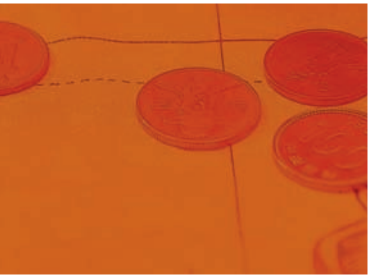
Financial Accounting and Auditing Collection

Scott Showalter and Jan Williams, *Editors*

Pick a Number

Internationalizing U.S. Accounting

Roger Hussey
Audra Ong



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BUSINESS EXPERT PRESS

Pick a Number: Internationalizing U.S. Accounting

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Abstract

For many years, individual countries decided their own rules and regulations for company financial accounting and reporting. As the world became more global, problems began to arise. A company could make a profit for the year if the rules in its own country were applied, but this could turn into a loss if another country's rules were used. This did not make sense.

Investors were hesitant to buy shares in foreign companies, companies were careful when the financial stability of foreign suppliers and customers could not be established, and companies wanting to list on a foreign stock exchange, for example, New York, experienced difficulties.

To prevent this confusing and misleading state of affairs, attempts were made at the international level to agree on what the rules, known as accounting standards, should be for financial accounting and reporting. Those standards are now issued by the International Accounting Standards Board (IASB). Since 2002, the standard setter in the United States, the Financial Accounting Standards Board (FASB), has been actively engaged with the IASB in attempting to converge U.S. regulations with international accounting standards.

These events are not only important to accountants, but to everyone who has been dealing with a company. This could be investors, employees, customers, banks, suppliers, and the tax authorities. If you are interested in the financial performance and status of a company, you need to understand the accounting rules, their changes, and the reasons they pursue an international set of standards.

This book describes in nontechnical language:

- The process for setting accounting regulations in the United States
- Attempts to establish international standards and the barriers confronted
- U.S. involvement in international activities through a process known as convergence
- Successes and failures in agreeing on international rules
- Differences that have halted convergence and the U.S. strategy

The U.S. involvement over the last 10 years has brought about many changes in the calculation of the numbers shown on a company's financial statements. This book focuses on the main changes and how and why they happened. It highlights frauds and questionable activities and describes the FASB's efforts to ensure that financial statements do not mislead their users.

Keywords

accounting standards, conceptual frameworks, convergence, Financial Accounting Standards Board, fraud, International Accounting Standards Board, Norwalk Agreement, principles-based approach, rules-based approach

Contents

Preface

Two accountants applied for the same job. The final interviews were with the chief executive officer (CEO). He asked the first candidate "What is three plus three?" The immediate answer was "six." The same question was asked to the second candidate who looked the CEO in the eye and said, "What do you want the answer to be?" The second candidate got the job.

The message of this story is that the answer in accounting can depend on the rules and regulations that are used. Unfortunately, those rules are subject to change. Even more confusing is that some countries have different accounting rules. This means that the amount of profit or loss made by a company may depend on whether U.S. rules, UK rules, or those from another country are being used. If those rules are altered, the figure of profit may change too.

Pick a Number: Internationalizing U.S. Accounting examines and explains the problems—legal, technical, and political—that influence the calculation of the numbers that appear on a company's financial statements. The outcome could vary—the numbers may assist you to make decisions, confuse you, or even obscure fraud and misleading practices. Put the decision on what number to pick at the international level and chaos could occur.

Chapter 1 sets the scene by explaining the developments of accounting standard setting in the United States and the structure and activities of the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC).

Chapter 2 explains the proposals, some 40 years ago, to develop international accounting standards that every country would follow. The increasing U.S. involvement in the discussions and its decision to converge its accounting regulations with international ones are described in Chapter 3.

Chapters 4 and 5 examine the successes and failures that resulted from the convergence relationship between the FASB and the International Accounting Standards Board (IASB). The main accounting issues causing problems, such as inventory valuation, goodwill, leasing, financial instruments, and stock-based payments, are discussed.

Chapter 6, the final chapter, takes a critical review of the fundamental differences between the FASB and the IASB. The issues discussed are the rules-based versus principles-based approaches, conceptual frameworks, the business entity concept, and regulatory acceptance. The chapter ends with an examination of the internationalization options open to the United States and a prediction of the route it may follow.

Acknowledgments

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CHAPTER 1

U.S. Accounting Regulation

About This Chapter

Many people assume that accounting regulations affect only the work of accountants. This is not the case. If we change the way we measure the financial performance of an organization, the impact affects many people.

Managers may find that profit has declined, not because there have been any changes in the organization, but because of the way that accountants measure their activities. Consequently, managers may have to change the way they work to achieve their expected profit. Potential and existing investors and other creditors track the financial performance of companies. If performance changes for the worse, they may decide to reduce their involvement with that company. Employees and customers form their own opinions of the reputation of a company. That reputation is also, to a large extent, tied strongly to financial performance.

Accounting rules and regulations form the magnifying glass we use to examine corporate performance and the performance of directors and managers. In this chapter, we discuss the reason for accounting regulations and how they have developed in the United States. We explain the structure and authority of the powerful Securities and Exchange Commission (SEC), which has no equal in any country. We also look at the work of the Financial Accounting Standards Board (FASB) and the financial information available about the organizations you invest in, work for, and shop with.

Why We Have Accounting Regulations

The apparent precision of financial numbers is largely spurious. Unlike most other forms of measurement, such as weight, length, time, and volume, accounting is a less exact science. Money measurement is elastic over time. For example, in 1970, the cost of a gallon of gas would have been less than \$0.4. In 2013, a gallon of gas would cost you well over \$3.00. If you ask for \$0.4 of gas you would get less than one-eighth of what you would get in 1970.

We know that inflation is the major culprit in distorting prices over a period of time. Unfortunately, the methods we have in accounting do not recognize this. The financial statements issued by companies largely ignore inflation, unless there is a specific requirement to do otherwise.

Although inflation is one factor in distorting financial statements, many economic transactions and events can be measured in different ways. This can have a major impact on any corporate financial information you receive. Unless there is some form of guidance, accountants may adopt different approaches to record the same type of transactions. The following examples show some of the dilemmas that arise as a result:

1. You are a retail company and purchase goods from a supplier during the year. Needless to say, the prices of goods have risen slightly in some months. At the end of the year, you have some unsold inventory. Do you value the inventory at the price you first paid for the goods at the beginning of the year, the price paid at the end of the year, or an average for the entire year? How you value your closing inventory will affect the amount of your profit for the year.
2. A customer, who is well known to you, has received goods from you at the end of the year and promised to pay you at the start of the New Year. Do you count this as a sale of goods in the current year or only when you receive payment?
3. Another customer has selected the goods he requires and has asked you to keep them for collection. He expects to collect them in two months' time when payment will be made. Have these goods been sold?
4. You purchased some land for \$250,000 about 10 years ago and you consider it is now worth \$350,000. What amount do you put in your accounting records?
5. You own a machine that cost \$200,000 five years ago. You believe that it will last another five years, but it is technologically outdated

and needs replacement. If you sold the machine you could only obtain $30,000 for it. What value should you put on the machine in your accounting records?

6. You sell heating systems for factories complete with a five-year maintenance contract. You have just installed a system for $180,000 with a five year contract for $40,000. What should you record as the sales figure in the current financial year?

Problems such as these confront accountants every day. Often, there are alternative solutions and they can all be argued to be "right." The solution chosen, however, often has an impact on the profit figure and what the financial strength of the business appears to be to outsiders.

It is essential that accountants agree on the solution that is the most appropriate so that the recipients of corporate financial information can understand the picture presented. The users need to be assured that an inappropriate solution has not been selected for the purpose of putting the financial affairs of the business in a better light.

To prevent users of financial information from being misled, accounting is conducted according to regulations. That regulatory framework, known as Generally Accepted Accounting Principles (GAAP), consists of legislation, stock exchange regulations for public companies, and accounting standards. In the United States, the FASB for many years issued Statements of Financial Accounting Standards (SFASs). Later in this chapter, we explain how the FASB Accounting Standards Codification (ASC) is now the official source of guidance.

Generally Accepted Accounting Principles

Generally Accepted Accounting Principles (GAAP) consist of a set of regulations with substantial authoritative support. GAAP is the framework that regulates companies in their recording of economic transactions and events to produce financial statements such as the income statement, balance sheet, and statement of cash flows.

Although legislation and stock exchange requirements are important, by far, the most dominant and pervasive influence on accounting practices and the nature of financial information is the accounting standards issued by the FASB, which is overseen by the SEC.

A major change in an accounting standard can change the profit of a company and its apparent financial strength even if it continues to conduct its business in the same way that it has always done. To understand the scope of these standards, we need to appreciate the main players that comprise the standard setting side of the regulatory framework. We also need to understand the concepts and assumptions they apply in deciding the regulations.

Accounting Concepts and Assumptions

At this stage, we are going to consider some basic assumptions used by accountants, most of which are contained in the accounting literature. We will return to some of the assumptions in later chapters to demonstrate how they are applied to the financial statements in practice.

Business Entity Concept

This assumption means that the accountant is preparing financial statements only for the activities of the business and not for the personal financial activities of the owners. The financial statements will inform us about the financial performance and position of the business, but very little about the financial situation of the owners. We will be able to obtain information about transactions between the owners and the business, such as when the owners invest money into the organization, but we will not have information about the activities of the owners that do not relate to the business's operations. For this reason, it is helpful to think of a business as an *entity* that is completely separate from its owners when you are preparing financial statements.

Unfortunately, the complexity of modern business relationships has made it more difficult to define the entity for reporting purposes. It is no longer possible to think of a physical entity such as a factory or a shop. Companies enter into agreements and relationships that they consider to be mutually beneficial. The problem is identifying which corporate body is responsible for what, and who should therefore report the financial outcomes of business activities.

The Consistency Concept

This concept has two aspects to it. The first is that there must be a consistency of treatment by an organization for transactions and events of a similar nature. An accountant cannot treat a transaction in a particular way and then later change to another method for a similar transaction. For example, if you decide to write off company cars over five years you cannot later change this to 10 years, unless there is a valid reason for doing so.

Second, an accountant must apply the same accounting treatment from one accounting period to another unless there is a very good reason to change. If a company has a policy of deciding that funds spent on certain items are considered long-term assets, it cannot then choose to treat the funds as day-to-day expenses. The purpose of the consistency concept is to reassure the users of financial statements that accountants do not change their accounting methods to show a more favorable picture of the organization.

Consistency is critical to ensure the comparability of the financial information of an organization over a series of time periods. Of course, there may be a very good reason for a company to decide in one financial period to change its accounting policy. Accounting regulations set out the circumstances in which companies can change their accounting policies and the information that should be disclosed in such situations.

The Matching Concept

If we want to know the performance of an entity for a financial period we need to account for the expenses it has incurred in that period and match them with the revenue it has generated. By doing this, we calculate the profit or loss of the company for the financial period. The timing of revenues and expenses is therefore critical in calculating the profit for the period.

Revenue tends to be time based and can be identified with a particular financial period, unless it is a long-term contract spanning several periods. Expenses may not always be contained within a specific time period and therefore a degree of judgment may be required to match the expenses with the revenue.

The Money Measurement Concept

This concept assumes that only the items that are capable of being measured reliably in financial terms are included in the financial records. Reliability in measurement is normally a requirement to recognize (i.e., enter into the financial records) an economic transaction or event.

This assumption should not cause any problems. If a company buys 20 tons of steel at $500 per ton, then $10,000 worth of steel inventory is entered into the financial records. If a company has 100 employees and pays them each $300 per week, the weekly wage bill is $30,000. What the company is unable to do is to enter into its records how much those employees are *worth*. They may be highly skilled and the company may not be able to operate without them, but a money measurement cannot be calculated reliably to account for this asset.

Another example is the case in which a successful business has built up a good *reputation*. It is known for making excellent products, keeping to delivery times, and offering an excellent after-sales service. You will not find a money measurement for these attributes.

Historical Cost Concept

The principle of this concept is that the amounts shown for assets are based on their original cost, which is when the transaction or event took place. No adjustments are made for subsequent changes in price or value. The concept has the great merit of being extremely reliable. If you wanted to know how much a company had paid for an item of equipment, you would only need to look at the actual payment.

This method also has some great disadvantages. A company might have purchased some land in 1970 for $750,000. It might decide in 2012 to buy an additional piece of land that is identical in all ways to the original purchase but the price is now $1,000,000. How is the user expected to interpret this information in 2012? In the financial statements, the amounts originally paid for the land will be added together and the company will disclose that it has an asset of $1,750,000. The question the user most likely wants to be answered is "What is the current value of the two pieces of land?"

It may be for some reason that the present value of the land has decreased. The land bought for $750,000 in 1970 may be now valued at only $500,000 in 2014. It could be that there has been environmental degradation, the local economic market has collapsed, or adjacent buildings or roadwork have impacted the value. Whatever the reason, accountants need to decide the basis for the amount they put in their financial statements.

There have been some attempts to replace historical cost accounting with a different method that better reflects current values. There are several methods, each with its own advantages and disadvantages. These methods make the information more relevant to the decisions being made by the user, but the reliability of the information may be uncertain. Once the regulations allow companies to depart from the rigors of historical accounting there is always the concern that users will not understand the figures, or that the company will exploit the regulations to present misleading information.

Variations and Manipulations

The purpose of accounting regulations is to ensure that accountants adopt identical and acceptable methods for similar transactions. This enables users of the financial statements to follow the progress of a company over a period of time or to compare its financial position with other companies, confident in the knowledge that all are applying the same methods of accounting. The sophisticated regulations and governance structures and processes in the United States do, as far as possible, achieve that end.

However, excluding financial fraud, there are still issues that may weaken the reliability of financial statements. We have given some examples of accounting dilemmas where the treatment of a particular economic event or transaction could be viewed in several ways. It is practically impossible to establish regulations so comprehensive that every eventuality is addressed and to ensure that the regulations are scrupulously followed. The danger is that loopholes will be found to mislead users on the financial status of the company.

For example, closing inventory valuations and revenue recognition offers opportunities for the unprincipled to manipulate their profit figures. Fraudulent practices can be found in all countries and are used by both large and small organizations. A small business may wish to reduce its profit to lower the tax it has to pay and the large organization may wish to inflate its profit to increase its share price on the markets.

If these fraudulent practices are discovered, it is the SEC that will take action. The cases they investigate and the penalties they impose are frequently publicized in the press. Additionally, the website of the SEC provides detailed information on such cases.

Possibly, the best-known fraud was The Great Salad Oil Swindle.[1] To carry out such a scheme you only need to know that oil floats on top of water. The perpetrator, Tino DeAngelis, rented a petroleum tank farm in New Jersey. He was able to convince auditors, investors, and investment bankers that the tanks contained over $100 million in valuable vegetable oil. Indeed, independent auditors could easily check this claim using dipsticks that the tanks were full. Unfortunately, the tanks were mainly filled with water with a little vegetable oil floating on the surface to give a positive reading on the dipstick.

Another major case was the *Securities and Exchange Commission vs. Bristol-Myers Squibb Company.*[2] The allegation by the SEC was that, from the first quarter of 2000 through the fourth quarter of 2001, Bristol-Myers was engaged in a fraudulent scheme to overstate its sales and earnings. The purpose of this was to make it appear that the company had met or exceeded financial projections set by the company's officers (targets) and earnings estimates established by Wall Street securities analysts.

There were two main methods adopted by Bristol-Myers. The first was stuffing its distribution channels with excess inventory near the end of every quarter in amounts sufficient to meet sales and earnings targets set by officers. In other words, the company was moving closing inventory from its own premises to distributors to make it appear as sales.

Second, the company improperly recognized about $1.5 billion in revenue from consignment-like sales associated with the channel-stuffing in violation of GAAP. At no time during 2000 or 2001 did Bristol-Myers disclose that: (1) it was artificially inflating its results through channel-stuffing; (2) channel-stuffing was contributing to a buildup in wholesaler inventory levels; (3) the buildup in wholesaler inventory posed a risk to Bristol-Myers's future sales and earnings; or (4) the company was using improper accounting, including cookie jar reserves, to further inflate its results. Cookie jar reserves is a way of putting aside funds in a prosperous year so that they can be used in a subsequent year to inflate profit. In March 2003, Bristol-Myers restated its prior financial statements and disclosed its channel-stuffing activities and improper accounting.

The next case exemplifies the comments we made earlier about recognizing revenue during the financial period in which it was actually earned. In 2002, SEC alleged that between 1997 and 2000, Xerox employed several accounting maneuvers, to enhance its reported profits.[3] The most significant was a change in which Xerox recorded revenue from copy-machine leases—recognizing a sale when a lease contract was signed, instead of recognizing revenue over the entire length of the contract. The dispute was not for the amount of total revenue, but for the financial periods to which it should have been allocated. At issue was when the revenue was recognized, not the validity of the revenue. In response to SEC's complaint, Xerox Corporation neither admitted nor denied wrongdoing. However, it agreed to pay a $10 million penalty and to restate its financial results for the years 1997 through 2000.

Valuation of inventory is a fruitful area for fraud. The following example, brought forward by SEC in 2011, highlights the issue of valuing inventory.[4] Point Blank Solutions (formerly DHB Industries) was a supplier to the U.S. military. Unfortunately for Point Blank Solutions, the U.S. Army changed its specifications for hard armor plates for protective clothing. This meant that approximately $12.5 million of hard armor plates became obsolete. An additional $4.5 million of inventory became obsolete due to other changes including the discontinuation of certain vest fabrics and colors. The SEC claimed that the company failed to report that its inventory was obsolete and started overvaluing inventory in 2003. Two years later, the books were carrying inventory that was overvalued by $33 million.

For those interested, the SEC website contains many examples of revenue and inventory frauds. Frequently, these manipulations are not detected for many years. The users of financial statements must be diligent and be alert to warning signs such as:

1. A significant change in trends in sales or inventories over a period of time.
2. Increases in revenue figures when the general market is stagnant or declining.
3. Closing inventory values increasing faster than revenues.
4. Decreases in inventory turnover, that is, the amount of inventory held in relationship to the level of sales in the financial period.
5. Inventory increasing as a percentage of total assets.
6. Changes in the gross profit margin.

The Securities and Exchange Commission

The formation of SEC can be traced back to the 1930s. The stock market collapse in 1929 destroyed public confidence in the financial markets. It has been contended that, among other factors, one reason for the crash was the poor state of economic intelligence.[5] Investors, both large and small, banks, and financial institutions lost great sums of money. There was a consensus that for the economy to recover, the public's faith in the capital markets needed to be restored. It fell to Congress to identify the problems and recommend solutions.

In 1933, the Securities Act was passed and this was followed in 1934 by the Securities Exchange Act. The latter created the SEC, a formidable body with significant powers. Its task was to restore investor confidence in the capital markets by providing investors and the markets with more reliable financial information and clear rules of honest dealing.

Our interest is the role of SEC in ensuring that companies publicly offering securities to investors must disclose to the public the truth about their businesses, the securities they are selling, and the risks involved in investing. To achieve this, the SEC requires public companies to disclose meaningful financial and other information to the public. These disclosures provide a base of knowledge for all investors to decide whether to buy, sell, or hold a particular security. Only through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions.

Although the focus of SEC is on public companies, it determines what may be regarded as *good accounting*. This establishes a perspective that influences the accounting used in private companies.

Organization of the SEC

One characteristic of SEC[6] is the size of the organization. It has approximately 3,500 staff located in Washington, DC, and 11 regional offices throughout the country. The agency's functional responsibilities are organized into 5 divisions and 23 offices, each of which is headquartered in Washington, DC. The SEC is responsible for:

1. Interpreting and enforcing federal securities law
2. Issuing new rules and amending existing rules
3. Overseeing the inspection of securities firms, brokers, investment advisers, and ratings agencies
4. Overseeing private regulatory organizations in the securities, accounting, and auditing fields
5. Coordinating U.S. securities regulation with federal, state, and foreign authorities

The Commission holds meetings that are open to the public and the news media unless the discussion is about confidential matters, such as whether to begin an enforcement investigation.

Enforcement Activity

Critical to the SEC's effectiveness is its enforcement authority. Each year, the SEC brings hundreds of civil enforcement actions against individuals and companies for the violation of the securities laws. The main types of activities that lead to an SEC investigation are:

1. Misrepresentation or omission of important information about securities
2. Manipulating the market prices of securities
3. Stealing customers' funds or securities; violating broker-dealers' responsibility to treat customers fairly
4. Insider trading (violating a trust relationship by trading while in possession of material, nonpublic information about a security)
5. Selling unregistered securities

The statistics from 2009 to February 1, 2013,[7] demonstrate the scope of the SEC's enforcement activities.

Number of entities and individuals charged	157
Number of CEOs, CFOs, and other senior corporate officers charged	66
Number of individuals who have received officer and director bars, industry bars, or commission suspensions	36
Penalties ordered or agreed to	$1.53 billion
Disgorgement and prejudgment interest ordered or agreed to	$756 million
Additional monetary relief obtained for harmed investors	$400 million*
Total penalties, disgorgement, and other monetary relief	$2.68 billion

*In settlements with Evergreen, J.P. Morgan, State Street, TD Ameritrade, and Claymore Advisors.

Every SEC investigation is conducted privately. Informal inquiry may be conducted by interviewing witnesses, examining brokerage records, reviewing trading data, and other methods. With a formal order of investigation, witnesses can be compelled by subpoena to testify and produce books, records, and other relevant documents. After reviewing the findings, the SEC can authorize the staff to file a case in federal court or bring an administrative action. In many cases, the SEC and the party charged may decide to settle the matter without trial.

SEC Filings

An SEC filing is a formal document that the SEC requires from certain groups and individuals. There are many such documents depending on the circumstances. Those companies with securities that are publicly traded are required to disclose information on an ongoing basis.

Public companies (other than small business issuers) are obliged to submit annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K for a number of specified events and must comply with a variety of other disclosure requirements. The Form 10-K, which should be filed with the SEC, contains very detailed information about the company's financial activities for the year.

At one time, companies were required to file their Form 10-K within 90 days of their financial year end. There have been some adjustments to

Table 1.1 Deadlines for filing periodic reports

Category	Form 10-K (days)	Form 10-Q (days)
Large accelerated filer	60	40
Accelerated filers	75	40
Nonaccelerated filers	90	45

the 90-day rule and the SEC has developed categories depending on the size of the company. Large accelerated filers are companies with at least $700 million in public float, while accelerated filers are companies with at least $75 million but less than $700 million in public float. The final group consists of the nonaccelerated filers. The present deadlines[8] for filing for these three groups are shown in Table 1.1.

Smaller Reporting Companies

The SEC has adopted a system of disclosure rules for smaller companies filing periodic reports and registration statements with the SEC. The rules are scaled to reflect the characteristics and needs of smaller companies and their investors.

