new structure for standard setting that was adopted in January 2001. It includes a board with knowledgeable accounting professionals that possess technical skills and experience of relevant business and market conditions. The new International Accounting Standards Board (IASB) has as its goal to work toward a "single set of high quality accounting standards that national bodies around the world can broadly support."

Convergence of IAS

In the past, different views of the role of financial reporting made it difficult to encourage convergence of accounting standards. In many European countries the financial statements have been prepared for the primary use of banks and other creditors that supply most of the funds for company operations. In the US and the United Kingdom, the statements are designed to meet he needs of investors, as well as creditors.

One difference traditionally has been that annual reports of U.S. companies contain a myriad of disclosures to ensure that relatively unsophisticated investors receive all the information they need to make informed judgments. Creditor-users in European countries already have much of this information so annual reports have not been as comprehensive and complete. The issue has been one of differences in financial statement detail and disclosure.

In recent years the role of the international investor has become more important in many countries and there appears to be a growing consensus that financial reporting should provide high quality financial information that is comparable, consistent and transparent, in order to serve the needs of investors. The movement toward convergence of accounting practices can be attributed to a number of factors including:

1. Large multinational corporations have begun to apply their home country standards, which may permit more than one approach to an accounting issue, in a manner consistent with other bodies of standards such as IASC standards or US GAAP.
2. The IASC has been encouraged to develop standards that provide transparent reporting and can be applied in a consistent and comparable fashion worldwide.
3. Securities regulators and national accounting standard-setters are increasingly seeking approaches in their standard-setting processes that are consistent with those of other standard-setters.

If convergence of disclosure and accounting standards contributes to an increase in the number of foreign companies that publicly offer or list securities in US capital markets, American investors would benefit from increased investment opportunities and US exchanges would benefit from attracting a greater number of foreign listings.

Principles-based Accounting Standards

In October 2002, the FASB issued a proposal, *Principles-Based Approach to U.S. Standard-Setting*, in response to concerns about the quality and transparency of financial reporting resulting from the increasing level of detail and complexity in U.S. standards. The purpose of the proposal was to seek comment on the concern raised that US accounting standards may be too cook-book oriented. The result could be the financial engineering of transactions to adhere to the technical requirements of rules but not the spirit of the rules. In essence, some critics of US standards claim that technical compliance is emphasized rather than reflecting the true economic substance of transactions.

Benchmark Standards and Acceptable Alternatives

Following IASC's core standards project the IASB began to identify a benchmark treatment and acceptable alternatives for all IAS. The long-term goal is to narrow the alternatives, whenever possible, by having the IASB and FASB review its standards to see if agreement can be reached on one standard only. Additional work needs to be done in this area to bring IAS and US GAAP closer together, as reflected by the following comparison.

A Comparison of IASB Benchmark and Alternative Standards with US GAAP

IAS #	IAS Benchmark Standard	IAS Acceptable Alternatives	US GAAP
2 (Inventories) avg/LIFO	FIFO/weighted avg	LIFO	FIFO/weighted
8 (Change in Acctg Policies)	Adjust opening balance in retained earnings prin-	Pass through net income of current year	Cumulative effect/current income (change in ciple) or retained earnings for special-type changes); Prospective (change in estimate)
12 (Income Taxes)	No deferred taxes for taxable temporary differences relating to investments in subsidiaries	N/A	Deferred taxes recorded on use of equity method (acctg) vs. cost (taxes)
16 (Property, Plant & Equipment)	Depreciated cost	Revaluation permitted using up-to-date fair value; credit to equity	Depreciated cost only
19 (Employee Benefits)	Past service cost spread over an avg period until vesting	N/A	Past service cost spread over avg remaining service lives of active employees in the plan
	No minimum pension liability liability recorded	N/A	Minimum pension
22 (Business Combinations)	Purchase or pooling method	N/A	Purchase method only
	Goodwill recognized and amortized	N/A	Goodwill recognized; no amortization but tested for impairments
23 (Borrowing Costs)	Expensed	Capitalized	Capitalized
32 (Financial Instruments/Disclosure and Presentation)	Compound instruments split into debt and equity; mandatorily redeemable preferred stock is debt	N/A	Compound instruments not split; mandatorily redeemable preferred stock listed between debt and equity
33 (EPS)	Contingent shares not included in diluted EPS	N/A	Contingent shares included if contract settled in shares

Future Considerations

Discussions between the IASB and FASB continue on the convergence of standards. In a recent issue of *IASB Update*, the IASB confirmed its decision to prohibit the use of the pooling of interests method and to require all business combinations within the scope of the IFRS to be accounted for by applying the purchase method. However, the IASB also confirmed its proposal to eliminate the LIFO method for determining the cost of inventories.

The prospective elimination of LIFO adds to the mixed message being sent by the IASB and FASB as these organizations pursue convergence. It is difficult to believe that FASB will give up LIFO in the name of bringing U.S. standards more in line with IAS. Moreover, Statement of Financial Accounting Standards No. 142 (FASB 2001) that was adopted after the comparability and core standards projects were completed provides for a treatment of goodwill (non-amortization) that changes the previous US GAAP standard (amortization) that had been consistent with IAS.

Another question mark is to what extent the US will embrace a principles-based approach to standard setting. A good example is lease accounting. Statement of Financial Accounting Standards No. 13 provides detailed rules and bright-line percentage tests to determine whether a lease should be accounted for as a capital lease. However, IAS # 17 follows the more typical principles-based approach of IAS in requiring that a lease should classified as a finance lease (capital lease) if it transfers substantially all the risks and rewards incident to ownership. The standard makes no attempt to define "substantially all." Statement No. 13, on the other hand, applies a 90% test to the present value of minimum lease payments and the fair value of the leased asset to determine whether capitalization treatment is appropriate.

It is difficult to conclude that FASB may be ready to give up the percentage tests that are ingrained in so many US standards including leases, cost and equity method accounting, pension accounting, segment accounting, and so on. The IASB and FASB should join together, perhaps with the help of the SEC and IOSCO, to study just how (and whether) a principles-based approach can be applied in the U.S.

An organization that can play an important role in narrowing the differences between US and IAS is the Public Company Accounting Oversight Board (PCAOB) that was formed after passage of the Sarbanes-Oxley Act. The PCAOB reports to the SEC. Neither the SEC nor PCAOB have indicated any intent to replace FASB as the accounting standard-setter in the US. However, if PCAOB decides to support a principles-based approach and convergence, the result may be a hastening of the internationalization process.

The successful development of and convergence toward high-quality internationally accepted accounting standards will provide direct benefits to auditors, users, preparers and regulators of financial information and statements. The availability of generally accepted and reliable financial data should facilitate international investment and reduce the cost of capital worldwide. Accounting costs for multinational firms operating in different countries will be reduced with the narrowing and eventual elimination of national differences. Regulators will benefit from greater consistency and quality of information.

It remains to be seen whether the process of setting IAS that began thirty years ago will continue to evolve and there will be true internationalization of accounting standards. For this goal to be met, both the IASB and FASB must be willing to compromise and give up some of the alternative treatments that cause differences and hamper the comparability and usefulness of international financial report information.