The *smaller reporting company* category includes all companies that enter the public reporting system with less than $75 million in common equity public float. Companies' eligibility for smaller reporting company status is based on the last business day of their most recent second fiscal quarter.

Smaller reporting companies prepare and file their SEC reports and registration statements with the same forms as other SEC-reporting companies, though the information required to be disclosed may differ. A new Article 8 of Regulation S-X contains the SEC requirements for financial statements, while Regulation S-K contains the nonfinancial disclosure requirements. To locate the scaled disclosure requirements in Regulation S-K, smaller reporting companies will refer to the special paragraphs labeled *smaller reporting companies* in Regulation S-K.

The SEC has immense authority in ensuring compliance with U.S. GAAP. One could argue that the reason for the formation of the SEC is the reason that U.S. GAAP has developed in the way that it has.

The actual work of setting accounting regulations, however, falls on the next body we discuss, the FASB.

The Financial Accounting Standards Board

The FASB was founded in 1973 following the recommendations of the 1972 Wheat Committee of the American Institute of Certified Public Accountants (AICPA). The FASB was a different type of organization from its predecessor, the Accounting Principles Board (APB), which was controlled by the accounting profession. The FASB was to be accountable to the SEC and had the responsibility of acting in the best interests of the main financial statement users, deemed to be investors. As we will see later in this book, the selection of the investor as the main user causes problems when international accounting is debated.

The FASB is composed of former auditors, preparers, and users of financial information and an academic member and its authority derive from the SEC. This is an unusual relationship as the FASB is a private-sector organization but under the careful surveillance of the SEC. The accounting standards issued by FASB are recognized as authoritative and generally accepted for purposes of U.S. federal securities laws.

SFASs were issued by the FASB for more than 30 years and were intended specifically for listed companies. However, their influence was much wider. Small businesses also have people interested in their financial affairs: the owners, tax collectors, banks, and any other party who is owed money. Although they do not directly fall under the accounting regulations of the FASB, those standards established what is considered common practice.

Statement of Financial Accounting Standard
A formal document that sets out detailed accounting, reporting, and disclosure requirements. Statements of financial accounting standards are issued with the expectation that all reporting companies listed on American stock exchanges will adhere to them.

Later in this chapter, we explain a system that was implemented to better structure the guidance available. In 2009, the FASB ASC was launched and now FASB Accounting Standards Updates (ASUs) are issued to amend the codification.

Organization of the FSAB

The FASB is part of a structure that is independent of all other business and professional organizations. This independent role is essential for the way that it operates. The structure includes the following organizations.

Financial Accounting Foundation

The Foundation is the independent, private-sector organization that is responsible for the oversight, administration, and finances of the FASB, the Government Accounting Standards Board (GASB), and their advisory councils Financial Accounting Standards Advisory Council (FASAC) and Government Accounting Standards Advisory Council (GASAC). The Foundation's primary duties include protecting the independence and integrity of the standards-setting process and appointing members of the FASB, GASB, FASAC, and GASAC.

Financial Accounting Standards Advisory Council

The primary function of FASAC is to advise the FASB on technical issues on the Board's agenda, possible new agenda items, project priorities, procedural matters that may require the attention of the FASB, and other matters as may be requested by the FASB or its chairman. At present, the Council has more than 30 members who represent a broad cross-section of the FASB's constituency.

Governmental Accounting Standards Board

The GASB was established in 1984 to set standards of financial accounting and reporting for state and local governmental units. As with the FASB, the Foundation is responsible for selecting its members, ensuring adequate funding, and exercising general oversight.

Governmental Accounting Standards Advisory Council

The GASAC has responsibility for advising the GASB on technical issues on the Board's agenda, project priorities, matters likely to require the attention of the GASB, and such other matters as may be requested by the GASB or its chairman.

There are seven full-time members of the FASB. The members are appointed for five-year terms and are eligible for reappointment to one additional five-year term. On their appointment, they must sever any existing connections with their current firms or institutions to ensure their independence.

The Board is assisted by a staff of more than 60 professionals who have knowledge and experience in investing, accounting, finance, business, accounting education, and research. The staff works directly with the Board and project resource groups, conducts research, participates in round-table meetings, analyzes oral and written comments received from the public, and prepares recommendations and drafts of documents for consideration by the Board.

Further support is given to the Board and staff by four advisory groups. These groups share their knowledge and experience with the Board on projects on the Board's agenda, possible new agenda items, practice and implementation of new standards, and strategic and other matters. Information provided by advisory group members is communicated to the Board in a variety of ways, including public advisory meetings and comment letters. Currently, the groups are:

- FASAC
- Investor Advisory Committee (IAC)
- Not-for-Profit Advisory Committee (NAC)
- Small Business Advisory Committee (SBAC)

The FSAB *Standards-Setting Process*

The process will depend on the nature and scope of the reporting issues involved. For complex subjects the process can take several years. However, the main stages are as follows:

1. The Board identifies financial reporting issues based on requests or recommendations from stakeholders or through other means. As we work through subsequent chapters we will examine some of these issues.
2. The FASB chairman decides whether to add a project to the technical agenda, after consultation with FASB members and others as appropriate, and subject to oversight by the Foundation's Board of Trustees.
3. The Board deliberates, at one or more public meetings, the reporting issues identified and analyzed by the staff.
4. The Board issues an Exposure Draft (ED) to solicit broad stakeholder input. (In some projects, the Board may issue a Discussion Paper (DP) to obtain input in the project's early stages.) EDs and DPs are an integral part of most standard setters including the International Accounting Standards Board (IASB).
5. The Board holds a public round-table meeting on the ED, if necessary.
6. The staff analyzes comment letters, public round-table discussion, and any other information obtained through due process activities. The Board redeliberates the proposed provisions, carefully considering the stakeholder input received, at one or more public meetings.
7. At this stage, it may be necessary to issue a revised ED incorporating the comments that have been received.
8. The Board issues an ASU describing amendments to the ASC.

The last point above introduces a significant change in the procedures of the FASB. From 1973 to 2009, the FASB issued 168 SFASs. Following a major five-year project, the FASB ASC was launched on July 1, 2009. From that date FASB ASUs are issued to amend the codification. Updates are published for all authoritative U.S. GAAP released by the FASB, regardless of the form in which such guidance may have been issued prior to the release of the FASB codification (e.g., FASB Statements, EITF Abstracts, FASB Staff Positions, and so on). Updates will also be issued for amendments to the SEC content in the FASB codification, as well as for editorial changes.

The FASB ASC is now the official source of authoritative, nongovernmental GAAP (also known as U.S. GAAP). When it was introduced the codification did not change U.S. GAAP as it was, but ordered and structured thousands of pronouncements issued by the FASB, the AICPA, and other standards-setting bodies into roughly 90 accounting topics. It also includes relevant SEC guidance that follows the same topical structure in separate sections in the codification.

The structure of the codification is in three tiers. Each *Topic* contains at least one *Subtopic* containing *Sections* that include the actual accounting guidance. Sections are based on the nature of the content (e.g., scope, recognition, measurement, and so on) and are standardized throughout the codification. Each Section includes numbered Paragraphs commencing with the Section number followed by the unique paragraph number. For example, in Section 20 the first paragraph is numbered 20–1.

New additions to U.S. GAAP are issued by means of a FASB document called an ASU. These bring changes in the ASC and therefore in U.S. GAAP. A useful guide to the codification system has been published by PricewaterhouseCoopers (PwC).[9]

Financial Information Available

We noted above that the SEC requires publicly traded companies to file specific documents to cover different periods of time. A fiscal or financial year is a period for calculating the annual (yearly) financial statements. In many countries, regulatory laws regarding accounting and taxation require such reports once every 12 months, but do not require that the period reported on constitutes a calendar year (i.e., January 1 to December 31).

Some companies choose to end their fiscal year on the same day of the week, such a day being the one closest to a particular date. However, the fiscal year is identical to the calendar year for about 65 percent of publicly traded companies in the United States and for a majority of large companies in the United Kingdom.

The date a company chooses as its year end may be important if there has been a recent change in accounting regulations. Given that word of caution, the amount of information that a publicly traded company makes available can be overwhelming and takes many forms.

Form 10-K

The annual report on Form 10-K provides a comprehensive overview of the company's business and financial condition as well as audited financial statements. Although similarly named, the annual report on Form 10-K is distinct from the *annual report to shareholders*, which a company must send to its shareholders when it holds an annual general meeting (AGM) to elect directors.

The Form 10-K is a lengthy document and the main sections are:

Part I

- ITEM 1. Description of Business
- ITEM 1A. Risk Factor
- ITEM 1B. Unresolved Staff Comments
- ITEM 2. Description of Properties
- ITEM 3. Legal Proceedings
- ITEM 4. Mine Safety Disclosures
- ITEM 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities
- ITEM 6. Selected Financial Data
- ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations
- ITEM 7A. Quantitative and Qualitative Disclosures about Market Risk
- ITEM 8. Financial Statements and Supplementary Data
- ITEM 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure
- ITEM 9A (T). Controls and Procedures
- ITEM 9B. Other Information
- ITEM 10. Directors, Executive Officers and Corporate Governance
- ITEM 11. Executive Compensation
- ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters
- ITEM 13. Certain Relationships and Related Transactions, and Director Independence
- ITEM 14. Principal Accounting Fees and Services
- ITEM 15. Exhibits, Financial Statement Schedules Signatures

Companies must produce their financial statements within a restricted time period. All the information needed to do so will not always be available; therefore, estimates are needed. These estimates are always drawn to the attention of the reader and an example is shown below.

Use of Estimates
The preparation of consolidated financial statements in conformity with U.S. Generally Accepted Accounting Principles (GAAP) requires us to make estimates and assumptions that affect the amounts reported and disclosed in the financial statements and the accompanying notes. Actual results could differ materially from these estimates. On an ongoing basis, we evaluate our estimates, including those related to the accounts receivable and sales allowances, fair values of financial instruments, intangible assets and goodwill, useful lives of intangible assets and property and equipment, fair values of stock-based awards, inventory valuations, income taxes, and contingent liabilities, among others. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

Source: Google Form 10-K for the year ended December 31, 2012.

All companies, foreign and domestic, are required to file registration statements, periodic reports, and other forms electronically through the Electronic Data-Gathering, Analysis, and Retrieval (EDGAR) system. Anyone can access and download information from the system for free. Here you will find links to a complete list of filings available through EDGAR and instructions for searching the EDGAR database (www.sec.gov/edgar/aboutedgar.htm).

Annual Reports

Companies must send annual reports to their shareholders. Under the proxy rules, reporting companies are required to post their proxy materials, including their annual reports, on their company websites. Companies sometimes elect to send their Form 10-K to their shareholders in lieu of providing shareholders with an annual report. Some companies may submit their annual reports electronically in the SEC's EDGAR database.

The annual report to shareholders is the main method adopted by most public companies to disclose corporate information to their shareholders. It is normally a state-of-the-company report, including an opening letter from the CEO, financial data, the results of continuing operations, market segment information, new product plans, subsidiary activities, and research and development activities on future programs.

Such a document can be lengthy; Ford's Motor Company fiscal year 2012 report, for example, runs to 161 pages, and this is by no means the largest annual report available. The financial information disclosed in Ford's annual reports is listed below.

Financial Content

10	Management's Discussion and Analysis of Financial Condition and Results of Operations
58	Quantitative and Qualitative Disclosures about Market Risk
63	Report of Independent Registered Public Accounting Firm
64	Consolidated Income Statement
65	Sector Income Statement
66	Consolidated Balance Sheet
67	Sector Balance Sheet
68	Condensed Consolidated Statement of Cash Flows
69	Condensed Sector Statement of Cash Flows
70	Consolidated Statement of Equity
71	Notes to the Financial Statements
156	Selected Financial Data
157	Employment Data
158	Management's Report on Internal Control over Financial Reporting
159	New York Stock Exchange Required Disclosures

Source: Financial information contained herein (pages 10–159) is excerpted from the Annual Report on Form 10-K for the year ended December 31, 2012 of Ford Motor Company.

Reliability of Information

The reliability of the financial information provided by companies is only as good as the accounting regulations requiring it, assuming that the company is in compliance with regulations. We have referred to the estimates and assumptions that companies are compelled to make because of the necessity to issue financial statements for a period of time, even if all of the information is not available.

Our confidence in accounting regulations and the financial information provided by companies is enhanced by the Auditor's Report. All publicly traded companies will have external auditors who will examine the accounting processes and procedures of the company. Their opinion will be given in conjunction with the financial statements. Remember that, as shown in the following example from General Motors, it is the responsibility of the company's management to prepare the financial statements.

Report of Independent Registered Public Accounting Firm

General Motors Company, its Directors, and Stockholders:

We have audited the accompanying Consolidated Balance Sheets of General Motors Company and subsidiaries (the Company) as of December 31, 2012 and 2011, and the related Consolidated Statements of Income, Comprehensive Income, Cash Flows and Equity for each of the three years in the period ended December 31, 2012. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audits.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of General Motors Company and subsidiaries at December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2012, in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

Detroit, Michigan
February 15, 2013

Source: http://corporate.ford.com/our-company/investors/reports-financial-information/annual-reports

Conclusions

It has taken the United States almost 100 years from the position of public companies having no requirement to publish financial information to a substantial amount of corporate financial information being freely available. Financial information disclosure itself has not been the only achievement: a system of regulation has been formed to ensure that companies have a framework by which to prepare and present their financial data.

The SEC is, in all probability, one of the most powerful bodies in the world with the responsibilities it has of ensuring public companies disclose meaningful financial and other information to the public. To do so, it requires a body to set out accounting regulations rather than allow individual companies to apply their own concepts and assumptions. The FASB has been established in the role of standard setter.

Most countries have a body responsible for setting accounting standards. Other countries do not necessarily follow, or even agree with, U.S. accounting regulations and follow their own methods. This has become a major problem as businesses have become global in their operations. Is the company you are trading within Germany as financially solid as you believe? Will your investments in apparently highly profitable foreign companies prove as financially rewarding as you hoped?

In the next chapter, we explain the growth of international accounting and how more than 100 countries (with the exception of the United States) have agreed to follow the same accounting methods as set out in International Financial Reporting Standards (IFRS). We examine the IASB, the organization that sets the international standards, and the process for issuing these standards.

In Chapter 3, we closely scrutinize the U.S. involvement in the internationalization of accounting, from its agreement in 2002 to participate in international accounting convergence to its current position in 2014. We also weigh the arguments for and against the United States fully adopting all international standards.

Over the last 10 years, U.S. accounting regulations have changed. Sometimes, this has been due to internal reasons, but more frequently the change has been driven by the requirement to internationalize.

In Chapter 4, we look at those areas of accounting that have changed and the potential impact on U.S. practices.

Chapter 5 considers the major topics that recently have caused significant problems to the FASB and the IASB in their strategy of converging their regulations. These topics are frequently complex and the practices in the United States and other countries can differ significantly. Bringing the two Boards to agreement requires not only discussions, but movement from each Board's current position on the topic at hand. As we will see, success in negotiations has proved very difficult to achieve.

The final chapter (Chapter 6) looks at the substantial barriers that probably prevent the United States from going fully international with respect to accounting standards. These are not merely technical hurdles and go far deeper. There are political, social, and economic factors that may prove to be far more formidable than any technical accounting differences.

CHAPTER 2

The Move Toward International Accounting

About This Chapter

Although the United States had implemented a procedure for rigorous accounting regulations within its own borders, one serious problem arose. As business became more international, the issue of countries developing their own, unique accounting standards became apparent. The financial statements of a company in one country could not be compared to that from another country as the rules in drawing them up were different. If a foreign company wished to be listed on the New York Stock Exchange, it would either have to do reconciliation with U.S. Generally Accepted Accounting Principles (GAAP) or draw up new financial statements complying with U.S. GAAP.

It did not make sense that national accounting was different and it was confusing when operating at the international level. The obvious solution was that either all countries should use U.S. accounting standards or an international body should be responsible for issuing standards. Many countries would be reluctant to abandon their own standards for those of the United States; hence, the international body appeared to be the only viable option. Unfortunately, there were barriers preventing the rapid development of international accounting.

In this chapter, we examine the weaknesses of national accounting standards and the factors that operated to give a country its particular form of accounting regulations. The background to the formation of the International Accounting Standards Committee (IASC) and its successor body the International Accounting Standards Board (IASB) are described. We complete this chapter by looking at the progress toward international accounting.

The Consequences of National Accounting

In the last chapter, we explained the developments in U.S. accounting regulations with the establishment of the Financial Accounting Standards Board (FASB) in 1973. A similar pattern of developments can be found in many countries, but with different results in their present standard-setting procedures. We give below the examples of three English-speaking countries: Australia, Canada, and the United Kingdom.

Although these countries have close relationships with the United States, the development of their standard setting system is different. More interestingly, these countries have all adopted International Financial Reporting Standards (IFRS), whereas the United States has not made that full commitment.

Australia

- The Institute of Chartered Accountants first issued its Recommendations on Accounting Principles in 1946. It is argued that "these were virtually copies of similarly titled documents produced by the Institute of Chartered Accountants in England and Wales."[1]
- The present position is that accounting standards are set by the Australian Accounting Standards Board (AASB), which was formed in 1991. The AASB is an Australian government agency that develops and maintains financial reporting standards that are applicable to entities in the private and public sectors of the Australian economy, and have the force of law for corporate entities under section 296 of the *Corporations Act 2001*. The standards must also be applied to all other general-purpose financial reports of reporting entities in the public and private sectors.
- AASB standards are known as Australian Accounting Standards and include Australian equivalents to IFRS. When the AASB first started to adopt IFRS as Australian Accounting Standards, it made some modifications to the international standards, including removal of some alternative accounting methods and addition of required disclosures to be made in

the financial statements. There has been some debate in the academic literature whether Australia has, in fact, adopted IFRS as it has not adopted the actual process of standard setting.[2]

- In 2007, the AASB modified Australian Accounting Standards so that their requirements were identical to the standards issued by the IASB for the for-profit entities. Some additional disclosure requirements have been retained, and some non-IFRS-compliant requirements apply for not-for-profit and public sector entities. It is intended that compliance with Australian Accounting Standards ensures that the financial statements and notes of the entity comply with IFRS.

Canada

- Prior to 1946, there were no accounting regulations. The Canadian Institute of Chartered Accountants (CICA) commenced to issue Bulletins that codified existing practice largely as a service to their members. The Bulletins were essentially professional recommendations, as they had no legal authority.
- In 1967, the Bulletins were published in the form of an official Handbook. In 1972, the Canadian Securities Administrators issued National Policy Statement 27, requiring publicly traded companies in Canada to follow the Handbook recommendations. Three years later, the regulations implementing the Canada Business Corporations Act were revised to specify that GAAP in Canada would now be defined as the practices and guidance within the CICA Handbook.
- The Accounting Standards Oversight Council (AcSOC) was established in 2000 by the CICA to serve the public interest by overseeing and providing input to the activities of the Accounting Standards Board (AcSB). The AcSB is responsible for establishing standards of accounting and reporting by Canadian companies and not-for-profit organizations.

- The activities of the AcSB are overseen by the AcSOC, which appoints the members of the AcSB and provides input to the AcSB, primarily in terms of its strategic direction and priorities. The AcSOC also assesses and reports to the public on the performance of the AcSB.
- In January 2006, the AcSB published a strategic plan to implement IFRSs, which have now been mandatory in Canada since 2011 for publicly accountable entities. The application of IFRS in Canada, therefore, is broader than that in Europe as it applies to many more types of entities. Publicly Accountable Enterprises can be generally described as profit-orientated enterprises that have responsibilities to a large or diverse group of stakeholders and include:
  - Publicly listed companies
  - Enterprises with fiduciary responsibilities, such as banks, insurance companies, credit unions, securities firms, mutual funds and investment banks
  - Certain government corporations

The period from 1981 to 1998 was an unusual one in Canada and not mirrored by experiences in other countries. The events give some insights into the present issues that can arise during the implementation of international accounting standards (IASs). Two competing standard-setting bodies existed during this period: the CICA and the newly formed Accounting Standards Authority of Canada. The unusual background and accounting developments at that time have been analyzed and explained. It is contended that the "alternative standard-setter, the Accounting Standards Authority of Canada, experienced significant implementation issues and was unable to overcome advantages accruing to the CICA by virtue of locked-in users, first mover advantage and reputation advantage."[3]

These three advantages can be reflected in internationalization of accounting. Companies and auditors are familiar with their national accounting standard setter and, possibly for many years, have been obliged to comply with these regulations. If they have confidence in the national standards, there must be distinct advantages for them to be persuaded that international standards should be adopted.

United Kingdom

- The first *Recommendations on Accounting Principles* in the United Kingdom were published in December 1942 on the subjects of Tax Reserve Certificates and War Damage Contributions, Premiums, and Claims. These recommendations, and those that followed, provided members of the Institute of Chartered Accountants in England and Wales with guidance on acceptable accounting practices.
- In 1970, the Institute of Chartered Accountants in England and Wales (ICAEW) established the Accounting Standards Steering Committee (ASSC) with the objective of developing definitive standards for financial reporting. The Irish and Scottish Institutes became members of the ASSC in the same year, followed by the Association of Certified Accountants, now the Association of Chartered Certified Accountants (ACCA), and the Institute of Cost and Management Accountants, now the Chartered Institute of Management Accountants (CIMA) in 1971.
- In 1976, the name of the ASSC was shortened to the Accounting Standards Committee (ASC) and its constitution was revised. Essentially, it was a committee representing the six professional accounting bodies in the United Kingdom that were responsible for issuing accounting standards.
- In 1990, the government announced the establishment of a new Financial Reporting Council (FRC). The FRC was charged with promoting good financial reporting through two subsidiary bodies: the AcSB, which replaced the ASC on August 1, 1990, and the Financial Reporting Review Panel (FRRP).
- Following the major corporate collapses in the United States, the UK government made the decision to strengthen its regulatory system. This decision finally led to the FRC's role being extended to become the single independent regulator of the accounting and auditing profession as well as being responsible for issuing accounting standards and dealing with their enforcement.

- Reforms were carried out in July 2012 to enable the FRC to operate as a unified regulatory body with enhanced independence. A new structure was implemented to ensure effective governance of all of the FRC's regulatory activities under the ultimate responsibility of the FRC Board.
- In June 2002, the European Union (EU) adopted an IAS Regulation requiring European companies listed in an EU securities market, including banks and insurance companies, to prepare their consolidated financial statements in accordance with IFRS, starting with financial statements for the financial year 2005 and onwards. There are various options that individual countries can choose in applying IFRS; hence, it would be incorrect to assume that each member state has the same regulations for accounting standards. The United Kingdom, however, has become even more committed to IFRS following the formation of the FRC.

As can be seen from the above explanation, the demands and pressures of national, political, and economic environments largely formed the way that led to countries establishing their own standard-setting bodies. The structure, operation, and authority of the national standard setters are shaped within existing national practices and conventions.

Standard setters work within a coalition of interests, including reporting organizations, shareholders, the media, and political groups. The powers of these interested parties differ, and the need and desire of the accounting standard setters to gain the support of these particular factions also vary. For example, the United States is notable because of the considerable statutory authority of the Securities and Exchange Commission (SEC) to participate in the standard-setting process and the extent to which lobbying takes place.

Given the unique histories of national accounting standards development in each country, it is not surprising that there are significant differences in their accounting regulations. In the early years of the 20th century, there seemed to be little need for countries to discuss with each other how accounting standards should be formulated and applied. However, opinions were soon to change.

In the latter half of the 20th century, there were some highly publicized examples of very profitable companies in Europe that wanted to list shares on the New York Stock Exchange (NYSE). In order to do so, the profitable company had to redraft those financial statements in accordance with U.S. GAAP. In some instances, the previously declared profit for a financial year turned into a loss.

The Classic Case

Possibly the most famous case is that of Daimler Benz AG, a German company that wished to list its shares on the U.S. Stock Exchange in the early 1990s. To do so, it had to reconcile the profit it had shown for 1993, which was prepared in accordance with German GAAP, with what the profit would have been if the company had adopted U.S. GAAP. The net income, or profit, the company had reported in its German financial statements was DM615 million. After the company had made all the adjustments to comply with U.S. GAAP the reported net income turned to a net loss of DM1839 million.

This significant difference in the financial results of Daimler Benz demonstrated that accounting regulations at the national level did not make sense when viewed with an international perspective. Accounting regulations needed to be changed, but the question was how this could be achieved.

Not only was there the implication that national standard setters may have to relinquish their authority over their own country's accounting regulations, but there were several forces operating behind the regulations in the individual countries. It could be that these differences would form strong barriers to agreeing to account for companies' financial performance in the same way.

Characteristics of National Accounting

The 1960s and 1970s attracted considerable interest in internationalizing accounting regulations. This interest led to attempts to identify the key factors or characteristics that formed the nature of a country's accounting regulations. Having identified the characteristics that shaped the standards, the next stage was to classify countries into groups of those sharing similar characteristics.

This classification of systems focused on the differences between country groups that were assumed to create potential barriers to internationalization.[4] One such classification that has remained relevant throughout the years is that based on a group of developed Western countries in the year 1980.[5]

Figure 2.1 has been adapted from that research. Many of the terms identified in the diagram should be regarded as *loose labels*, which capture the attributes of the national accounting system.

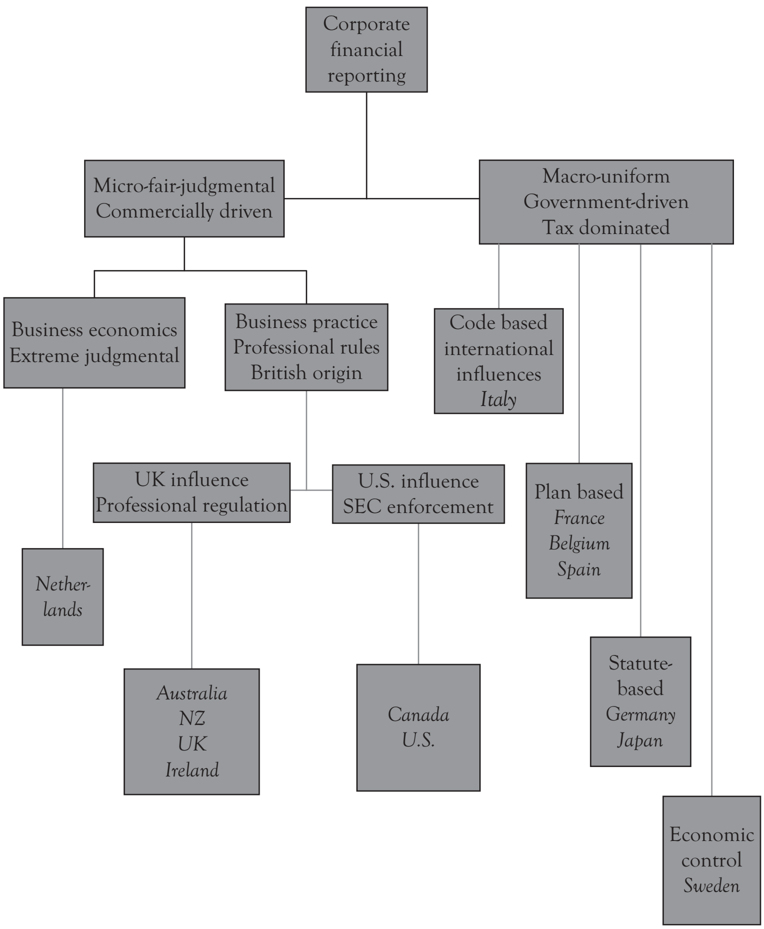

Figure 2.1 Classification of accounting systems

Source: Adapted from Nobes (1983).

The two main classifications were labeled as micro-fair-judgmental and macro-uniform. The former was commercially driven and the latter government driven with tax requirements being dominant. The micro-judgmental classification is subdivided into Business Economics and Business Practice. The latter is further subdivided into UK influence and U.S. influence.

Of course, much has changed since 1980, both at the national level and within the countries themselves. Recently, however, a similar study of eight countries has been made. The results confirm that the classification by IFRS practices is similar to the classification of national practices drawn up in 1980, despite many years of pursuing harmonization.[6]

Several studies have revealed that there are, even within the EU, distinct national profiles of IFRS practices. This distinction is, in large part, because of the flexibility within IFRS and the manner in which individual countries determine how IFRS should be applied within their own borders. The barriers to full internationalization of national accounting systems are discussed below.

Legal System

Normally, countries either evolve or adopt one of the two legal systems. One is the common law system, which is developed on a case-by-case basis, with no general rules set out that could be used to resolve several different cases. Countries such as England, Singapore, and New Zealand have a common law system. Where a country has common law, accounting rules are not part of the law and are developed by the country's professional accounting bodies or some other form of standard setters.

In contrast, countries such as France, Portugal, and Japan have a code law system. Where there is a code law system, there is a wide set of rules to give guidance in all situations. Accounting regulations in these systems are often part of the law and controlled by the government either directly or indirectly.

Types of Business Organizations and Ownership

National accounting regulations address the different sources of finance obtained by a business, as well as its size and complexity in its country of operation. When they first start, businesses frequently obtain financing from the founders or owners. As companies grow larger, they cannot only rely on the existing owners of the company to invest more. Companies must seek external finance to fund that growth. The external finance can come from either individuals or organizations wishing to invest in the company, or financial institutions willing to lend money to the company.

In some countries, such as the United States, the United Kingdom, and Australia, the funding for companies has frequently come from individuals or groups. These shareholders make an investment in the company and, if the company is profitable, they receive a dividend and their share of the company grows in value. In such countries, there is often a powerful stock exchange that regulates some aspects of companies' activities. The shareholders are many in number and they are not able to demand specific financial information from companies for their own use. They must, therefore, rely on accounting regulations and stock exchange requirements to ensure that they receive financial statements that meet their needs.

Where small family or privately owned businesses are a significant part of the national economy, different forms of funding may prevail. In Germany, France, and Italy, the funding has often come in the form of loans from banks, family members, or other organizations. In these circumstances, the lenders demand regular interest and will want the loan repaid at some future date. They also normally have access to the financial records of the company.

Where the state has a significant interest in the company, such as in China, then financial information will also be provided to the state.

Tax Systems

Countries have their own tax regulations for companies. In some countries, the tax rules dictate the way that the financial accounts are prepared. In other words, the financial statements are constructed in accordance with the tax legislation. The figures shown in the financial statements are the basis for the tax charge and, understandably, some companies may make decisions and present financial information in such a way as to lower their tax charge.

In other countries, the tax regulations are separated from the accounting regulations. Companies will prepare financial statements applying the accounting regulations and then adjustments will be made on the basis of the tax regulations to determine the amount of tax the company must pay. The two activities are therefore separated and the tax rules do not influence financial disclosures required by the accounting regulations.

Stock Exchanges

The size and sophistication of stock exchanges around the world vary. In those countries where there are many institutional and private investors, stock exchanges will be well managed and require companies to disclose certain information at specific times. There is easy access to this information and the stock exchange ensures that the market is kept well informed.

In some countries, particularly where companies are not financed substantially by private investors, the authority of the stock exchange is not so powerful. The requirements for companies to disclose financial information will be fewer and the monitoring and enforcement activities weaker. The approximate size by number of listers of the stock exchanges of the countries we discussed at the beginning of this chapter is shown in Table 2.1

The Accounting Profession

In some countries, the accounting profession is very strong and involved in all aspects of corporate financial activities. Before the establishment of formal national accounting standard setters it was normally the

Table 2.1 Number of companies on stock exchanges

Country	Number of companies on stock exchange
Canada	2,100
United Kingdom	2,400
Australia	2,100
United States	2,700 on NASDAQ, 4,300 on NYSE

NASDAQ, National Association of Securities Dealers Automated Quotations;
NYSE, New York Stock Exchange.

Table 2.2 The main accounting firms

Name of firm	Number of employees	Revenue 2011 (billion U.S.$)
Deloitte LLP	182,000	28.8
PwC	168,000	29.223
Ernst & Young LLP	152,000	22.880
KPMG	145,000	22.710

Source: The 2012 Big Four Firms Performance Analysis, January 2013, www.Big4.com

accounting profession that issued advice to its members on the accepted accounting methods for business transactions.

A highly developed accounting profession in a country will have a significant influence on the financial accounting regulations in that country. The members will sit on various committees, act as advisers, sponsor research, and publish papers on the correct way of accounting.

In the United States, there are nearly 386,000 members of the American Institute of Certified Public Accountants in 128 countries and the Institute of Management Accountants has 65,000 members. The United Kingdom has several accounting bodies with a total membership of 559,000. Members of accounting bodies could be working in industry, government, education, and auditing.

There is a concentration of accountants working for firms of auditors. These may be small firms offering a range of services to individuals, including tax advice and auditing. The four largest firms have a massive presence and offer a complete range of services. The strength and influence of these firms are shown in Table 2.2.

Culture

Culture is regarded as highly influential on the financial accounting and reporting system in a country, but it is difficult to define the direction and power of its influence. Research has classified countries according to cultural differences. A major influence was the theory that there are four dimensions along which cultural values can be analyzed: individualism–collectivism, uncertainty avoidance, power distance (strength of social hierarchy), and masculinity–femininity (task orientation versus person orientation).[7]

Many disciplines have applied the above theory, and the theoretical framework has been applied to develop a model that shows the relationships between cultural and accounting values.[8] The model did not operationalize the hypotheses or conduct any empirical tests, but several researchers have attempted to extend or refine this framework. The research has helped in understanding why differences in accounting regulations in a country may arise, but has not been of much help in resolving technical accounting issues.

Although the above factors have been important in the past in explaining the different national regulations, they are overshadowed by the needs of an increasingly globalized world. For companies, particularly multinational ones, it is expensive and complex to draw up different sets of accounts for the countries in which they operate. For investors, it is almost impossible to compare a company in one country with a similar company in another country.

Companies that conduct transactions with foreign suppliers and customers would find that a shared accounting language enhances ease of business and understanding. Investors, both large and small, need to be able to compare the financial statements of companies in different countries. For international capital markets to operate efficiently and effectively, IASs are essential.

Given all these reasons for introducing IASs, the question that can be asked is: Why it did not happen sooner? It is also pertinent to ask why the United States, as well as some other countries, has still not committed fully to adopting IFRS. This issue will be discussed in subsequent chapters.

The International Accounting Standards Committee

The IASC was founded in 1973 by the accountancy bodies, not the governments, of nine countries: Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and Ireland (UK), and the United States. It was established as a private sector nongovernment organization (NGO) with a part-time body of standard setters who met three or four times a year in cities around the globe. The organization was based in London, UK, with a small, full-time secretariat. At this point in the chapter, it is worth mentioning that the International Accounting Standards Board is still based in London.

The objectives of the IASC were:

- To formulate and publish, in the public interest, accounting standards to be observed in the presentation of financial statements and to promote their worldwide acceptance and observance;
- To work generally for the improvement and harmonization of regulations, accounting standards, and procedures relating to the presentation of financial statements.

The above objectives were extremely ambitious for an organization that was resourced very modestly and had no enforcement powers. The IASC intended to achieve these objectives by:

- Ensuring that published financial statements comply with IASs in all material respects;
- Persuading governments and standard-setting bodies that published financial statements comply with IASs;
- Persuading authorities controlling securities markets and the industrial and business community that published financial statements comply with IASs.

It is important to emphasize that the IASC was not established primarily to promote the growth of international capital markets. The reverse was the case and it was the increasing globalization of markets and business that led to increasing pressure for IASs.

Although the IASC made considerable progress, it had a number of weaknesses that meant that it was less effective than was required. Its main problems were:

1. Too many of its standards allowed alternative choices in accounting treatment and were open to different interpretations. Thus, companies could claim to be following IASs but still draw up financial statements that were not comparable.
2. It did not have enforcement powers or mechanisms to obtain compliance. Thus, consensus could only be achieved by issuing standards containing sufficient flexibility to obtain widespread acceptance.
3. There were structural and resource problems that the IASC could not remedy. The members of the IASC were from national profes-

sional accounting bodies. Many of these had no responsibility for standard setting in their own countries, thus, reducing IASC's ability to influence and persuade national standard setters.

4. There was the question of how much independence the IASC needed from the professional accounting bodies to conduct its activities. The technical contribution of the professional accounting bodies was essential but was regarded by some as placing the IASC in the direct influence of one particular interest group. There were other interest groups represented, for example, analysts and academics, but professional accounting bodies were perceived as dominant. To some extent, this perceived dominance also weakened the possibility of achieving a mechanism for enforcement. Few would wish to allow professional accounting bodies, however well intentioned, to make the regulations for worldwide accounting as well as having the power to enforce them.

Although interest was expressed in making progress in internationalization, the major national economies were still relying on national accounting standards. The question whether the IASC could achieve its goals still remained. Either a complete overhaul of all aspects of the IASC was required or a new body needed to be formed. The latter was the course of action chosen.

The International Accounting Standards Board

The IASB was established formally in April 2001 with the following objectives:

- Developing in the public interest, a single set of high-quality, understandable, and enforceable global accounting standards;
- Helping participants in the world's capital markets and other users make economic decisions by having access to high-quality, transparent, and comparable information;
- Promoting the use and vigorous application of those standards;
- Bringing about convergence of national accounting standards and IASs to high-quality solutions.

Its present structure is displayed in Figure 2.2.

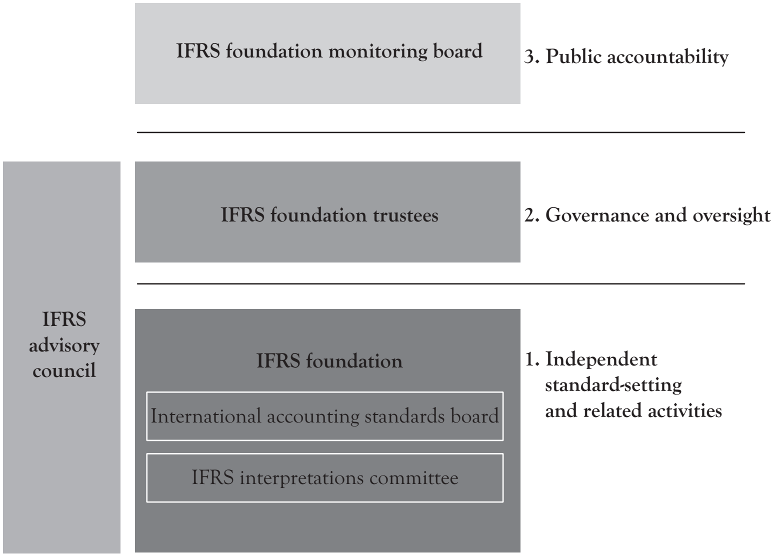

Figure 2.2 The IFRS foundation

Our interest is focused on the IASB, the body responsible for issuing International Financial Reporting Standards. The process in issuing a standard has the following six stages:

1. Establishing an agenda
   The IASB evaluates the merits of adding a potential item to its agenda, mainly by reference to the needs of investors.
2. Planning the project
   In developing a plan to conduct the work, the Board will decide whether to conduct the work by itself or jointly with another standard setting body.
3. Issuing a Discussion Paper (DP)
   It is normal practice for the Board to issue a DP and ask for comments. In issuing a DP, the Board gives a comprehensive review of the issues, possible approaches in addressing them, and their own preliminary views.
4. Publishing the Exposure Draft (ED)
   The ED is the IASB's main vehicle for consulting the public. The ED sets out a specific proposal in the form of a proposed standard (or amendment to an existing standard).

5. Publishing the standard
   The Board has to decide whether to publish revised proposals for comments as a second ED or whether to proceed to issuing a standard. When the IASB is satisfied that it has reached a conclusion on the issues arising from the ED, it instructs the staff to draft the IFRS.
6. Implementation of the standard
   After an IFRS is issued, the staff and the IASB members hold regular meetings with interested parties, including other standard-setting bodies, to help understand unanticipated issues related to the practical implementation and potential impact of its proposals.

As far as the present standards themselves are concerned, there is some confusion because of the change of names and the apparent duplication of some individual standards. The IASC issued 41 standards between 1975 and 2000. The standards were numbered consecutively starting with 1 and each standard also had a descriptive title; for example, IAS 7-Cash Flow Statements. Most of the IASC standards are still in force.

When the IASB took over from the IASC, it adopted the IASs that were still in force and started to add its own standards, which were titled IFRS. Once again these standards are numbered consecutively, starting with 1, and have a descriptive title, such as IFRS 3-Business Combinations.

When referring to the issued standards, the terms International Accounting Standards or International Financial Reporting Standards may be used. It is essential, however, to attach correctly the term IAS or IFRS when referring to a specific standard, for example, IAS 2-Inventories or IFRS 2-Share-Based Payment.

The IASB has made substantial progress with the acceptance of international standards. It is claimed that there are more than 100 countries that have adopted international standards. However, caution should be expressed about the rigor and extent of that adoption. In some instances, the adoption is partial, with only certain types of organizations in a particular country compelled to comply with the international standards.

A few countries maintain that their standards are similar to and are based on international standards, but this does not mean that there is full compliance. A list of countries that claim to have adopted international standards and the scope are given on the IAS plus website (http://www.iasplus.com/en/jurisdictions).

Two research papers that have investigated the characteristics of adopting and nonadopting companies have arrived at interesting conclusions.

The first paper examined 102 non-EU countries.[9] The researchers found that more powerful countries are less likely to adopt IFRS and suggested that more powerful countries are less willing to surrender standard-setting authority to an international body. This is pertinent to the United States where the SEC has the ultimate authority for accounting regulations. The researchers also found that a country is more likely to adopt IFRS if its trade partners or countries within its geographical region are IFRS adopters.

A later study took a different perspective and examined how standards were accepted and implemented.[10] Their sample included 183 nations around the world. They gave significant focus to the 25 largest nations according to the gross national product. They concluded that the probability of assuring strict implementation of accounting and reporting standards may be affected by weak national cultural ethics, unstable authoritarian forms of government, and economic power measured by high debt levels and rapid growth rates.

Of course, adoption is only one part of the process and for standards to be effective, some form of monitoring and enforcement is required. The IASB does not have direct powers or procedures to ensure companies in individual countries comply with international standards, but some mechanisms are already available or are being created. The IASB, however, has to rely on the mechanisms in place in individual countries to ensure enforcement.

Enforcement Mechanisms

The first stage of monitoring for compliance with IFRS is within the company where control systems, including internal audit, can ensure that standards are applied. The commitment of management is also required to ensure that financial statements fairly represent the financial performance and position of the organization.

A second stage in ensuring compliance with IASs is an audit conducted by an auditor who is deemed to be independent of the company. An audit will involve an examination of the procedures, processes, and records of the company, and the financial statements that are drawn from those records. The auditor will express an opinion on those financial statements in a standard audit report.

There are different national rules on the status of organizations that require an external audit. At a minimum, an external audit is normally required by those companies whose shares are listed on a stock exchange and the auditors are reporting their opinion to the shareholders.

The specific duties performed by an external auditor will normally be set out in the contract with the company. The auditors will be expected:

- To ensure that all the necessary information and explanations for the audit have been obtained.
- To ensure that proper books of accounts have been kept and maintained by the organization.
- To confirm that the accounts dealt with in the report are in agreement with the books of accounts and are in conformity with national regulations.
- To issue an auditor's report that should contain a clear written expression of opinion on the financial statements taken as a whole.

It is not the normal duty of an auditor to conduct a fraud investigation. Unfortunately, research indicates that there are important differences in the understanding between auditors and users of the purpose of the audit and the meanings of statements made in the audit report.[11] One misunderstanding that appears in most countries is that users of financial statements mostly believe that auditors search for fraud and financial manipulations. That is not the case.

The final and critical stage is the monitoring and enforcement mechanism held by a regulator. There are models currently employed at the national level. There are security commissions, such as the SEC in the United States, stock exchanges that can delist companies for regulatory transgressions, and other national bodies that have some legal support.

The Progress of Internationalization

Although it is claimed that more than 100 countries are using IFRS, it does not necessarily mean that those countries apply the same regulations to economic transactions. Even where a country claims it has adopted IFRS, caution must be present when examining the financial statements of companies within that country. The reasons for this are:

1. Some counties may decide to *adopt* international standards. If so, it is highly likely that the standards will apply only to certain organizations, that is, the large listed companies. Other types of organizations such as small- and medium-sized companies will continue to rely on national standards. Some countries *adapt* international standards, in other words change them to some degree to meet their particular needs.
2. National accounting traditions are likely to continue where scope for this exists within IFRS rules. This is not to suggest that the continuation of practices is merely due to inertia, but that the reasons for the barriers to internationalization, described earlier in this chapter, remain relevant.
3. The mix of political and other pressures on regulators varies from country to country, caused partly by the financing system, legal system, and tax system. Some countries have well-organized lobby groups of finance directors. Regulators may be hesitant to fully adopt IFRS because of political pressures and may delete certain paragraphs of the standards or search the IFRS for parts where there is room for different interpretations.
4. The implementation date of a standard can vary from country to country. New standards generally are in force on the date of annual periods beginning on or after January 1, but early applications are normally permitted. The result is that two different versions of IFRS can be in force at the same time depending on the implementation year chosen by a particular country compared to the choice by another country.
5. The year ends of companies can differ and some financial statements may be caught in the IFRS timing while others avoid it. In some countries, for example, Australia and the United Kingdom, corpo-

rate accounting periods do not necessarily end on December 31. In other countries, that may be the usual year-end date.

6. Enforcement regulations are not always stringent in some countries. Although it may be claimed that IFRSs have been adopted in a country, the lack of strong enforcement may mean that companies have considerable latitude in how the standards are applied.

Given all the above reasons why international accounting may not be effective, it would appear difficult to put forward an argument that international accounting works. One response is to argue that the number of countries adopting IFRS has been increasing since the establishment of the IASB in 2001. This suggests that many countries do find benefits, but there are other specific advantages of internationalization.

1. Many small countries do not have sufficient resources to fund a rigorous standard-setting process of their own and therefore adopt IFRS to ensure sound financial reporting by companies.
2. The debates generated through the process of internationalization have meant that countries have gradually changed their own practices to fit better with IFRS. Although the United States has not adopted IFRS, as will be discussed in Chapter 4, its relationship with the IASB has led to several changes in U.S. accounting practices.
3. By focusing on specific accounting issues and promoting discussions and research, the IASB has brought about a general improvement in the nature of financial accounting and reporting. This applies not only to those countries adopting IFRS but to nonadopters as well.
4. A study[12] examined the effect of accounting standards and investor protection on value relevance of earnings and book value of equity among EU countries during the years 1999 to 2007. It concluded that IFRS led to improvements on these issues.
5. A large sample of firms that were using IFRS in 26 countries revealed that, on average, market liquidity increased around the time of the introduction of IFRS.[13] There was also a decrease in

firms' cost of capital and an increase in equity valuations. Reservations on their findings included the strength of the enforcement measures in the country concerned. This is an aspect that has been observed in several studies as critical to the success of international accounting.

6. A sample[14] of non-U.S. borrowers from 40 countries during 1997 through 2005 investigated the effect of the voluntary adoption of IFRS on price and nonprice terms of loan contracts and loan ownership structure in the international loan market. It showed that banks charge lower loan rates to IFRS adopters than to nonadopters. Banks impose more favorable nonprice terms on IFRS adopters, particularly less restrictive covenants. Banks are more willing to extend credit and IFRS adopters attract significantly more foreign lenders participating in loan syndicates than nonadopters.

Internationalization of accounting regulations has made progress, but the United States was not involved until 2002 and even today the strength of its commitment is uncertain. A major study[15] was conducted for the Council of Institutional Investors in the United States. The Council opposed replacing U.S. accounting standards and standard setters with their international counterparts unless seven specific criteria were achieved.

The study explores evidence and views regarding each of the seven criteria. The criteria and the main conclusions are as folows:

Criterion No. 1: **In the aggregate, information that results from application of IFRS is, at a minimum, of the same quality as the information resulting from U.S. accounting standards**.

Findings. A majority of U.S. and European financial executives surveyed believe the quality of IFRS is high. Most also believe that the IASB and the U.S. FASB have made progress developing joint standards to address improvements needed prior to adoption of IFRS in all major capital markets.

Criterion No. 2: Application and enforcement of IFRS are at least as rigorous and consistent as U.S. accounting standards.

Findings. Research reveals a relationship between a country's institutional setting, including corporate governance and audit quality, and characteristics of a country's financial reporting.

Criterion No. 3: The IASB has sufficient resources including a secure and stable source of funding that is not dependent on voluntary contributions of those subject to the standards.

Findings. The IFRS Foundation, the parent entity of the IASB, is focused on moving as soon as possible to a funding source that relies on public sponsorship or other intermediated mechanisms. As of 2011, the United States is the only country where the IFRS Foundation will seek direct corporate contributions. The IFRS Foundation's 2011 budget, released in April, projects a break-even year and indicates that direct contributions from U.S. companies (8 percent) and international accounting firms (26 percent) represent 34 percent of total projected revenues.

Criterion No. 4: The IASB has a full-time standard-setting Board and staff that are free of bias and possess the technical expertise necessary to fulfill their important roles.

Findings. Recent changes to the IASB's governing documents have elevated the importance of geographic representation as a criterion for serving on the Board (previously, technical expertise was the primary criterion). The changes also permit up to three part-time members of the Board.

Criterion No. 5: The IASB has demonstrated a clear recognition that investors are the key customers of audited financial reports and, therefore, the primary role of audited financial reports should be to satisfy in a timely manner investors' information needs. This includes having significant, prominent, and adequately balanced

representation from qualified investors on the standard setter's staff, standard-setting Board, and oversight Board and outside monitoring or advisory groups.

Findings. The IFRS Foundation and the IASB have taken several steps to increase their focus on investors. Those steps include changes to the IASB's governing documents to designate investors as a major target audience, increasing investor representation in the standard-setting process and enhancing investor outreach. Notwithstanding the progress that has been made to increase investor representation in the standard-setting process, only 5 of the present 20 seats on the IFRS Foundation, 8 of 47 seats on the IFRS Advisory Council (IFRS Council), and 3 of the 15 seats on the IASB are held by individuals from the investor community.

Criterion No. 6: The [IASB] has a thorough public due process that includes solicitation of investor input on proposals and careful consideration of investor views before issuing proposals or final standards.

Findings. Evidence is mixed about whether recent amendments to the IASB's governing documents are sufficient to improve due process. Nevertheless, in 2007, an independent think tank recognized the IASB as possessing the best developed external stakeholder engagement capabilities among 30 of the world's most powerful global organizations.

Criterion No. 7: The IASB has a structure and process that adequately protect the standard setter's technical decisions and judgments (including the timing of the implementation of standards) from being overridden by government officials or bodies.

All organizations involved in standard setting face ongoing questions regarding their authority and responsibility. The IASB is no exception. To date, its technical decisions and judgments have been subject to significant pressures from governmental officials and bodies, particularly those representing the European Union (EU).

This is a thorough analysis of the situation but it must be remembered that the seven criteria were established by the Council of Institutional Investors in the United States. Other groups in other countries may have different criteria that they would wish to be satisfied. In Chapter 6, we will consider how one country's particular view may not be shared by others when attempting to establish international accounting.

Conclusions

The defects and problems of national accounting regulations are easy to understand. Imagine that you are in the United States and wish to buy goods from a company in Germany. You do a financial investigation and find that they appear to be a well-established company that made a healthy profit last year.

You discuss this with an accounting friend who examines the German company's accounts and declares that the company had, in fact, made a loss. You are confused but even more so when your friend explains that different countries use different methods to measure company performance. You want to know whether there is a profit or loss. Being told it depends on how you do your calculations does not help.

The arguments for international accounting are compelling, although the barriers have, historically, been difficult to surmount. However, over recent years, they have been eroded gradually. International accounting has become more widespread, although its application in particular countries is not as rigorous as it should be.

The research indicates that there are benefits to be enjoyed from adopting IFRS set by the IASB. Nevertheless, the United States has still not decided to adopt IFRS fully. The research quoted above illustrates the criteria for internationalization required by one particular group in the United States. In the following chapter, we will discuss U.S. involvement in international accounting and how we have arrived at the U.S. position known as convergence.

CHAPTER 3

The U.S. Engagement

About This Chapter

The United States has been a supporter of international accounting since 1973 and a very active player since 2002. It has directed considerable resources into the development of International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB), and at the same time has changed parts of its own regulations so that they complement the international approach to accounting issues.

Unlike other jurisdictions, including Australia, Canada, and countries in the European Union (EU), the Financial Accounting Standards Board (FASB) has chosen not to adopt IFRS as they stand. Instead, it has worked with the IASB in developing standards that both Boards find acceptable. By choosing the convergence approach, U.S. accounting regulations have been heavily influenced by international thinking and alterations have been made to existing U.S. regulations.

Many believed, or at least hoped, that the convergence approach would finally lead to the United States fully adopting IFRS. Despite comments from the FASB that this would occur, the Board has not yet done so and the current indications are that it will not happen.

In addition to individuals who argue as to what constitutes good accounting, there are those who would not wish the Securities and Exchange Commission (SEC) and the FASB to relinquish their roles to an outside standard setter. In this chapter, we explain the route that the United States has selected with regard to international accounting standards (IASs), and the debate on internationalization that has taken place within the country.

The Early Commitment

The lengthy and arduous progress of the relationship between the United States and international standard setters has been extremely well documented.[1] The research not only incorporates documentary evidence, but also correspondence with some of the major decision makers. This section draws from that work and also adds material from other relevant sources.

In the first few years following the IASC's formation in 1973, there was limited contact between the Committee and the FASB. The International Accounting Standards Committee (IASC) was, however, gradually spreading its influence with an increasing number of smaller countries that decided to follow IASs. It was not until 1988, when the IASC had issued nearly 30 separate standards, that the FASB publicly announced its position on international accounting. It stated that the Board would support the development of superior international standards that would then gradually supplant national standards as the superior standards became universally accepted.

There were barriers, however, that could prevent, or at least delay, such an occurrence.

1. The differing national objectives of financial reporting.
2. The wide spectrum of national standard-setting structures from predominantly government-led to predominantly private-sector standards.
3. Nationalism and the reluctance to relinquish control to an outside body.
4. The particular economic, political, and social priorities of different nations.

The FASB believed that it could contribute to improving IASs in many ways.

1. Joining the IASC Consultative Group.
2. Expanding and strengthening relationships with national standard-setting bodies.
3. Greater systematic analysis of international accounting literature relating to major FASB projects.

4. Encouraging more comments on FASB Exposure Drafts from an international perspective.
5. Discussion with IASC leadership on holding an international conference of national standard setters on accounting conceptual frameworks.
6. Recruiting accountants with foreign experience to join the FASB staff.

In August 1991, the FASB published its plan for international activities, which was based on two key assumptions. The first assumption was that domestic financial reporting needs would continue to be the FASB's first priority. The second assumption was that its international activities would be conducted within its charter and mission statement. In retrospect, it can be concluded that this was not an overwhelming desire to move toward convergence, but rather a wish to be involved.

The declaration by the FASB for greater international involvement was met with enthusiasm by the IASC. It was difficult to claim that IASs were international when the largest market did not adopt them. In addition, some countries, without their own national Generally Accepted Accounting Principles (GAAP), followed U.S. GAAP.

In 1996, the SEC indicated that it supported the IASC's objective to develop accounting standards that could be accepted when preparing the necessary financial statements in cross-border offerings. The elements of the IASC's strategy were a core set of comprehensive, generally accepted accounting pronouncements, which were of high quality and resulted in three elements: comparability, transparency, and full disclosure for users. These standards were expected to be rigorously interpreted and applied.

Once the IASC had achieved these three elements, it was the Commission's intention to consider permitting foreign issuers offering securities in the United States to draw up their financial statements by applying international standards. It would be some 10 years before this consideration became a reality.

Both the SEC and FASB had expressed their support for IASs. In the year 1999, the FASB and its oversight body, the Financial Accounting Foundation (FAF), made public their vision for the future of international accounting. They regarded the desired outcome as the worldwide use of a single set of high-quality accounting standards for both domestic and cross-border financial reporting. To achieve that, the FASB would be required to:

- Take a leadership role in the evolution of international accounting.
- Commit to the required resources to ensure that international standards were of a high quality.

It was accepted that, if a quality international accounting standard-setting structure and process were established, it could lead to structural and procedural changes to the FASB, as well as potential changes in its national role.

In pursuing this vision, the FASB stated that it should retain its worldwide leadership role in standard setting and believed that "Worldwide acceptance of internationally recognized standards and a global standard-setting process is impossible without U.S. acceptance and participation."[2]

Although the IASC made considerable progress, prior to the year 2000, the major national economies, including Australia, Canada, the United Kingdom, and the United States, were still complying with their own national accounting standards. These national standards differed significantly from international standards. If this situation was to improve, either a complete overhaul of all aspects of the IASC was required, or a new and more powerful body needed to be formed. The latter was the course of action chosen.

The IASB was established formally in April 2001 with the objectives of:

- Developing in the public interest a single set of high-quality, understandable, and enforceable global accounting standards;
- Helping participants in the world's capital markets and other users make economic decisions by having access to high-quality, transparent, and comparable information;
- Promoting the use and vigorous application of those standards;

- Bringing about convergence of national accounting standards and IASs to produce high-quality solutions to accounting issues faced by companies across the globe.

In 2002, the recently appointed chair of the IASB, David Tweedie, made clear his aim of spreading IASs to the United States. He declared that the IASB's two main objectives were:

1. *Convergence of U.S. and international standards*. Possibly, Tweedie realized that it was unrealistic to expect the United States to adopt IASs. The most sensible approach was to converge IASs and U.S. GAAP. Convergence in this context is defined as jointly agreeing on changes to both sets of standards to produce one set of high-quality, global accounting regulations.
2. *An improvement project*. This was seen as the first step to promote convergence on high-quality standards. The Board's objective was to revise and reissue 12 named standards by the first half of 2003.

The appointment in July 2002 of a new FASB chair, Robert Herz, added a fresh international dimension to the United States' way of thinking. Herz was a qualified UK Chartered Accountant and had previously served on the IASB. His appointment brought with it a greater commitment to convergence, which complemented the objectives of the restructured IASB under David Tweedie. The rapport led to the signing of the Norwalk Agreement, which had the objective of converging United States and international standards.

The position adopted by the IASB was formed at a time when both internal and external factors strengthened the argument for convergence. The New York Stock Exchange (NYSE) was facing growing competition from markets in other countries, while foreign companies were finding that the United States' requirements, such as the Sarbanes–Oxley Act, were becoming increasingly onerous. In addition, a succession of financial scandals such as Enron and WorldCom weakened confidence in U.S. financial reporting regulations and the effectiveness of the rules-based approach to regulation.

External pressures were also becoming apparent. Several countries had either adopted international accounting or were planning to do so, which meant that the United States could potentially lose its vision of becoming a world leader and become isolated instead. The IASB was proving a much more effective organization than the IASC and was generating support from many organizations while simultaneously improving its standards. Additionally, new capital markets were expanding abroad and threatening New York's claim as the premier capital market.

The Norwalk Agreement

As a consequence of the events discussed in the previous section, it is not surprising that in October 2002, the FASB and the newly formed IASB signed an agreement in Norwalk, Connecticut. This agreement sets out the aims of the two Boards and the actions they intended to take jointly.

Aims

- The existing financial reporting standards of the FASB and the IASB would become fully compatible as soon as practicable.
- The future work programs of the two bodies would be coordinated to ensure that once compatibility was achieved, compatibility of standards would be maintained.

Priority Actions

- To undertake a short-term project aimed at removing a variety of individual differences between U.S. GAAP and IFRS.
- To remove other differences between IFRS and U.S. GAAP that remained on January 1, 2005, through coordination of future work programs. This would require the Boards to invest the time and resources to undertake substantial projects.
- To continue progress on the joint projects that were currently being undertaken.
- To encourage their respective interpretative bodies to coordinate their activities.

The problems faced by the two parties in following the convergence route chosen were probably underestimated. Although it is claimed that the differences between U.S. GAAP and internationalization are not insurmountable,[3] it is recognized that "for many countries convergence with international accounting standards will be a monumental task."[4] There was also the issue that seems to be overlooked, that convergence involving changes to international standards meant that all those countries that had already adopted them would have to make changes to their accounting practices.

Not surprisingly, although "the goal of their convergence efforts was common standards, they sometimes fell short of that objective."[5] The reasons behind why the aims set out in the Norwalk Agreement were not fully achieved are examined in the next section, which discusses the opinions of different groups on internationalization of accounting regulations.

The Internationalization Debate

When assessing the extent of adoption by countries, care must be taken in making assumptions on what this action means in a particular country. Some countries will adopt IFRS completely as they stand, and some may not only adopt them but also adapt them by passing the standards through their own regulatory procedures. The adopted IFRS may therefore be modified to some extent to correspond with perceived national needs and existing practices. Finally, some countries will issue standards that they claim are similar to (or based on) IFRS, which implies that there still remain differences. It is therefore difficult to state categorically how many countries are using IFRS in their complete and original form. It is even more difficult to know the extent to which companies comply with the standards and the enforcement procedures in place.

Where a country claims to be following IFRS, it does not follow that all types and sizes of companies in that country are complying with IFRS. Normally, companies listed on the national stock exchange will be expected to apply IFRS, although banks and other financial institutions may be exempt. Smaller, private companies with less complex operations and fewer resources will not be applying full IFRS. They may be following a simplified version or the country may have issued its own accounting standards for smaller entities.

Furthermore, another key factor in the internationalization debate is the strength of enforcement practices in a particular country. The IASB only issues standards; it does not conduct any surveillance to ascertain whether the standards are strictly followed. National regulators and auditors are charged with the responsibility of ensuring that regulations are followed, and the effectiveness of their actions may not be very high.

Finally, corporate financial reporting not only reflects the requirements and enforcement of accounting standards, but it is argued that influences such as legal institutions, capital market forces, product market competition, and governance are also involved in shaping the financial disclosures made by companies.[6]

A further concern regarding internationalization is that the standard-setting process involves a compromise among a large and very diverse set of constituents from around the world. Countries have differing objectives with respect to financial reporting regulations. Although the United States has the objective that financial reporting satisfies the needs of external investors, companies in other countries may rely heavily on close relationships among a large set of stakeholders for financing, and are less focused on capital markets.

Given the practices in other countries, there is the concern that the United States may discover that the IASB is influenced to modify or develop IFRS to meet the demands of insider or stakeholder economies. Thus, IFRS may not meet the objectives of U.S. financial reporting, which is to meet the needs of the external users.

Given the above background, it is fruitless to attack or defend the U.S. stance by reference to the conduct of other countries. This section concentrates therefore on the attitudes and opinions within the United States. There are many interest groups in the United States with differing opinions on U.S. involvement in the development of IASs. The views within each of these groups can change as time passes and new events occur. The following sections examine the opinions of five interested groups. They capture the main thrust of their opinions, but also attempt to reflect differences and changes through time.

Regulatory Bodies

The United States has been setting accounting standards for half a century. This has involved a substantial investment and has resulted in a highly sophisticated system of accounting regulation. Abandoning completely the success that has been achieved does not appear to be an attractive proposition.

A positive argument for U.S. regulators embracing IFRS is that there is a potentially wider political benefit for the United States. A strong message is made public that U.S. regulators wish to cooperate with other major countries on important global business issues. It reinforces the reputation of the United States as a global force.

Although it may be impossible for the FASB to fully adopt IFRS, the Board's involvement ensures that the United States is in a position to greatly influence the development of IFRS. Given the size of its international trade and capital markets, the United States can make a valuable contribution to the improvement of international standards.

At the other end of the spectrum, there are potentially negative consequences if the United States does not adopt IFRS or play a major role in their formation. As IFRS become more widely established, multinational corporations may find that international standards meet their strategies and policies. It is even possible that GAAP could become an ineffective competitor relative to an increasingly dominant IFRS.

There are also more specific reasons for U.S. involvement. One reason put forward is that regulators have seen a significant shift in global market capitalization, with U.S. market share steadily declining.[7]

The NYSE market cap at the end of 2003 was 41 times that of the Bombay Stock Exchange (BSE) and 31 times that of Shanghai Exchange. In July 2009, the NYSE was 9 times that of BSE and only 3.6 times that of Shanghai.[8]

According to the September 2009 Standard & Poor report, the U.S. market is now less than 41 percent of global capital markets, a substantial decline from January 2004, when it was nearly 53 percent.[9]

This decline must be considered in the context of other events, in particular the state of the economy. Since 2009, opinions have changed. In the first few months of 2014, 42 Initial Public Offerings (IPOs) were listed on the NYSE or NASDAQ. In the last 12 months, there have been many more IPOs listing on the NYSE and NASDAQ than in any other country. The Global Financial Centre Index shows that London has lost the top spot it has had for seven years and is now in second place behind New York.[10] Additionally, in 2014, Alibaba, the Chinese tech company, has an IPO that by common consent will exceed Facebook's IPO in 2012 of $16 billion.

There are still arguments for regulators to remain involved and continue to participate in international standard setting, but there is also an opposing view. It is claimed that the political incentives currently driving convergence efforts between the United States and the IASB are mostly short term, and there are no evident incentives for U.S. firms to adopt international standards. There is also a well-documented history of American exceptionalism as a means of defending U.S. sovereignty in matters of U.S. foreign policy.

There is considerable strength in the exceptionalism argument in another global arena. The United States is one of the only three countries, the others being Burma (Myanmar) and Liberia, that have not adopted the International System of Units (SI) metric system as their official system of weights and measures. Such a home-centric stance is not unusual in foreign matters and Britain, although a member of the EU, still steadfastly refuses to adopt the euro and continues with sterling as the legal currency.

The discussion on whether U.S. regulators should be more closely involved with IFRS and the extent to which that full involvement should take has not reached any definite conclusions. At this stage, in 2014, it seems highly unlikely that the United States will adopt IFRS fully and relinquish its own control of the standard-setting process to the IASB. There is even the doubt that the SEC has the legal authority to delegate its regulatory powers regarding financial reporting by U.S. companies to a foreign, private body of standard setters.[11]

U.S. Corporates

Corporates, when taking a position on the adoption of IFRS, will be attempting to weigh the benefits against the costs of changing their accounting systems. Undoubtedly, there are costs and benefits if all corporates are using the same accounting system. The following factors may persuade some corporates that an IFRS reporting has its advantages:[12]

- Some U.S. companies already have to report using IFRS because it is the subsidiary of an international parent or has an investor company, and these demand IFRS reporting.[13]
- If the U.S. company has foreign subsidiaries that are required to follow IFRS reporting in their own countries, it is simpler and cheaper for the entire group to follow IFRS.
- Where there are operations in other countries, those jurisdictions may make IFRS reporting mandatory.
- Although U.S. companies are required to follow U.S. GAAP reporting, they may choose to disclose statements with IFRS-based reports to allow for an accurate comparison with foreign competitors.

As always, there are cost–benefit calculations to be taken into account. The costs of transferring from U.S. regulations to IFRS can be high and can include the following:

- Existing accounting staff will require training and additional staff with experience will have to be recruited;
- Information systems will require substantial changes;
- Multiple charts of accounts and consolidation methods will need to be coordinated;
- Standardization of policies and procedures need to be implemented for consistency in standards in different jurisdictions;
- Company's strategies may need to be reviewed as new financial information becomes available;
- Management information systems need to be reviewed;
- Managers will need to be trained to understand the information available and its implications on planning, control, and decision-making responsibilities.

There are always problems in making cost comparisons based on other countries' experiences, but the recent transition to IFRS by

Canada gives some insights. For larger-sized companies, defined as organizations with revenues of CDN$1 billion or more, the average total cost of transitioning was CDN$4,041,177. The lowest spent by a large company was CDN$80,000, by a financial services company with revenues of more than CDN$1.28 billion. The highest cost in the category was CDN$25.5 million, spent by a financial services company with revenues of CDN$30 billion. Costs as a percentage of revenues were 0.006 percent for the lowest spender and 0.08 percent for the highest spender in the category.[14]

Foreign Listers

Foreign companies that wish to list in the United States have three options regarding their mandatory SEC filings. They can provide reports under IFRS as issued by the IASB, use U.S. GAAP, or file reports in their own domestic GAAP with reconciliation to U.S. GAAP. Clearly, if a foreign company is required by the regulations in its own country to comply with IFRS, the first option appears the most sensible.

One study investigated the decisions made by foreign companies confronting these options.[15] They found an increase of 20 percent (30 firms) in the group of IFRS-reporting firms over the two-year sample period, whereas the fraction of foreign filers that use U.S. GAAP or domestic accounting standards decreased by four percent (12 firms) and seven percent (18 firms), respectively. In addition, the total number of foreign filers from countries requiring the use of IFRS increased from 137 firms in 2009 to 173 firms in 2010 (26 percent). Within this group, there was an increase of IFRS reporting by 35 firms.

Given the growth of IFRS reporting in the world and the elimination of the reconciliation requirements in the United States, it may have been assumed that there would be more cross-listed companies filing IFRS reports with the SEC. There are two reasons that this may not have happened.

First, foreign cross-listed firms from countries that have not adopted IFRS may have been listed in the United States for some years. Their original choice of accounting standards would have been U.S. GAAP or domestic GAAP with reconciliation to U.S. GAAP. There would be costs associated with the change to IFRS. Furthermore, the users of their financial statements are most likely more familiar with U.S. GAAP.

Another reason for not using IFRS for filing may be that the companies consider that U.S. GAAP is of higher quality, and the rules-based approach in the United States provides clearer guidance and direction on what to report and how. The AAA FRPC[16] argues that although both IFRS and U.S. GAAP represent a high-quality set of accounting standards, it is less certain whether IFRS provides equivalent financial reporting quality relative to U.S. GAAP. In a survey of U.S. accounting professors, only 13 percent of the respondents considered IFRS to be of better quality than U.S. GAAP.[17]

Finally, U.S. GAAP has been a dominant system for many years. Foreign companies and foreign investors know the regulations and have confidence in them. The possible incentives to change to IFRS may not be sufficient for that change to take place.

Investors

The key benefit claimed for international accounting is the comparability of financial information. Individuals, groups, and corporates conduct their investments in an ever-increasingly integrated world of capital markets. In such a world, there is a need for comparability and transparency of financial reporting worldwide to allow for easy comparison of the financial results of a manufacturing company in, for example, France with those in the United States, Australia, and anywhere else in the world.

Of course, U.S. investors also operate in jurisdictions where IFRS are the required standards for financial reporting. A study examined whether mandatory IFRS adoption at the national level lowers U.S. investors' tendency to overweigh domestic stocks in their common stock portfolios.[18] The results showed that a common set of global accounting standards matters for portfolio holdings of U.S. investors. Interestingly, they also observed that the enforcement of standards in a country is a crucial determinant when making investments outside the United States.

It would seem that from the investors' viewpoint, a global set of accounting standards is preferable. However, this does depend on the quality of those standards and the levels of compliance and enforcement in a particular country.

Accounting Profession

There can be financial benefits in changing regulations for those who provide services, but it can be a two-edged sword. Where a company has to move from U.S. GAAP to IFRS, accounting advice, at a cost, will be required. However, if accountants are offering their services to companies with international connections, they receive fees from constructing financial statements that comply with the requirements of different accounting regimes.

Where IFRS are being adopted, corporate bodies and accountants may experience the following:

- Companies will require a considerable input of accounting knowledge and experience to make the switch to IFRS.
- Considerable training will be required for accountants working within a company.
- Communications with other companies using IFRS will be improved.
- Business transactions should become easier.
- Auditing of multinational companies will be simpler.

One issue that is infrequently discussed is accounting education. Numerous studies have shown that, understandably, most accounting professors in the United States teach U.S. GAAP. Most of the textbooks, case studies, and other materials are based on U.S. GAAP. Although the requirements of IFRS are slowly appearing in some universities, any significant move to full adoption of international standards in the United States would require a huge change in U.S. accounting education.

High-Quality Standards

It is fairly certain that members of the five groups above would all claim to support high-quality standards. This phrase has been used many times in this chapter and is abundant in articles and speeches on standard setting.

In 1997, the then Chair of the SEC[19] claimed that standards must result in comparability and transparency, and provide for full disclosure. Investors must be able to meaningfully analyze performance across time periods and among companies. Of course, one main aim of IASs is to ensure comparability of companies' financial results at the international level.

The SEC[20] echoes the words of many others when it states that high-quality accounting standards consist of a comprehensive set of neutral principles that require consistent, comparable, relevant, and reliable information. It believes that the information should be useful for investors, lenders, creditors, and others who make capital allocation decisions.

The IASB shares the same sentiments as the others. With so much agreement on the need for high-quality standards it is confusing that convergence did not take place years ago. One reason may be that the phrases used are descriptive and also avoid the tougher issues.

For example, high-quality standards should have relevance and reliability. It can sometimes be difficult to combine these two characteristics. Let us assume that I bought a house for $250,000 some years ago and I am now seeking a bank loan. I tell the manager that my house has a current market value of $350,000. Does the manager take the reliable value of $250,000 or the value relevant to his decision, which may not be reliable? Mostly, in preparing financial statements, accountants use the reliable or historic values. We discussed this in Chapter 1.

Another issue raised by the SEC is the question of the users of financial statements. The United States' approach has been to steadfastly identify the users as those who make capital allocation decisions. We have briefly discussed this before and we will expand on our discussions in Chapter 6. The problem is that not every country agrees that the only users of financial statements are investors.

Given the difficulties in defining high-quality standards, there are several questions that need to be addressed:

1. What are high-quality standards? The present description of characteristics such as relevance and reliability does not help.

2. What is the purpose of high-quality accounting standards? The answer must be high-quality financial statements. This, however, requires not only good standards but a process of interpretation, monitoring, and enforcement to ensure companies comply.
3. How do we measure high quality?

Some of these questions have been answered by a research study,[21] which compared characteristics of accounting amounts for firms that apply IASs to a matched sample of firms that do not. Measures of accounting quality used earnings management, timely loss recognition, and value relevance metrics.

The results showed that firms applying international standards use less earnings management, more timely loss recognition, and more value relevance of accounting amounts than do those applying domestic GAAP. The conclusion suggests that improvement in accounting quality is associated with applying IAS.

Of course, one study does not provide complete answers. But it does emphasize that the pursuit of high-quality standards requires some measures by which we can assess them. It must also be accepted that standards are not only driven by technical accounting considerations but other powerful influences. These will be discussed in the remaining three chapters of the book.

The Route Taken

We started this chapter by explaining the establishment of the IASC in 1973 by national accounting bodies in nine countries. It is revealing to examine the progress toward international accounting by each of them at the end of 2013. The main source of this information is from an excellent website that updates the position of their progress frequently.[22]

Some of the countries are members of the EU. The position with these nations is that the audit report and basis of presentation notes refer to compliance with "IFRS as adopted by the EU." The EU has adopted virtually all IFRS, though there is a time lag existing in adopting several recent IFRS, and one aspect of IAS 39 was modified. The modification affects approximately 50 EU banks that follow IFRS. The EU is also permitting separate company financial statements to be marked as complying with IFRS as adopted in the EU.

Australia

Australia and New Zealand have adopted national standards that they describe as IFRS-equivalents. Those standards include the IFRS requirement that an entity whose financial statements comply with IFRS makes an explicit and unreserved statement to that effect in its notes. In both countries, this statement is made in the audit report.

Canada

Canada has adopted IFRS in full, effective from 2011, and titled them as Canadian Financial Reporting Standards. However, mandatory adoption of IFRS has been deferred for entities with rate-regulated activities (until 2015) and investment companies (until 2014). Those deferrals were provided to give time for the IASB to complete projects affecting those entities. Rate-regulated entities have regulatory restrictions regarding the prices that can be charged to customers for services or products.

Member Countries of the European Union

France, Germany, Netherlands, United Kingdom, and Ireland.

The position of these nations is that the audit report and basis of presentation notes refer to compliance with *IFRS as adopted by the EU*.

Mexico

On November 11, 2008, the Mexican SEC (Comision Nacional Bancaria y de Valores [CNBV]) announced that all companies listed on the Mexican Stock Exchange would be required to comply with IFRS starting in 2012. Listed companies would have the option to comply with IFRS earlier—starting as early as 2008—subject to requirements that would be established by the CNBV.

United States

The progress toward conversion from 2002 to 2013 has been one of memorandums, roadmaps, objectives, and milestones. Despite all of these carefully worded documents, full conversion has still not been achieved and U.S. GAAP remains firmly in place, although definitely changed. The time line of the progress that has taken place is summarized below.

2002—The Commencement of the Journey

The Norwalk Agreement was signed.

2006—Issue of a Roadmap

Both Boards affirmed their commitment toward making progress toward convergence. Instead of attempting to remove the differences in existing standards, they agreed that it would be more fruitful to develop new and high-quality standards. They also agreed to replace weaker standards with better ones and a number of objectives to be achieved by 2008 were agreed upon.

2007—Foreign Issuers Permitted to List Using International Financial Reporting Standards

In the light of the progress achieved by the Boards and other factors, the SEC adopted a final ruling.[23] This indicated the Commission's confidence that IFRS, as issued by the IASB, were robust enough to provide investors with reliable and relevant financial data. Some outsiders were quietly asking why U.S. companies could not use IFRS if they were acceptable from foreign issuers wishing to list on the NYSE.

2008—Issue of a Roadmap

An update was issued to the 2006 document, which identified a series of priorities and milestones, emphasizing the goal of joint projects to produce common, principle-based standards. The 2008 IFRS roadmap indicated that adoption of IFRS in the United States would be conditional upon the achievement of progress toward these milestones:

- Improvements in accounting standards. The SEC was to continue to monitor the degree of progress made by the FASB and IASB regarding the development of accounting standards.
- Accountability and funding of the International Accounting Standards Committee Foundation (IASCF). The IASCF was required to show indications of securing stable funding that supported the independent functioning of the IASB.
- Improvement in the use of interactive data for IFRS reporting. The SEC mandated filings for public companies in the Extensible Business Reporting Language (XBRL) format. The mandate came into effect for the largest 500 U.S. companies for financial disclosures made after June 15, 2009.
- Education and training. The SEC was to consider the state of preparedness of U.S. issuers, auditors, and users, including the availability of IFRS education and training.

The 2008 Roadmap generally received applause. We reproduce below part of a synopsis from the influential Financial Reporting Policy Committee of the Financial Accounting and Reporting Section of the American Accounting Association. The Committee stated:

> Based on a review of the literature, the AAA FRPC has concluded that a move to an international set of financial reporting standards is a desirable goal. We have also concluded that continued convergence of U.S. GAAP with IFRS by joint relations between the International Accounting Standards Board, hereafter IASB, and the Financial Accounting Standards Board, hereafter FASB, is preferable to near-term adoption of IFRS as a strategy for convergence.[24]

2009—Pressure from Outside Bodies

There were requests from other parties, including various government agencies, for the two Boards to speed up their progress. In response, the IASB and the FASB published a progress report describing an intensification of their work program, including the hosting of monthly joint Board meetings and to provide quarterly updates on their progress on convergence projects.

2010—Draft Strategic Plan Issued—Final Decision Set for 2011

The SEC published its Draft Strategic Plan for fiscal years 2010 through 2015. The document includes drafts of the SEC's mission, vision, values, strategic goals, major initiatives, and performance metrics. In the plan, the SEC proposed an objective of promoting high-quality financial reporting worldwide through, among other things, support for a single set of high-quality global accounting standards and promotion of the ongoing convergence initiatives between the FASB and the IASB.[25]

The Plan also stated that the decision about incorporating IFRS in the U.S. financial reporting system would be made in 2011. The document did not provide any details of potential transition dates or approaches, but the staff stated that 2015 or 2016 seemed reasonable based on comments received on the 2008 IFRS roadmap. The SEC also indicated that an early adoption was viable if it decided to make the use of IFRS mandatory.

2012—Joint Progress Report Issued

The IASB and FASB published a joint progress document in which they described the progress made on an accounting standard for financial instruments. This included a joint expected loss impairment (provisioning) approach and a more converged approach to classification and measurement.

It was anticipated that the SEC would make a final decision on the time of full adoption of international accounting in 2012. It did not do so and the response from some other major players was that the IASB should cease its relationship with the United States and direct its attentions to the rest of the world.

The Institute of Chartered Accountants in England and Wales (ICAEW) responded to the failure of the SEC to decide on convergence and proposed that the convergence project should be ended formally, in months and not years. The argument was made that the IASB should concern itself with the 100-plus countries that had adopted international standards and assist those countries, such as China, which were making moves to convergence.[26]

The Chairman of the IASB, Hans Hoogervorst, is quoted as saying that "Five years ago, it (lack of U.S. adoption) might have led to a disintegration of the whole project. I am not worried about that now. But I am worried that the U.S. finds it so hard to make a decision and that it might lead to a growing divergence between IFRS and U.S. GAAP."[27]

2013—Publishing of an Update

The IASB and FASB published a high-level update on the status and time line of the remaining convergence projects. The report includes an update on the impairment phase of the joint project on financial instruments.

2014—Financial Accounting Standards Board Promotes Convergence

The term international convergence of accounting standards can be interpreted in different ways. The FASB argues that the term refers to both the intended goal and the path by which to reach it and explains its strategy on its website:

- The FASB believes that, over time, the ultimate *goal* of convergence is the development of a unified set of high-quality IASs that companies worldwide would use for both domestic and cross-border financial reporting.
- Until that ultimate goal is achieved, the FASB is committed to working with other standard-setting bodies to develop accounting standards that are as converged as possible without forgoing the quality demanded by U.S. investors and other users of financial statements.

- From 2002 to 2013, the *path* toward convergence has been the collaborative efforts of the FASB and the IASB to both *improve* U.S. GAAP and IFRS *and eliminate or minimize the differences between them*.
- As the FASB and the IASB complete their work on the last of their joint standard-setting projects initially undertaken under the 2006 Memorandum of Understanding (MoU), the process will evolve to include cooperation and collaboration among a wider range of standard setters around the world.
- Moving forward, the FASB will continue to work on global accounting issues with the IASB through its membership in the Accounting Standards Advisory Forum (ASAF), a newly established advisory body comprising 12 standard setters from across the globe.
- For issues of primary interest to stakeholders in U.S. capital markets, the FASB will set its own agenda. As the FASB initiates its own new projects based on feedback from its stakeholders, it will reach out to all who have an interest in improving financial reporting for companies and investors that participate in U.S. capital markets, including U.S. capital market stakeholders who live and work outside the United States.

Conclusions

The issues in continuing with national accounting regulations in a world where business activities are becoming increasingly international in nature had become apparent toward the second half of the 20th century. The solution appeared to be IASs where the emphasis would be on high quality and the objective would be the comparability of financial statements, no matter the country in which the company operated.

Unfortunately, although the barriers toward countries adopting international standards have been identified, the success in removing these barriers has been difficult to achieve. The IASC had achieved some success in harmonizing accounting practices, and since 2001, the IASB can claim to have significantly advanced the cause of internationalization. However, the United States has still not adopted IASs and its position is uncertain.

In the beginning stages of internationalization, the economic strength of the United States in the world and the size of its capital markets made it unthinkable that international standards could be developed successfully without the full involvement of the United States. That position has changed. The increasing economic strength of other countries, the success of foreign stock exchanges, and the large corporate frauds in the United States, which shook confidence in the regulatory system, has lessened the influence of the United States.

There are indications that the IASB considers that it is able, and is also willing, to proceed with international standards without the complete involvement of the United States. There are also signs that other countries are questioning the favored position of the United States in being able to significantly influence standards before they are issued, whereas they have adopted standards in their entirety.

It is unthinkable that the United States will turn its back completely on international standards, but the road that it has chosen is one of convergence. One suspects that there will never be complete convergence and the SEC will retain its authority and the FASB will remain the national standard setter. Currently, the stance that the FASB is taking is clearly stated on its website:

> The FASB believes that pursuing convergence—making global accounting standards as similar as possible—is fully consistent with that mission. Investors, companies, auditors, and other participants in the U.S. financial reporting system should benefit from the increased comparability that would result from internationally converged accounting standards. More comparable standards would reduce costs to both users and preparers of financial statements and make worldwide capital markets more efficient.[28]

This is sound support for continuing a dialogue and, despite the events in 2012, it appears as if the United States intends to continue its international involvement. It is impossible to predict whether full convergence will be achieved. Our opinion is that the combined work to produce high-quality standards will continue, but where agreement on particular issues cannot be agreed, the two Boards will make their own decisions. The result will be that U.S. GAAP is *similar* to IFRS but will have changed significantly from its original form. However, it will remain as U.S. GAAP controlled by the SEC and the FASB, and will *not* be fully compatible with IFRS as issued by the IASB.

In predicting the future, the changes to U.S. accounting regulations that have already occurred and are still taking place should not be ignored. In the next chapter, we examine the alterations to U.S. accounting policies and practices that have already taken place because of its international involvement. In Chapter 5, we consider discussions that are currently taking place between the FASB and the IASB on several issues. The final chapter scrutinizes the major hurdles to full adoption that remain and assesses the probability of them being overcome.

CHAPTER 4

Successes and Failures

About This Chapter

Accounting regulations are constantly changing, irrespective of the developments of the convergence projects. The work of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) over the last 10 years has certainly made substantial changes to the standards of both bodies. The FASB, irrespective of the convergence project, is constantly seeking to improve its standards in response to national needs. It continuously monitors practice and the implementation of standards and issues revised or new standards where there are deficiencies.

Sometimes there are new business practices to be regulated, or political and legal decisions made at the national level that require a new standard or amendments to an existing one. Not surprisingly, the process of convergence becomes entangled with these political and legal influences.

This chapter is divided into two parts. In the first part, we discuss three examples of changes that have been made to accounting regulations. The examples involve convergence, politics, legislation, and technical accounting considerations. Given this brew, both the FASB and the IASB are to be congratulated on the progress that has been made with convergence efforts at this stage.

The second part of the chapter examines projects where progress toward convergence has been made but not achieved fully. One can claim that the FASB and the IASB standards have converged, but frequently there are still some differences. These can be minor but may be more problematic especially for companies in particular industries.

In the third section of this chapter, we examine an example of a standard that followed business developments accounting for intangible assets, specifically goodwill.

Convergence, Politics, and Business Practices

Financial accounting is not only regulated by accounting standards, but there is also legislation that regulates companies and that necessarily impacts on the financial information they prepare and report. A significant piece of legislation was the Sarbannes–Oxley (SOX) Act of 2002. This was a regulatory response to the large financial frauds and accounting irregularities that had occurred in companies such as Enron, WorldCom, and Tyco.

The Act generally applies to U.S. and non-U.S. public companies. The requirements of the Act that are particularly relevant to this book are as follows:

- The chief executive officer (CEO) and chief financial officer (CFO) are responsible for signing off their company's financial statements and indicating that the financial statements do not omit material information.
- The CEO and CFO must indicate that they are responsible for the company's system of internal controls over financial reporting.
- The Public Accounting Oversight Board was established to oversee the audit of public companies.
- Listed companies must have a majority of independent directors and there must be regular meetings scheduled with managers of the company.

The SOX Act is possibly the most substantial legislation addressing the financial accounting and reporting, and corporate governance for many decades. There have been criticisms that it places too large a burden on companies but, given the extent of the corporate misbehaviors that were taking place, the government was compelled to take action.

Attempting to converge U.S. GAAP and IFRS, therefore, is not only about technical accounting. Indeed, it is sometimes less about technicalities and more about politics. Although the Securities and Exchange Commission (SEC) may be extremely powerful, it is still exposed to lobbying, arguments, persuasions, and criticisms. As the direct standard setter, the FASB has the same pressures, plus it is also answerable to the SEC.

The IASB, in some ways, is in an even more difficult position than the FASB as it is unable to enforce its standards. They must rely on the fact that the countries adopting IFRS are in agreement with the Board. There have been extensive discussions and debates over the issues surrounding enforcement and adoption of IFRS. The Board does, however, have an advantage over the FASB as it does not have a legal obligation to issue standards on any particular area of accounting.

Although technical accounting issues need to be addressed, both the FASB and the IASB must be receptive to the opinions of their constituents while trying to achieve convergence.

Two examples of accounting areas in which the correct, technical answer was disputed while politics and business were strong influencers, are stock-based payment (referred to as share-based payments in international standards) and inventories. The two topics have no technical similarities, but both illustrate the reason for which complete convergence has not always been achieved.

Somewhat confusingly, the international standard on share-based payments is IFRS 2 issued by the IASB, while the standard dealing with inventories is IAS 2 issued by the International Accounting Standards Committee, not the IASB, and it is still very much in force.

It would also be fair to say that for the most part, standards do not lead new business developments, but follow them. The FASB and the IASB attempt to identify developments at their early stages and introduce standards to regulate them.

For example, accounting for goodwill has technical complexities in dealing with new phenomena rather than a route to conversion. There are differences in the approaches taken by the FASB and the IASB, but there are also many similarities. The debate over accounting for goodwill is still continuing, in part due to the business and political pressures fueling it.

Stock-Based Payments (Share-Based in the International Standard)

The concept of share-based payments in IFRS 2 encompasses the issuance of shares, or rights to shares, in return for services and goods. This term covers several different types of transactions, but we will restrict our discussions to schemes that are designed for the benefit of employees, particularly directors (share options).

The price the company sets on the share (called the *grant* or *strike price*) is usually the market price of the share at the time the employee is given the options. Since those options cannot be exercised for some time, the hope of the lucky recipient is that the price of the shares will go up, so that selling them later at a higher market price will yield a profit. Definitions of some of the terms we use will be helpful.

Definitions

Stock options (UK "Share options"): A benefit, given or sold by one party to another (in this case the employee), which gives the recipient the right, but not the obligation, to buy (call) or sell (put) a stock at an agreed-upon price within a certain period or on a specific date.

Strike price: The price at which the holder of a stock option may purchase the stock.

Vesting: When employees are given stock options, they usually do not gain control over the stock or options for a period of time. This period is known as the vesting period and is usually three to five years. During the vesting period, the employee cannot sell or transfer the stock or options.

Stock option expensing: The method of accounting for the value of stock options on the income statement.

Expiration date: The date by which you must exercise your options.

At the money stock options: The stock option's strike price is *identical* to the prevailing market price.

In the money stock options: The stock options grant or strike price is *lower* than the prevailing market price.

An example of a stock option is as follows: The recipient receives options on 1,000 shares of company stock. The vesting period is spread over five years, with one-fifth of the stock vested each year. The recipient can buy 200 shares each year at the strike price, and if so wishes can sell the shares at the current market price.

There is considerable, and often heated, debate as to whether stock options should be permitted. There are those who argue that the issuance of options aligns executives' interests with those of the company, increasing motivation and improving corporate performance. Others claim that it is merely a method of secretly siphoning off money to directors who are already handsomely rewarded.

One important aspect of the U.S. debate is stock optioning expensing—in other words, how companies should account for the options. In 1972, a new revision in U.S. GAAP meant that companies did not have to report executive incomes as an expense to their shareholders if the income resulted from an issuance of the money stock options. The result was that organizations reported higher profits and directors benefited without the full knowledge of shareholders.

There was an increasing growth in the use of stock options by companies and research indicated that in 2002, profit at technology firms in the S&P 500 would drop by 70 percent if they expensed options on the income statement. In utility organizations, the drop would only be two percent.[1] The pressure was on for stock options to be expensed, but there were political hurdles preventing this regulation.

It was not until March 31, 2004, that the FASB issued its long-awaited Exposure Draft, *Share-Based Payments.* Congress became involved with the draft and a bill was put before Congress in 2004 to limit stock option expense reported in the statements to the top five officers.[2]

Subsequent research[3] of the events in 2004 found that employee stock option expense under the bill before Congress would only be approximately two percent of what it would be under the FASB's preferred method. The research also reports that political connections and business interests were influencing the debate in Congress.

In December 2004, the FASB published FASB Statement 123 (Revised 2004): *Share-Based Payment*. This required that the compensation cost relating to share-based payment transactions be recognized in financial statements. It took the Board two years to develop a revised standard that provided investors and other users of financial information with more complete and neutral financial information.[4] While Statement 123(R) is largely consistent with IFRS 2, some differences remain, as described in a Q&A document that FASB issued along with the new Statement.

IFRS 2 was originally issued by the IASB in February 2004 and first applied to annual periods beginning on or after January 1, 2005. The standard requires an entity to recognize share-based payment transactions (such as granted shares, share options, or share appreciation rights) in its financial statements, including transactions with employees or other parties that are to be settled in cash, other assets, or equity instruments of the entity. Specific requirements are included for equity-settled and cash-settled share-based payment transactions, as well as those transactions where the entity or supplier has a choice of cash or equity instruments.

The key provision of U.S. and international regulations is for public entities to recognize the fair value of the compensation cost for vested employees over their service period.

Critics could claim that the two Boards were unable to reach full convergence on this topic. However, given the many problems faced by the FASB, the reasonable response is that these accounting transactions were poorly regulated and a substantial degree of convergence has been achieved. Both U.S. GAAP and IFRS have issued standards over stock-based compensation.

The discussion above has been about accounting for stock options, from a technical accounting and convergence viewpoint. It is illuminating to look at business practices where the accounting regulations are not sufficiently clear. Stock options are a good example of a case where questionable (or even fraudulent) activities may be conducted by directors of a company.

With regard to stock options, two courses of action were taken that were of benefit to the directors receiving stock options. One of these was backdating, where option granting dates were retrospectively set to precede a rally in the underlying shares, locking in risk-free profits for recipients. The second is referred to as spring-loading, where grant dates are scheduled for just before a positive announcement or just after a negative one, anticipating a stock price rally and therefore, resulting in higher profits for recipients.

The two practices above are not illegal, but must be properly disclosed in regulatory filings, taxed and reported on the accounting ledger. There is also a measure of control under the Sarbanes–Oxley Act that reduced the time that companies are required to report their options grants to the SEC from 30 days to two business days.

It is always difficult to state the extent of questionable behavior. One recent study[5] took a sample of 111 fraudulent companies and 111 matched nonfraudulent companies. The results indicated a significantly positive association between director stock-option compensation and the likelihood of fraud. On the other hand, there is no association between the fraud likelihood and independent directors' cash compensation and stock ownership.

The academic study conducted above does not reveal the financial impact of these questionable activities. In June 2007, in a report[6] examining the involvement of general counsels (GC) stated that the SEC:

- Brought civil fraud charges against Nancy Heinen, former GC of Apple, for her involvement in backdating stock options.
- Filed a civil complaint against former Amkor Technology GC Kevin Heron for alleged insider trading. A federal grand jury previously indicted Heron on four counts of securities fraud for the same activities. Heron allegedly netted U.S.$290,000 from the illegal trades.
- D Marvell Technology Group announced the termination of Matthew Gloss, GC of its U.S. operating subsidiary. The company did not say why Gloss was terminated, but did say that it would take a U.S.$350,000 charge related to stock options backdating.
- D Amtel Corp. released the results of an internal investigation that found former GC Mike Ross and former CEO George Perlegos responsible for a stock options scandal at the semiconductor company. The company said Ross personally benefited from backdated options that were not approved by the Board.

Possibly the most publicized case is that of Greg Reyes in 2007, the former CEO of Brocade Communications Systems Inc. Bloomberg (BRCD). In a broad government crackdown on options backdating, Reyes was the first chief executive convicted by a jury. He lost his bid to reverse his conviction for backdating employee stock-option grants and hiding the practice from auditors and investors.

He received an 18-month prison sentence and U.S.$15 million fine imposed after his second criminal trial. Brocade investors lost as much as U.S.$197.8 million in 2005 when they sold shares that had fallen in value after the practice was uncovered and the company restated financial results, prosecutors said in court filings.

Inventory Valuation

Closing inventory valuation is an extremely important subject as it is a key item in the calculation of profit and it informs the reader of the financial statement of the value of inventory at the company's fiscal year-end. Inventory includes all of the costs incurred in purchasing merchandise and preparing it for sale. This includes raw materials, direct labor, and manufacturing overhead. Inventory values at the year-end can be substantial; we will demonstrate this fact through the example of General Electric (GE).

December 31 (in millions, U.S.$)	2013	2012
Raw materials and work in progress	10,220	9,295
Finished goods	6,726	6,020
Unbilled shipments	584	378
	17,530	15,693
Less revaluations to last-in, first-out	273	398
	17,257	15,295

Source: GE Annual Report 2013, 91.

The cost for a significant portion of GE's U.S. inventories is determined on a last-in, first-out (LIFO) basis: a method allowed in the United States but not under the international accounting standard. The cost of other GE inventories is determined on a first-in, first-out (FIFO) basis, which is a U.S. and international permitted method.

Given the substantial dollar amounts, it is essential that we understand the impact of a change in valuation methods. A very simple example will demonstrate the calculation of gross profit and the critical importance of inventory valuation.

Example

A merchandising company imports shoes at a cost of U.S.$10 each and sells them at U.S.$20 each. In January 2014, the number of shoes it purchases and sells is:

Number imported: 100
Number sold: 90

Calculation of gross profit for January	$	$
Revenue (90 @ $20)		1,800
Cost of goods sold		
Purchases (100 @ $10)	1,000	
Deduct closing inventory (10 @ $10)	100	900
Gross profit		900

With this simple model, it is easy to calculate that a gross profit of U.S.$10 is made on each sneaker. If the company sells 90 of its products, the gross profit must be U.S.$900. The critical factor is the inventory or stock taking, which is conducted at the end of January. It is imperative to ensure that the closing inventory of 10 shoes is physically being held by the company. If the actual count of inventory is less than 10, this variance is an indication of an error, whether due to misappropriation of assets or disposals due to damage. If this is the case, then the closing inventory will be lower and the gross profit will therefore also be lower.

Calculation of gross profit for February

	$	$
Revenue (90 @ $20)		1,800
Cost of goods sold		
Opening inventory from January (10 @ $10)	100	
Purchases (100 @ $15)	1,500	
	1,600	
Closing inventory 20 @ ?		

Having confirmed that 10 shoes are indeed in closing inventory, the next question is how they are to be valued. In the above example, valuation would be at the cost of U.S.$10. Problems will arise if the cost of shoes increases. Let us assume that the information for February is the same as that for January, except that the supplier has increased the cost of the shoes to U.S.$15.

The question is how do we value the closing inventory of 20 shoes? There are several ways to do so, but the dispute occurs between two main options.

1. We can assume that we sold the last shoes that came in February first. Therefore, of the 100 shoes that came in February, we have 10 remaining at U.S.$15 and we still have the 10 from January at a cost of U.S.$10—total U.S.$250. This is known as the LIFO method.
2. We can assume that in February, we first sold the 10 remaining shoes that had cost U.S.$10 each. The 20 shoes remaining therefore were all purchased in February at U.S.$15—total U.S.$300. This is known as the FIFO method.

The method that is chosen has a significant impact on gross profit. Table 4.1 shows the results for February using both methods.

Under the LIFO method, the value of the closing inventory is lower and therefore the accounting calculation of the costs of goods sold is higher than that of the FIFO method. As the profit is lower, the company will pay less income tax. The difference between the cost of an inventory calculated under the FIFO and LIFO methods is called the LIFO reserve. This reserve is essentially the amount by which an entity's taxable income

Table 4.1 LIFO and FIFO comparison

	LIFO		FIFO	
Revenue		1,800		1,800
Opening inventory	100		100	
Purchases	1,500		1,500	
	1,600		1,600	
Less closing inventory	250	1,350	300	1,300
Gross profit		450		500

FIFO, first-in, first-out; LIFO, last-in, first-out.

has been deferred by using the LIFO method. Of course, this is only true when the costs of purchases are increasing. If the purchase price declines the opposite results would occur.

For some companies, the different use of the inventory valuation method has little impact. There are also examples where separate parts of the business use alternative methods, such as the case with Walmart.

Inventories

The company values inventories at the lower of cost or market as determined primarily by the retail method of accounting, using the last-in, first-out (LIFO) method for substantially all of the Walmart U.S. segment's inventories. The retail method of accounting results in inventory being valued at the lower of cost or market since permanent markdowns are currently taken as a reduction of the retail value of inventory. The Walmart International segment's inventories are primarily valued by the retail method of accounting, using the first-in, first-out (FIFO) method. The Sam's Club segment's inventories are valued based on weighted-average cost using the LIFO method. At January 31, 2013 and 2012, the Company's inventories valued at LIFO approximate those inventories as if they were valued at FIFO.

Source: Walmart Annual Report 2013, 36.

Not only does Walmart use both LIFO and FIFO, the weighted-average method is also used as it is permitted under both U.S. regulations and international standards. Walmart applies the retail method of accounting, which is allowed in the United States and is in accordance with international standards.

Accounting for inventory in high-volume retail operations raises problems. It is difficult to determine the cost of each sale. The retail method, which is widely used, compiles the inventories at retail prices. In most retail entities, an observable pattern between cost and price exists. Retail prices can therefore be converted to cost through use of a formula.

The sales for the period are deducted from the retail value of the goods available for sale, to produce an estimated inventory at retail value. The ratio of cost to retail for all goods passing through a department or firm is then determined by dividing the total goods available for sale at cost by the total goods available at retail. The inventory valued at retail is converted to ending inventory at cost by applying the cost-to-retail ratio.

In the United States, the LIFO method has been an acceptable, popular accounting method since its inception in 1939 and is permitted for tax purposes. It is claimed that Congress believed that companies would not adopt it because it lowered profits, but the added effect of lowering taxes was too great an attraction for many companies.[7]

The tax advantages associated with LIFO have been documented by tax laws, research, literature, and Congress. The advantage is substantial in some industries and has led to the criticism of LIFO resulting in an unfair tax loophole for a few beneficial industries.[8]

Criticisms of LIFO have gathered strength and as part of the convergence project, it seemed that LIFO would be abolished so as to fall in line with the IFRS that prohibits LIFO as an acceptable method. The Obama administration proposed in its 2010 budget to repeal LIFO in the future, but there are signs that such a move will meet considerable opposition.[9]

Although there is resistance to the repeal of LIFO, there is evidence that some companies are voluntarily abandoning this method of valuing inventories. The number of public companies reporting LIFO reserves exceeded 1,000 from the late 1970s to the late 1980s. The tax advantage of LIFO is dependent on the presence of inflation, and the number of U.S. companies reporting a LIFO reserve has actually decreased over the past five years (Table 4.2).[10]

It could well be that the final regulation on the use of LIFO will follow the main practice of companies. If there is a continuing movement

Table 4.2 Number of companies reporting LIFO reserves, 2004–2008

	2004	2005	2006	2007	2008
Companies with inventory balances at the year-end	5,673	5,489	5,301	5,072	4,783
Companies with inventory balances and LIFO reserves at the year-end	449	420	401	369	339
Percent of companies with inventory balance and LIFO reserve at the year-end	7.91%	7.65%	7.56%	7.28%	7.09%

LIFO, last-in first-out.

away from the use of LIFO, it will be easier for FASB to fall in line with the IFRS. Whether it would claim this as part of the convergence project is doubtful, but the result will be the same: LIFO would eventually disappear.

LIFO has been a method of valuing in the United States for nearly 100 years. The decision by the IASB to ban LIFO contributed to the calls within the United States to ban it. Despite political pressures and lobbying by businesses, it seems that the method will be finally abolished.

Intangible Assets

> In 2014, Facebook bought WhatsApp for U.S.$19 billion in cash and stock. WhatsApp has been in operation for approximately five years and had just over 50 employees.

What did Facebook get for its money? Certainly not an extensive range of buildings, land, machinery, and other assets you can see and touch. What it paid for was upwards of 450 million users.

Increasingly, companies have found that their most important assets for generating future benefits are not material assets such as buildings and machinery, but assets that have no physical substance. For example, every cab in New York City has to purchase a license in the form of a medallion to display. The city strictly limits the number of licences that are issued and the cost of a license in auction can be more than U.S.$1million—a substantial amount for an item that is not tangible in nature.

For an intangible asset to be recognized it must be (a) identifiable and (b) reliably measured. This means that the asset must be capable of being separated from the rest of the company and can be sold, licensed, rented, or exchanged either individually or together with a related item. The intangible asset can also be identifiable because it arises from contractual or legal rights, even if those rights are not separable from the business.

Recognizing and measuring the intangible asset will depend on how it has been identified. Some intangible assets will have been purchased by the company from another entity. The recognition is evident through the purchase and the measurement of the asset is by the price paid.

Some intangibles can be internally generated, in other words, the company has developed the intangible asset itself. For example, a food company may have developed a new slimming food that resulted in a patent, or a company may have developed a special kind of software for controlling its operations that led to increased efficiency.

One intangible asset in particular where it has been problematic to agree with the correct accounting treatment is goodwill. This is a term that is difficult to define and somewhat easier to explain through an example. Consider the case of a very successful company that has built up a strong customer base, designed a range of quality products, and trained a good workforce. The company has gained an excellent reputation; this reputation, however valuable, will not appear anywhere on the financial statements of the company.

Imagine that a very large company acquires a smaller, but highly successful, company. Because the small company is so successful, the large company is willing to pay a high price for it. Let us assume that the price in this case is U.S.$5 million. The purchase is made and the large company calculates the fair value of the tangible assets, such as buildings and machinery, which it has acquired.

The large company calculates the fair value of the net identifiable assets, excluding goodwill, to be U.S.$4 million. As the purchase price was U.S.$5 million, the large company paid an extra U.S.$1 million for its acquisition. This excess represents all those aspects that are not tangible, but has made the smaller company successful, such as its reputation. In accounting, we assume that this payment of U.S.$1 million is for an intangible asset we term goodwill. This asset does not appear on the balance sheet of the smaller company as it was generated internally. However, as the large company has paid for goodwill, it will need to account for it. There are several options of doing so:

1. Write off the cost of goodwill immediately to the income statement. This is not acceptable as U.S.$1 million has been paid for something; if that sum of money has gone out, we need to record what was received in exchange. Acquisitive companies had to convince their investors that they were purchasing something of value that would appear on the balance sheet.

2. Record it on the balance sheet as an intangible asset and leave it there. Companies were mainly in favor of this method as the goodwill was an additional asset on their balance sheet and there were no costs to the income statement. The argument, mainly from standard setters, against this approach is that although the goodwill life may be indefinite, nothing is infinite. The goodwill cannot last forever. This leads us to the third option.
3. The goodwill is placed on the balance sheet as an asset and written off to the income statement over several years in the same way as we do with tangible assets.

In most countries, after considerable experiments with the different methods, option 3 was selected. Not surprisingly, as it was national standard setters deciding for their own country, the periods of write-off time varied considerably, ranging from five years to 40 years.

Before 2001, the United States allowed companies to use one of two methods when making an acquisition: the pooling of interests or the purchase method. The first method combined the book value of assets and liabilities of the two companies to create the new balance sheet of the combined companies as if it had always been one. The acquisition price was not disclosed, so there was no goodwill. The second approach, purchase method, did give rise to goodwill and the regulations at that time required goodwill to be written off over 40 years.

In 2001, the FASB issued FAS 142, which, to the dismay of some, removed the pooling of interest option. At the same time, the method of writing off goodwill over 40 years was removed. Instead, it became necessary to review goodwill for impairment, either at the operating level, meaning a business segment, or at a lower organizational level.

Conceptually, there is considerable merit for a policy requiring the write-down of an asset when there has been a significant decline in value. A write-down can provide important information about the future cash flows that a company can generate from using the asset. However, in practice, this process is very subjective. Even if it appears certain that significant impairment of value has occurred, it is often difficult to measure the amount of the required write-down.

The procedure for assessment of impairment must be conducted annually. The computed fair value of a business segment, using the present value of future cash flows, is compared to the carrying value (book value of assets plus goodwill minus liabilities).

Where the book value of the unit exceeds its fair value, no further exercise needs to take place and valuation of goodwill remains unchanged. If, however, the fair value of the reporting unit is lesser than the book value, the goodwill is impaired and the amount of the impairment must be written off.

Under FASB ASC 350, *Intangibles—Goodwill and Other*, the asset of goodwill is tested for impairment at least annually using a two-step process.

With the first step, the reporting unit's fair value, including goodwill, is measured by using an appropriate valuation technique, such as a discounted cash-flow method. Fair value is compared to the reporting unit's carrying amount or book value of the goodwill. If the reporting unit's fair value is greater than its carrying amount, the reporting unit's goodwill is not considered to be impaired. If the reporting unit's fair value is less than its carrying amount, then the second step is performed to determine if goodwill is impaired.

In step 2, for all classifications of property, plant, equipment, and intangible assets, the amount of impairment is measured as the excess of the book value of the asset over its fair value. However, unlike for most other assets, the fair value of goodwill cannot be measured directly (market value, present value of associated cash flows, and so on.) and so must be implied from the fair value of the reporting unit that acquired the goodwill.

The implied fair value of goodwill is calculated in the same way that goodwill is determined in a business combination. That is, the implied fair value is a residual amount measured by subtracting the fair value of all identifiable net assets from the purchase price. The unit's previously determined fair value is used as the purchase price.

In July 2012, the FASB issued guidance that gives companies the option to perform a qualitative impairment assessment for indefinite-lived intangible assets that may allow them to skip the annual fair value calculation.

The present U.S. GAAP and international regulations are now very similar with some remaining differences. The international standard IAS 36—Impairment of Assets—has the following principles:

- Acquired goodwill should be recognized.
- Goodwill should be tested for impairment at least annually.
- Goodwill cannot be systematically amortized.
- Goodwill should not be revalued.
- Internally generated goodwill cannot be recognized.

Although the standards are substantially converged, there could potentially be future changes. The initial calculation of goodwill on the acquisition is a balancing figure between what the acquirer paid minus the assets acquired that could be valued fairly. The subsequent measurement of goodwill for impairment is subject to a high degree of estimation and judgment.

There have been criticisms of the current regulations from users of financial statements who are uncertain about the reliability of the information. Preparers and users also express concern about the cost and complexity of the impairment testing.[11]

There is a considerable amount of work involved in conducting impairment testing for goodwill and the method is questionable as it relies heavily on judgment and estimates. The amounts to be written off can be significant if the company and the industry are experiencing poor economic conditions. For example, in 2012, General Motors Company wrote off goodwill impairment charges of U.S.$27,145 million. The note from their 2012 annual report, page 81, states:

> Goodwill is tested for impairment for all reporting units on an annual basis during the fourth quarter, or more frequently, if events occur or circumstances change that would warrant such a review. When the fair value of a reporting unit falls below its carrying amount an impairment charge is recorded for the amount, if any, by which the carrying amount of goodwill exceeds its implied fair value. Fair values of reporting units are established using a discounted cash flow method. Where available and as appropriate, comparative market multiples and the quoted market price for

our common stock are used to corroborate the results of the discounted cash flow method.

On June 10, 2013, the FASB endorsed, for purposes of public exposure, a recommendation by its Private Company Council (PCC) to amend U.S. GAAP for private companies. The proposal is that these companies can elect to write off goodwill over a period not exceeding 10 years.

These recommendations have been well received. There are also some who argue that the uncertainties of the present impairment testing should be replaced by the certainty of a definite period of amortization for all companies. This practice would be a complete departure from the approach being adhered to by international accounting standards.

We started this section with a question and we will end with one—Is what Facebook bought worth U.S.$19 billion? Because Facebook paid that amount, accountants assume that is the value to appear on the balance sheet. Would other companies have paid that amount? We do not know but several commentators have queried the size of the payment.

If you are an investor in Facebook, we may be confident that they have complied with the regulations. However, you may think that Facebook has overpaid for the intangible assets that will appear on Facebook's balance sheet. After all, much of the declared value may represent little more than expectations for the future.

Taking the Score

There are several standards that have been converged, but we would point out that even with converged standards there may still be differences. In this section, we revisit the three topics from the beginning of the chapter: stock-based payments; inventories; and goodwill, and highlight some of the differences remaining. At the end of the chapter, we examine research findings that compare U.S. standards and IFRS.

Stock-Based Payments

- U.S. GAAP uses the common law definition of an employee while the IFRS has a more general definition that includes those providing services similar to those of an employee.

- U.S. GAAP uses the measure of the more reliable of either the value of the goods or services received while the IFRS mainly uses the fair value of the goods or services received.
- U.S. GAAP bases cost on the fair value of the modified award if it is modified while the IFRS does not recognize modification.

Inventory Valuation

- U.S. GAAP permits LIFO while IFRS prohibits it.
- U.S. GAAP values inventory at the lower of cost or market (which is the current replacement cost) while IFRS uses only lower of cost or net realizable value.
- U.S. GAAP does not allow reversals of write-down of inventory to the lower of cost or market while IFRS allows reversals.

Intangible Assets—Goodwill

- U.S. GAAP assigns goodwill to a reporting unit while the IFRS allocates goodwill to a cash generating unit (CGU).
- U.S. GAAP allows a qualitative assessment and if the fair value of a reporting unit is less than its carrying value and if goodwill appears impaired, a two-step process would be conducted. The IFRS requires the impairment test to compare the carrying amount of the CGU with its recoverable amount.

U.S. GAAP and IFRS Comparability

The argument in favor of international accounting is that it ensures comparability of financial statements irrespective of the jurisdiction. Our brief review above demonstrates that, even where there has been convergence, some differences remain. Several research studies have been conducted to assess the amount of comparability and we consider three of these studies.

In 2007, the SEC decided that non-U.S. firms using IFRS would no longer be required to reconcile to U.S. GAAP when reporting earnings. In the transition period of the two years 2004 to 2006, EU firms trading in U.S. markets provided financial statements using two different standards: IFRS and GAAP. Two of the studies concentrated on those periods.

The first study[12] examined the extent to which the FASB and IASB convergence projects and the EU-wide adoption of IFRS impacted on the differences between firms' financial results under U.S. GAAP and IFRS.

The reconciliation disclosures of 75 EU cross-listed companies were analyzed. This study revealed that the average gap between U.S. GAAP and IFRS income and between U.S. GAAP and IFRS shareholders' equity declined from 2004 to 2006. This supports the progress of convergence. However, the net income gap remained significant. The researchers found that the dominant adjustments were due to pensions and goodwill.

The second study[13] took the same period of time and had the objectives of describing some of the key differences between U.S. GAAP and IFRS and comparing actual financial statements reported under both standards. The conclusion was that, although there were differences between U.S. GAAP and IFRS, the similarities exceeded the differences. The author observed that the implication was that, if the United States adopted IFRS, it would not cause major changes in U.S. financial reporting results. The caveat was made that, although this was the overall picture, individual companies may still be significantly affected on specific accounting items.

The final study[14] sought to ascertain the extent to which application of IFRS by non-U.S. firms results in accounting amounts that are comparable to those resulting from application of U.S. GAAP by U.S. companies. A sample of companies from 27 countries adopting IFRS between 1995 and 2006 was matched by size and industry with a sample of U.S. firms. The conclusion was that non-U.S. companies using IFRS had shown significantly greater accounting system and value relevance comparability with U.S. firms when they apply IFRS than when they applied their own domestic standards.

The above research studies provide evidence that the convergence project has been substantially successful. Although differences still remain between U.S. GAAP and IFRs, these are not major and the adoption of IFRS to replace domestic standards has led to improved financial reporting.

These comments require some words of caution. First, the research did not attempt to measure the quality of the standards, neither the United States nor the IFRS. The fact that convergence has been achieved does not necessarily mean that we have higher-quality standards. We discuss this more thoroughly in the subsequent chapter.

Second, the research uses samples and gives overall results. Investors and others interested in the financial statements may find that companies in certain industries or with specific transactions fall into the differences category. Assumptions must be used with care as the research considers one particular change in a dynamic environment.

Conclusions

Standard setting is subject to changes in business activities, political influences, and lobbying by those who are interested or opposed to amendments to accounting regulations. The FASB and IASB convergence project is not only directed by technical accounting, but also by other influences and we discussed these in the first section of the chapter.

Stock-based payments, inventory valuations, and intangible assets demonstrate the complexities and influences on standard setting. These topics also exemplify the successes of convergence but also highlight that convergence may not always be total and differences can remain.

The research that has been conducted confirms that the convergence project has narrowed the differences or distance between U.S. GAAP and IFRS. There is also the suggestion that, in doing so, higher-quality standards have been produced, a notion we discussed in Chapter 3.

In the next chapter, we examine the recent projects that reveal the benefits of convergence as well as exposing the opposing views of the two Boards.

CHAPTER 5

The Disagreements

About This Chapter

The process of converging U.S. Generally Accepted Accounting Principles (GAAP) and International Accounting Standards Board (IASB) standards continues to be a lengthy journey. The Financial Accounting Standards Board (FASB) and the IASB have been working closely on several projects for many years. Currently, the two Boards have four major joint projects that are due for completion as a major part of the conversion project. These are:

1. Revenue recognition
2. Leasing
3. Accounting for financial instruments
   Classification and measurement
   Impairment
4. Insurance

Despite the numerous meetings, plethora of documents, and dissemination of progress reports, these projects have still not reached fruition and an agreed joint standard has not been issued. Revenue recognition is the project possibly closest to reaching a conclusion, and it would seem that there is a substantial amount of agreement between the two Boards. This topic is the first that we address in this chapter.

The second topic, Leasing, has proved more contentious. U.S. GAAP and the international standard, international accounting standard (IAS) 17, are very different in their approach. The U.S. accounting requirements for leasing transactions have always been considered a prime example of the rules-based approach with specific numerical threshold known as bright-line rules. The opposite approach is the

IASB standard, which is a principles-based approach, and gives examples of events and circumstances as a guide to the accountant in making a decision.

With such a difference in their positions, some credit must be given to the Boards in having reached a stage where an Exposure Draft has been issued. Unfortunately, there have been some severe criticisms of the proposals, and some substantial changes will have to be made if the Boards are ever to reach the intended stage of a joint standard.

The final topic in this chapter is on financial instruments. This is a subject that is contentious and incomprehensible to most people. Over many years of discussion, some progress has been made toward conversion, but there have been several redeliberations. The project has two subsets: (1) Classification and Measurement and (2) Impairment. One senses that a consensus will not be reached on this topic, which is a serious blow to the conversion relationship.

Insurance is a specialized topic outside the parameters of this book. In addition, all the current indications are that it is highly unlikely that the two Boards will agree on a converged standard on the topic and will continue to operate two distinct models.

Revenue Recognition

To calculate the profit or loss of a company for a financial period, we need to know the revenue from the transactions that were carried out by an organization in that period—that is, the sale of goods or services. This calculation can be far more difficult than individuals may realize. There are several factors that have an impact on the calculation of revenue and on the income statement, which shows the profit or loss.

First, financial statements (apart from the cash flow statement) must be prepared on the accruals basis. This means that transactions and other events are recognized as they occur and not when cash or other equivalents, such as checks, are actually given or received. In other words, transactions are recorded when they are entered into, not at the time of the cash inflow or outflow. This rule applies in both accounting for revenue and the expenses generated in achieving it. The following straightforward example demonstrates the issues that can arise:

Example of recognizing revenues and costs

On the 1st of March, an auto dealer buys a pre-owned Jaguar car for $30,000. He pays for the Jaguar immediately and fully in cash. The dealer subsequently discovers that the car, once some work has been done on it, can be considered a collector's item. The work is completed by an associate for $10,000, which the dealer has to pay by the end of April. The dealer sells the car by the end of March for $60,000. The buyer pays a deposit of $15,000 by check and promises to pay the remaining balance in June.

Looking at the month of March, when applying the accruals basis of accounting, profit is calculated as follows:

	$	$
Revenue		60,000
Cost of car	30,000	
Repair work	**10,000**	**40,000**
Profit		20,000

There may be a major problem for the dealer as he has paid $30,000 for the car, but has only received $15,000 toward the sale. There is a cash deficit. There are also some uncertainties with the profit. Suppose the associate who did the repairs also worked on some other of the auto dealer's vehicles at the same time, and these repairs were all included in the total bill for $10,000. How much of the $10,000 relates to the Jaguar?

Suppose now that the buyer finds a problem with the car—will the dealer be expected to correct it free of charge? If the dealer goes out of business and disappears, how do we record the $10,000 of expenses? If the check for $15,000 is dishonored, how do we account for it and how does that impact on the total revenue?

The scenario above is a very simple example; in many businesses, transactions are far more complex:

- Customers may purchase several items over a period of time, but wish to pay for everything at one date, or in a series of instalments.

- Costs can be incurred before the sale takes place, during the transaction, and sometime after. Payment can be immediate, delayed, or never made.
- Customers may require credit.
- The supplier may offer interest-free credit, but how does this affect the revenue and costs?
- The sale may cover two or more financial periods.
- If a service is offered, such as a maintenance contract, it could be for several years, although the customer pays the full amount in the first year. How is the payment recorded?

Determining the amount of revenue received by an organization and the financial period into which it falls is crucial to calculating the entity's profit or loss. In many industries, the contracts for the supply of goods and services can be complex, both in identifying the nature and timing of the transaction and the method and timing of payments by the customers. Both U.S. GAAP and International Financial Reporting Standards (IFRS) have had regulations on this subject that were sometimes difficult to apply. There were also considerable differences between their respective approaches.

U.S. GAAP is comprised of broad revenue recognition concepts and numerous requirements for particular industries or transactions. These concepts and requirements can result in different accounting for economically similar transactions. The requirements can be found in *Accounting Standards Codification Topic 605, Revenue Recognition*. International accounting has two main revenue recognition standards, IAS 18, *Revenue*, and IAS 11, *Construction Contracts.*

In addition to the two approaches being different, it was acknowledged that with existing regulations there were opportunities for unscrupulous companies to massage their revenues. The companies could either accelerate the revenue into an earlier financial period or delay it into a later one. Understandably, the topic of revenue recognition was an important regulation to complete by the FASB and the IASB. It was an issue that required attention and appeared to offer an opportunity to develop a common standard for U.S. GAAP and IFRS that would:

1. Remove inconsistencies and weaknesses in existing revenue requirements.
2. Provide a more robust framework for addressing revenue issues.
3. Improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets.
4. Provide more useful information to users of financial statements through improved disclosure requirements.
5. Simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer.

In 2002, the two Boards agreed to conduct a joint project examining revenue recognition. The project has lasted longer than either of the Boards could have anticipated. The result of this work was an Exposure Draft in 2010 entitled *Revenue from Contracts with Customers*. It would be fair to say that the proposals were not met with overwhelming acclaim; a second Exposure Draft was issued in the following year.

Based on the 2011 Exposure Draft and some tentative decisions reached at an FASB meeting in April 2013, a proposed revenue recognition standard was set to replace IAS 11 and 18 and most of the existing revenue recognition requirements in U.S. GAAP. The FASB issued a revised Proposed Accounting Standard Update on January 4, 2012.

The main principle of the current regulations is to recognize the transfer of goods or services to customers in an amount that shows the consideration that the entity expects to be entitled to in exchange for those goods or services. To do this, the company must follow the five-step model shown in Figure 5.1.

The following clarification helps to appreciate the application of the model.

Step 1: Identify the contracts—A legally enforceable contract can be oral or implied by an entity's customary business practices. A contract is disregarded if it is wholly unperformed and each party can unilaterally terminate the contract without compensation.

Step 2: Identify separate performance obligations—A performance obligation can be defined as a promise, whether explicit or implicit, within a customer contract to transfer a good or service to the

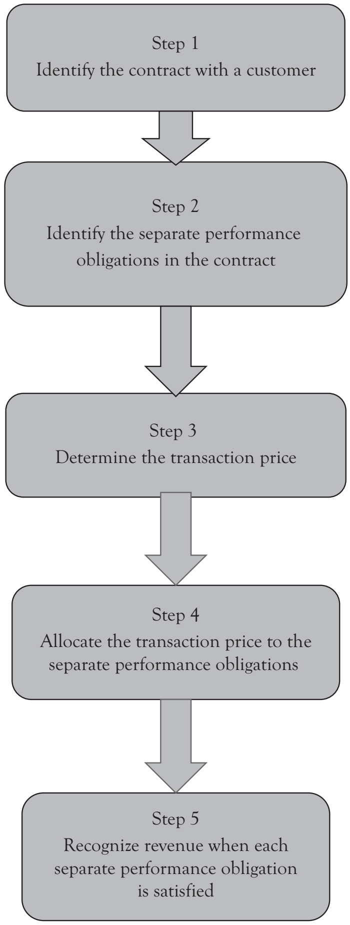

Figure 5.1 Five-step model for revenue recognition

customer. It is necessary to identify in a contract the specific goods or services promised. If there are various goods, services, or both, these represent separate performance obligations.

Step 3: Determine the transaction price—Transaction price equals the total amount of consideration an entity expects under the contract in exchange for transferring goods or services. In other words, the price represents the returns expected from the customer. The transaction price does not include amounts collected on behalf of others (e.g., sales taxes), nor does it include the effects of a customer's credit risk.

Step 4: Allocate the transaction price—If the contract contains only a single performance obligation, the transaction price would be for that one performance obligation. If there is more than one performance obligation, the transaction price should be allocated to each performance obligation based on the relative stand-alone selling price of the goods and services. In determining the stand-alone selling price, the best benchmark would be the observable price of the good or service when the organizations sells that specific good or service separately.

Step 5: Recognize revenue—If the performance obligation is satisfied, the revenue is recognized over time, using the method that best depicts the timing of the transfer of goods and services to the customer.

It is suggested[1] that the new standard proposed for revenue recognition has the following characteristics:

- It is a principles-based standard requiring greater use of professional judgment in assessing a company's performance obligations, and when these obligations are satisfied.
- The regulation requires companies to disclose more information about their contracts with customers than is currently required.
- For investors, the standard represents convergence between IFRS and GAAP, allowing for easier comparisons of companies.

Undoubtedly, as with any change in regulations, the transition to the new standard will place a burden on companies. There are some problems that may be confronted in different industries as shown by a survey of 148 senior financial executives.[2] The question asked was: How much effort will your company have to expend in 2014 on the following activities related to new recognition rules? Table 5.1 shows the results.

It is reasonable to assume that the level of effort to be extended depends on both the nature of the revenue transactions conducted by the organizations and the skill set that is available currently. The feedback

Table 5.1 Revenue recognition and companies' opinions

Areas of effort	Great deal (%)	Moderate (%)	Little (%)	None (%)
Understanding the new rules	12.1	37.9	28.8	21.25
Adapting accounting practices for contingent revenue, contract costs, or sales commissions	23.4	39.8	30.5	6.3
Booking appropriate adjustments from rebates, pricing arrangements, etc.	6.2	26.2	30.8	36.9
Making IT system changes	10.0	30.0	36.9	23.1
Making other back-office adjustments	9.2	30.0	42.3	18.5

shown in Table 5.1 does not indicate that a large proportion of companies anticipate a new standard being a burden.

Although revenue recognition has been a lengthy project, it should be successful. A superficial glance at the revenue recognition problem may lead one to conclude that a solution would be easy. Indeed the Boards are attempting to reach agreement on four seemingly simple questions:

1. What was the amount of revenue?
2. What was provided in exchange?
3. In which financial periods did the transactions take place?
4. What were the costs incurred in generating the revenue?

The fact that the Boards have taken so long in their deliberations is because of the complexity in answering these four apparently simple questions. The signs are that, despite some criticisms, a standard will eventually be issued and the process of convergence will be proven fruitful in this particular area.

Leasing

Leasing has become an increasingly important activity in the business world and represents an essential source of funding for companies wishing to acquire or use noncurrent assets. In some taxation jurisdictions, it has been possible to structure agreements so that either, or both, the lessor or lessee enjoy significant taxation benefits.

Option 1

Barebones could attempt to borrow U.S.$300,000 from the bank. The bank will want repayment of the loan plus interest. If we assume five annual repayments of U.S.$60,000 for the loan and U.S.$12,000 annually for interest:

- The balance sheet will show an asset under machinery of U.S.$300,000 and a liability to the bank of the same amount.
- On payment of each installment, the liability to the bank reduces by U.S.$60,000, and an interest charge goes to the income statement of U.S.$12,000.
- The end of each year brings an annual depreciation charge to the income statement of U.S.$60,000.

There are various methods that can be used to account for a lease. These methods can result in very different entries on the financial statements if there is no accounting standard in place to regulate practices.

Two of these methods can be demonstrated by taking the hypothetical example of Barebones Inc. Assume that the company wishes to buy some machinery with a useful life of five years costing U.S.$300,000, but has no cash. It therefore has to seek a method for funding the acquisition; there are two options for the company, assuming that no accounting standards exist.

With Option 1, Barebones will show a large loan on its balance sheet. It may not want to disclose on its financial statements that it has such a loan, as this may be assumed to be a financial weakness.

If you compare Option 2 to Option 1 you will see that the charge to the income statement is the same U.S.$72,000. The big difference is that nothing is shown on the balance sheet although Barebones owes the bank U.S.$300,000.

Currently, under both FASB and IASB regulations, avoiding the entry of the lease on the balance sheet is a possibility. Lease agreements can be classified as either capital lease (also referred to as a finance lease) or an operating lease. If it is the former, the asset will appear on the

Option 2

Assuming that there are no accounting regulations, Barebones may make arrangements that

- The bank buys assets for U.S.$300,000 and claims to be the owner.
- The bank charges Barebones annual rental installments of U.S.$72,000.
- In Barebones income statement there is only the annual charge of U.S.$72,000 and nothing appears on the balance sheet.

balance sheet of the lessee, as will the liability. If it is an operating lease, neither the asset nor the liability appears in the financial statements of the lessee, the only record being a periodic rental amount to the income statement.

It is contended that companies may construct agreements to purposely classify leases as operating to avoid putting assets and liabilities on the balance sheet.[3] This practice is made somewhat easier by U.S. GAAP having bright-line rules to define the two types of leases.

The U.S. standard (SFAS 13) defines a capital lease as one under which any one of the following four conditions is met:

1. The present value at the beginning of the lease term of the payments not representing executory costs paid by the lessor equals or exceeds 90 percent of the fair value of the leased asset;
2. The lease transfers ownership of the asset to the lessee by the end of the lease term;
3. The lease contains a bargain purchase price;
4. The lease is equal to 75 percent or more of the estimated economic life of the leased asset.

It does not require much ingenuity to draw up a contract where the percentages fall on the most advantageous side for the company and the information it wishes to disclose.

The international standard (IAS 17-Accounting for Leases) is principles based. It avoids setting out quantitative thresholds, as is the case in the U.S. standard, but states that the classification of a lease depends on the *substance* of the transaction rather than the *form*. The standard describes situations that would normally lead to a lease being classified as a finance lease, including the following:

- The lease transfers ownership of the asset to the lessee by the end of the lease term;
- The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than its fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised;
- The lease term is for the major part of the economic life of the asset, even if the title is not transferred;
- At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- The lease assets are of a specialized nature such that only the lessee can use them without major modifications being made. An example would be where certain equipment is required for certain manufacturing operations unique to the organization.

The standard also provides additional examples that could lead to the agreement being classified as a finance lease.

- If the lessee is entitled to cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- Gains or losses from fluctuations in the fair value of the residual fall to the lessee (e.g., by means of a rebate of lease payments); and
- The lessee has the ability to continue to lease for a secondary period at a rent that is substantially lower than the market rent.

Under current regulations, it is claimed that companies using U.S. standards can structure agreements to avoid the quantitative thresholds and define the lease that best meets their purposes.[4] Criticisms on the ethicality of intentionally structuring lease contracts to avoid disclosing leased asset and liability amounts are voiced frequently. There is also the contention that the slippery slope of rule-based *accounting* for synthetic *leases* and special purpose entities led to the *accounting* scandals at Enron and other companies.[5]

Given the substantial differences between the United States and International Standards and the claimed abuse of the U.S. standard, it is not surprising that a project was added to the IASB's agenda in 2006 to develop a new international accounting standard that addresses the deficiencies in existing regulations for accounting for leases. The FASB's involvement stems from its commitment originally given in the Norwalk Agreement, to converge U.S. standards with international standards. The aim of the project is to develop a new single approach to lease accounting that would ensure that all assets and liabilities arising under lease contracts are recognized in the statement of financial position.

In March 2009, the IASB published a Discussion Paper *Leases: Preliminary Views*. The Discussion Paper was open for comment until July 17, 2009. In August 2010, the FASB, jointly with the IASB, published an Exposure Draft *Leases*. The Exposure Draft was open for comment until December 15, 2010. The proposals in the Exposure Draft did not meet wide acceptance.

The Boards began redeliberations on the *Leases* Exposure Draft in January 2011. In May 2013, the FASB issued a Proposed Accounting Standards Update (Revised) on Leases (Topic 842) as a revision to the 2010 proposed FASB Accounting Standards Update, Leases (Topic 840).

In the model now being proposed, most leases would be recorded on the lessee's balance sheet as a right-to-use asset. There would also be a liability recorded as the obligation to make lease payments. However, short-term leases (i.e., leases with a maximum possible term of 12 months or less, including renewal options) can remain off the balance sheet, with lessees or lessors recording lease expense or income on a straight-line basis over the lease term.

The new proposals also classify leases into Type A and Type B with different accounting treatments. Leases of assets that are not property (e.g., motor vehicles, plant, or equipment) would be classified as Type A leases, unless either of the following conditions exists:

- The lease term is for an insignificant part of the asset's total economic life.
- The present value of the lease payments is insignificant compared with the asset's fair value.

Leases of property (i.e., land or a building or an identified portion of a building) would be classified as Type B leases, unless either of the following conditions exists:

- The lease term is for the major part of the asset's remaining economic life.
- The present value of the lease payments accounts for substantially all of the asset's fair value.

The most obvious change to a lessee's financial statements is the substantial increase in recorded assets and liabilities on the balance sheet for entities that have significant number of operating lease. Putting these items on the balance sheet would have a detrimental impact on gearing and working capital ratios. Altering these ratios may have major consequences on banking covenants and any other contractual arrangements. The lease proposals could also result in the recording of deferred tax assets or liabilities, further affecting the balance sheet structure.

It has also been suggested that organizations would need to review key provisions such as lease terms (including possible extensions, residual value guarantees, purchase options, and term option penalties) on all of its existing leases.[6] Under the proposals, not only would management estimates be required to initially record the lease, but an ongoing assessment of key measurement assumptions would also be necessary for each reporting period. Accordingly, an entity would need to establish systems and processes to capture, analyze, document, and process relevant data and key judgments.

There have been criticisms of the proposals and it is argued that:

> The Boards should expect to receive numerous comment letters raising valid issues that will require further work. If ED2 is adopted as is, the new rules will provide less useful decision making information than the current rules for both lessee and lessor accounting; however, a few key changes would make the proposed rules both workable and an improvement over current GAAP.[7]

Even if the proposals are finalized, it is pertinent to ask to what degree the changes bring about convergence with international practices. Certainly, it will not be complete convergence. In its current revision proposals, the FASB states that the following are the primary differences between the FASB and the IASB proposals.

1. *Revaluations*
   IFRS allows revaluation of the right-to-use asset (and related disclosure requirements)
2. *Statement of cash flows*
   a. U.S. GAAP requires that interest paid is classified as an operating expense.
   b. IFRS allows interest to be classified as operating, investing, or financing expense.
3. *Disclosure*
   a. U.S. GAAP requires disclosure of a maturity analysis of nonlease components.
   b. U.S. GAAP does not require disclosure of a reconciliation of the opening and closing balances of the right-to-use asset.
4. *Nonpublic entities*
   a. U.S. GAAP permits a policy election to use a risk-free rate to discount the liability.
   b. U.S. GAAP permits an exemption from the liability balance reconciliation disclosure.
   c. The IASB will consider whether or not and if so, how to incorporate this requirement into its IFRS for small- and medium-sized entities at a later date.

In examining these differences, it must not be overlooked that the two Boards have managed to agree on regulations that should reduce some of the abuses taking place. In particular, more leasing agreements will be shown on the balance sheet and users of financial statements should be better informed.

Financial Instruments

Financial Instruments Explained

The definition of financial instruments states that there must be a contract and this gives rise to financial assets, financial liabilities, and equity, which appear on a balance sheet. The definition of a financial instrument is also two sided: The contract must always give rise to a financial asset of one party, with a corresponding financial liability or equity instrument of another party.

Financial markets are used by companies to raise finances for their business activities. External financial markets can be considered short term, less than a year, or long term. Short-term financial markets are often called money markets. Long-term financial markets are called capital markets, and include the equity market, the debt market, which includes borrowing from other firms, and the bank market. Multinational companies that used to raise equity capital solely from sources within their own country now look to other countries for potential shareholders; this is known as cross-border financing.

There are several types of risks associated with using financial markets. There is interest-rate risk from making investments or taking out loans, or exchange-rate risk through international trade. It is impossible to eliminate risk completely. However, companies can attempt to reduce it by hedging the risk.

An example of hedging is as follows: A company knows that it has to purchase supplies of materials in three months' time. The materials, such as agricultural crops, may not be ready to be purchased right away, or the company may not wish to hold the materials until they are needed. There is a risk that the price of materials will increase before the end of the three months.

The company can enter into an agreement now to purchase the goods in three months' time, but at a current price. The company avoids the risk of the prices increasing in three months' time when it requires the materials. It also loses the opportunity to make a gain if the price decreases in three months' time.

Contracts are used for trading in derivatives. These are commonly traded among financial institutions, individual investors, fund managers, corporations, and private companies. The trades are conducted at either a physical location such as an Exchange or remotely in what is termed the over-the-counter market.

The four main types of derivatives are: forward contracts, future contracts, options, and swaps.

Forward Contract

These contracts are the simplest form of derivatives. One of the parties in a forward contract agrees to buy the underlying asset on a future specified date for a certain specified price. The other party agrees to sell the asset on the agreed date for the agreed price. The price at which the parties agree to transact in the future is called the delivery price. No money changes hands at the time the parties enter into a forward contract.

Once forward contracts are agreed upon, they can be traded between investors, typically on the over-the-counter market. Assume that a company in the United States expects a large payment in Canadian dollars in three months' time. It will need to convert this payment in Canadian dollars into U.S. dollars and there is the risk that the exchange rate will be unfavorable. The company will therefore attempt to hedge this exchange risk by entering into a forward contract.

Futures Contract

A futures contract is very similar to a forward contract. Futures contracts are traded on a variety of commodities, including live cattle, sugar, wool, lumber, copper, gold, tin, and aluminium. They are also traded on a wide array of financial assets, including stock indexes, currencies, and treasury bonds.

Options

There are two types of options. In contrast to forwards and futures, options give the owner the right, but not the obligation, to transact. The owner, therefore, will only transact if it is profitable to do so. The price at which the parties transact in the future is called the strike price. When the transaction takes place, the owner of the option is said to exercise his option.

Swaps

A swap is simply an agreement between two parties to exchange cash flows in the future. The agreement defines the dates when the cash flows are exchanged and the manner in which amounts are calculated. Swaps typically lead to cash flow exchanges on several future dates. There are interest rate swaps, where a floating-rate loan is exchanged for a fixed-rate loan by agreeing to pay a fixed payment in return for a variable payment. Similarly, currency swaps can be used to transform borrowings in one currency to borrowings in another currency, by agreeing to make a payment in one currency in return for a payment in another currency.

At their joint meetings in April and October 2005, the FASB and the IASB discussed the future of reporting for financial instruments. The Boards established three long-term objectives to improve and simplify the reporting for financial instruments:

1. Develop a new standard for the derecognition of financial instruments. In other words, guidelines to follow when removing them from the financial statements.
2. Require all financial instruments to be measured at their fair value with realized and unrealized gains and losses recognized in the period in which they occur.
3. Simplify or eliminate the need for special hedge accounting requirements.

The Crisis

The global financial crisis of 2007 to 2008 caused considerable panic. Understandably, people wanted to know the cause of the crisis and financial instruments became the focus. The reasons offered for financial instruments being the culprit fell into two main camps. There were those who believed that the complex financial instruments had been used inappropriately. Others, particularly the banks, argued that it was not the financial instruments that were to blame but the way that they had to be accounted for, in other words, the accounting regulations.

The accounting standards were castigated because of the requirement for fair-value accounting. This required valuation of financial assets at their current market value. Thus, fair-value accounting forced companies to write-down financial asset values, destroying equity and weakening banks' lending practices. The defenders of fair value accounting argued that the method was not the cause of the crisis. They claimed that fair value only revealed the effects of poor decisions.

For the FASB and the IASB, the focus on accounting for financial instruments started in March 2006. The Boards declared their intentions to work together to improve and converge financial reporting standards by issuing a memorandum of understanding (MoU), *A Roadmap for Convergence between IFRS and U.S. GAAP—2006–2008*. As part of the MoU, the Boards worked jointly on a research project to reduce the complexity of the accounting for financial instruments.

As with all efforts to develop a new or revised standard, progress was slow. Considerable pressure and lobbying took place and the Boards were strongly encouraged to speed their deliberations.

The Boards' work resulted in the IASB's issuance of the March 2008 Discussion Paper, *Reducing Complexity in Reporting Financial Instruments*, which the FASB also published for comment by its constituents. Focusing on the measurement of financial instruments and hedge accounting, the Discussion Paper identified several possible approaches for improving and simplifying the accounting for financial instruments.

In addition to considering the potential for short-term responses to the world-wide credit crisis that was taking place, both Boards emphasized their commitment to developing common solutions aimed at providing greater transparency and reducing complexity in the accounting of financial instruments.

As starting points for this longer-term objective, the Boards have gathered evidence from the following sources:

- Comments received in response to the Discussion Paper on reducing complexity,
- Comments on the Exposure Draft on hedging,
- Deliberations of the Financial Crisis Advisory Group,
- Input received at the 2008 round tables,
- Input received from the IASB Financial Instruments Working Group,
- Numerous informal discussions with constituents.

The Aftermath

The objective of the FASB Financial Instruments Project is to significantly improve the decision usefulness of financial instrument reporting for users of financial statements. It is intended to replace the FASB's and IASB's respective financial instruments standards with a common standard.

Despite the many meetings and issue of documents, the Financial Instruments Project is making very slow progress. The two main subheadings of the project are Classification and Measurement and Impairments. The differences in the impairments subproject have been extracted from a summary[8] of several standards and are shown in Table 5.2.

Recent events illustrate that not only were the two Boards unable to agree on a joint standard, but that the failure to do so has strengthened the view that the formal convergence relationship is at an end. In 2012,

Table 5.2 Major differences between U.S. GAAP and IFRS financial instruments—impairment

U.S. GAAP	IFRS
Testing is required only when circumstances change	Testing is required at the end of each reporting period
Reversals are not allowed	Reversals are allowed
Undiscounted sum of future cash flows is used for measurement	Value-in-use and fair value less costs to sell are used for measurement

GAAP, Generally Accepted Accounting Principles; IFRS, International Financial Reporting Standards.

the FASB and the IASB tried to resolve their differences. Finally, it was decided that the two Boards would each expose their different approaches for discussion and comment.

In November 2009, the IASB issued IFRS 9-*Financial Instruments*, reissued it in October 2010, and then amended it in November 2013. The current version of IFRS 9 does not include a date from which companies must comply with it. An effective date will be added when all phases of the project are complete; currently, this date is expected to be in 2018. IFRS 9-*Financial Instruments* includes requirements for recognition and measurement, derecognition, and hedge accounting. The IASB is adding to the standard as it completes the various phases of its comprehensive project on financial instruments.

In April 2012, the FASB issued a proposed Accounting Standards Update, *Financial Instruments—Overall (Subtopic 825–10): Recognition and Measurement of Financial Assets and Financial Liabilities—Proposed Amendments to the* FASB Accounting Standards Codification. The comment period ended on May 15, 2013.

In early 2014, the state of play with the two subprojects Classification and Measurement and Impairment was making no progress. The public comments received on these proposals can be found on the FASB's website. It is expected that the FASB will expose reviewed proposals toward the end of 2014.

Conclusions

As part of the Norwalk Agreement, the two Boards had four major projects to achieve their original aims. The fact that complete success has not been achieved should not detract from the progress that has been made, as well as the changes that have taken place within U.S. regulations as a consequence.

Revenue recognition has been possibly the most successful of the projects. Both Boards approached the discussions with the desire to improve their own regulations on how to account for revenue. The development of a high-quality standard also supported convergence. Although the proposals will place a burden on companies, particularly in the transition period, the proposals have met with general approval.

Accounting for leases has proved to be more difficult to resolve. The two Boards have very different ways of dealing with the topic. The United States has a rules-based approach and the IASB a principles-based approach. From the start, it was apparent that achieving convergence would be a problem and there would also be resistance from those organizations that did not want all lease agreements to be disclosed on their balance sheets.

Although complete convergence on a leasing standard has not been achieved, the proposals, as they now stand, should remove the abuses that were taking place. However, the topic has proved to be very contentious and there may be some further changes before the regulations are finalized.

The Financial Instruments project was known beforehand to require serious input on the technical accounting required. In addition, there were the lobbying and other pressures that demanded attention. To develop a national standard that everyone would find acceptable would have been difficult. To agree on a converged standard, within a short time frame, may have been impossible.

Although the revenue recognition project should result in a joint standard, there remains a question mark on the leasing project. It is evident that full agreement will not be achieved for financial instruments and this could prove to be the one that signaled the end to a dream of converging U.S. GAAP and IASB standards completely. Although there have been levels of agreement, the two Boards have essentially decided to go their own way.

This does not mean that the United States is withdrawing from the international debate. As we will see in the final chapter, the FASB intends to consult and cooperate with many international accounting bodies. In doing so, it will influence the future of international accounting regulations, but U.S. accounting regulations will also be influenced by international developments.

CHAPTER 6

The End and the Beginning

About This Chapter

In the previous chapters, we discussed accounting regulations in the United States, as well as the U.S. involvement in the growth of international accounting. We have examined the impact of the U.S. strategic approach to internationalization and the accounting standards that have been changed due to the influence of international thinking.

In Chapter 4, we alerted you to the fact that, although U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) may be claimed to have converged on specific topics, the possibility of differences still exists. In Chapter 5, we emphasized this possibility by looking at the four projects that are still under discussion. The conclusions drawn from the evidence were that the convergence relationship, as it stood, may have ended. That is not to say, however, that the United States has turned its back on internationalization completely.

In this chapter, we explain the fundamental differences between the United States and international standard setters. We start by elaborating on the importance of the principles- versus rules-based approach to standard setting. These approaches have been mentioned in previous chapters and we elaborate on those comments in this chapter.

The second section of this chapter explains what is meant by a conceptual framework. This term describes the convictions and assumptions held by standard setters on the role of financial accounting and reporting. The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) opinions are not aligned, and unless they arrive at better understanding on the nature of the conceptual framework, further progress is unlikely.

The complex issues attached to the conceptual framework are exemplified by present discussions on the definition of a Business Entity. We scrutinize the debate that has taken place on the topic, and the unsatisfactory result.

Finally, we conclude the chapter by examining the possible avenues that are open to the United States. The formal convergence relationship with the IASB may have reached the end of its life, but new ways are opening up for the internationalization of U.S. accounting.

Principles-Based Versus Rules-Based Approach

If international accounting is to be achieved, there must be agreement on the assumptions and concepts that are to serve as the basis for setting standards. Unfortunately, the IASB (and the UK standard setters) have a very different starting position on the subject compared to the United States. The IASB uses a principles-based approach to standard setting; the United States uses a rules-based approach.

The difference between a principles-based approach and a rules-based approach is that the former applies fundamental concepts to ensure that financial statements are not misleading. With the principles-based approach, the burden is placed on the preparers and auditors of the financial statements to use their professional judgment and experience to ensure that the financial statements are not misleading.

The rules-based approach holds that by following the rules strictly when preparing financial statements, such statements will give faithful representation. The main characteristic of a rules-based approach is that the regulations set out specific criteria, *bright line* thresholds, examples, scope restrictions, exceptions, subsequent precedents, and implementation guidance.[1]

With a rules-based approach more detailed instructions and guidance must be given than in the case of a principles-based approach, where the accountant has to decide how to resolve certain accounting questions using his own judgment. It is frequently claimed that these differences are very visible, as the accounting regulations for the United States covers 25,000 pages and for the IASB 2,500 pages. This may be an exaggeration, but U.S. GAAP is certainly wordier than its international counterpart.

In Chapter 5, we discussed leasing and we repeat below the main requirements of the U.S. standards and the IFRS guidance on determining what constitutes a lease. Both standards concentrate on what is a capital (finance) lease and therefore must be shown on the balance sheet.

The original U.S. standard (SFAS 13) defines a capital lease as one under which any one of the following four conditions is met:

1. The present value at the beginning of the lease term of the payments, not representing executory costs, paid by the lessor equals or exceeds 90 percent of the fair value of the leased asset;
2. The lease transfers ownership of the asset to the lessee by the end of the lease term;
3. The lease contains a bargain purchase price;
4. The lease is equal to 75 percent or more of the estimated economic life of the leased asset (FASB, 1976).

As suggested in previous chapters, it does not require much ingenuity to draw up a contract where the percentages fall on the most advantageous side for the company and the information it wishes to disclose.

The international standard, Accounting for Leases (IAS 17), states that the classification of a lease depends on the *substance* of the transaction, rather than the *form*. The standard describes situations that would normally lead a lease to be classified as a financing (capital) lease, and these include the following:

- The lease transfers ownership of the asset to the lessee by the end of the lease term;
- The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised;
- The lease term is for the major part of the economic life of the asset, even if the title is not transferred;
- At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

- The leased assets are of a specialized nature such that only the lessee can use them without major modifications being made.

The above examples demonstrate the rules-based approach with its specific, quantitative guidelines, and the principles-based approach with its descriptive guidance. One might conclude that more stringent rules would ensure that companies would properly define a lease as a capital lease rather than an operating lease, which does not have to appear on the balance sheet. This does not, however, always occur. Research[2] has shown that firms that follow U.S. GAAP and use a lease standard that contains bright-line rules are more likely to classify leases as operating than firms that utilize IFRS and adhere to a principles-based standard.

The problem with adhering strictly to specified rules is that it excludes professional judgment. This can result in decisions that are consistent with the rules but inconsistent with the principle of providing the most useful financial information to users. If the rules are very specific, such as in the U.S. regulations on leasing, companies may be able to arrange their activities so that they comply and fall within the rules, but the financial statements still remain misleading. This action may be outside legal criticism, but may stretch the limits of what is permissible under the law, and may not be ethically or morally acceptable—or even contribute to good accounting.

Conversely, it can be argued that the principles-based approach gives too much scope to preparers and auditors, which creates opportunities for creative accounting. Without clear guidance on how to account for a transaction, several methods may be considered acceptable. Those different methods can lead to different answers, which is not in the best interests of the users of financial statements.

Additionally, if there are no clear rules, individual companies may choose different accounting treatments for the same transaction and the characteristic of comparability will be lost. It is difficult to compare the financial results of companies if they use different methods to account for transactions and events. A main argument in favor of international accounting is that it permits the comparability of financial statements from multiple jurisdictions.

The principles approach of the IASB may have been influenced by the long-held tenet in the United Kingdom that financial statements should give a true and fair view. The concept of a true and fair view first appeared in the United Kingdom in the Joint Stock Companies Registration and Regulation Act of 1844[3] and over the years, there has been debate over its meaning.

In 2005, the Financial Reporting Council[4] in the United Kingdom confirmed that, following the adoption of IAS 1 and *fair presentation* in the European Union (EU), the concept of *true and fair view* remained a cornerstone of financial reporting and auditing in the United Kingdom.

In 2012, this position has been reconfirmed by the Financial Reporting Council[5] and the consequences of its application explained:

> Para 18—The requirement to give a true and fair view may in special circumstances require a departure from accounting standards. However, because accounting standards are formulated with the objective of ensuring that the information resulting from their application faithfully represents the underlying commercial activity, the FRC envisages that only in exceptional circumstances will departure from the requirements of an accounting standard be necessary in order for financial statements to give a true and fair view.
>
> Para 19—If in extremely rare circumstances compliance with the requirements of an accounting standard is inconsistent with the requirement to give a true and fair view, the requirements of the accounting standard should be departed from to the extent necessary to give a true and fair view.

Although IAS 1 used the term financial presentation, the ability to override the requirements of accounting standards was maintained, although some argued that its interpretation was very different from true and fair. Evans[6] critically examined the evidence and concluded that the override in IAS 1 should be viewed in its narrowest possible interpretation, and not as an independent and all-pervasive fundamental concept.

A different and more philosophical stance was taken by Alexander and Jermakowicz.[7] They contended that the "underlying economics of any company, as a 'reality', cannot exist independently of a conceptual scheme agreed between human actors." Subsequent articles by other authors have continued the debate without a conclusive answer.

Given the above background, it is not surprising that the debate on the principles- versus rules-based approach is so heated, and one can appreciate the problems that some countries confront in adopting IFRS completely. The United States has a very strong rules-based approach. It is almost impossible to envisage that approach being overturned. It is equally difficult to envisage the FASB and the IASB reaching a stage where the differences between those two approaches are no longer considered important.

The Conceptual Framework

If one reads the definitions of conceptual frameworks given by the FASB and the IASB, there are few differences in the terminology used. The FASB sees the framework as a coherent system of interrelated objectives and fundamentals that is expected to lead to consistent standards. The IASB considers that it lays down the concepts that underpin the preparation and presentation of financial statements, and is to be used when the IASB develops or revises standards.

Clearly, the conceptual framework is intended to assist in the setting of high-quality standards. Unfortunately, the definitions do not help us much to understand how this will be done. We can make matters more understandable by listing four simple questions that the conceptual framework attempts to answer.

1. *Who* are the users of financial statements?
2. *What* information do they need?
3. *Why* do they need this information?
4. *How* can accounting best provide this information?

The length of time the two Boards have spent on constructing a conceptual framework without reaching an agreement demonstrates that these questions are harder to answer than one might imagine. Alternatively, the Boards individually can determine their own answers, but they disagree on the answers of the other party. This problem can be demonstrated by looking at the first question.

In considering the potential users of financial information, it is important to remember that we are taking a global stance and, as explained in Chapter 2, countries have their own characteristics that form barriers to internationalization.

The search to identify the users of financial statements has had a long history. In November 1978, the FASB published *Financial Accounting Concepts No 1*.[8] This publication states that financial reporting should provide information that is useful to present and potential investors, creditors, and other users in making rational investment decisions. This tenet has been adhered to by the United States.

The IASB's opinions can be traced back to 1975 and an influential document entitled The Corporate Report. This report considered to whom companies should report and identified seven user groups and their needs. In addition to investors, these groups included employees, prospective employees, and trade unions. Interestingly, one group that was mentioned was the public, because of the perceived societal need for information on the economic activities of entities.

It has been claimed that The Corporate Report has been by far the most innovative and enterprising of conceptual frameworks, and has reflected a much broader vision of social accountability than the investor–creditor focus, which has historically been predominant in the United States.[9] The International Accounting Standards Committee's (IASC) Framework for the Presentation and Preparation of Financial Statements issued in 1989 echoed the sentiments in The Corporate Report. It repeated in its document, IAS 1 Presentation of Financial Statements, first issued in 1997 that:

> The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of the management's stewardship of the resources entrusted to it.[10]

The two objectives identified in the previous paragraph are often referred to as the decision model and the stewardship model. It is argued that the decision model must provide information that is relevant, and the most interested users of this information would be the providers of capital, that is, shareholders and lenders. Relevant information would show, for example, current values for the assets held by the company. It is of no use to know the cost of a piece of land purchased 20 years ago. It is much more relevant to have an estimate of its current value, even if that is not 100 percent reliable.

Advocates of the stewardship model contend that what is most important is the *reliability* of the information and that there is a moral, if not legal, obligation for entities to provide it to a wide range of users who may be interested in the entity's activities. Current employees, suppliers, and customers are good examples of such users. Reliability is achieved by providing the original cost of assets, no matter what their current value is assumed to be.

Although standard setters attempt to capture the qualities of relevance and reliability, it is proving exceedingly difficult to do so. The answer would seem to be to obtain an acceptable balance between the two characteristics. Unfortunately, obtaining agreement on that balance may prove impossible.

The two Boards have been attempting to produce a converged Conceptual Framework, but there are difficulties in achieving this aim. The convergence project has been divided into eight phases, and in 2006 a discussion paper was issued, which addressed, among other issues, the two Boards' agreed objective of general financial reporting, which was:

> To provide financial information that is useful to present and potential investors, and creditors and others in making investment, credit, and similar resource allocation decisions.[11]

It is evident from this extract that the objective of financial reporting is perceived as a decision-making one—the U.S. concept. The users are identified and so are the types of decision that they make. However, several respondents to the discussion paper claimed that financial reporting has not one, but two objectives: decision making *and* stewardship.

There are various opinions on the meaning of stewardship, but O'Connell[12] reflects the main opinion by contending that

> *The contemporary concept of stewardship is synonymous with the notion of accountability to both internal and external parties for the purposes of revealing and evaluating the past actions of both the enterprise and its management and, to some extent, influencing future actions.*

The UK Accounting Standards Board is a strong proponent of the stewardship objective. It issued its own discussion paper (2007) after a detailed review of all the comment letters made to the IASB's discussion paper in 2006, and argued that:

- There is a broad consensus among the majority of the respondents that the stewardship and accountability objective should be a separate objective of financial reporting;
- Stewardship and accountability is linked to the agency theory and is a broader notion than resource allocation as it focuses on both past performance and how the entity is positioned for the future. It should therefore be retained as a separate objective of financial reporting to ensure that there is appropriate emphasis on company performance as a whole and not just on potential future cash flows; and
- Stewardship and accountability have implications for financial reporting, which can be demonstrated by way of examples.

A Project Summary and Feedback report (FASB 2010) explained the responses from external parties to the converged IASB and FASB opinion on objectives. Undoubtedly, the concept of stewardship was troublesome and the FASB stated that, in view of the comments received, the wording of the chapter would be changed to describe what stewardship encapsulates, even if that particular word would not be used.

In late 2010, the Boards effectively deferred further work on the joint project until after other more urgent convergence projects were completed. As a result of the IASB's Agenda Consultation project, the IASB decided to reactivate the Conceptual Framework project in December of 2012 as an IASB-only comprehensive project.

In July 2013, the IASB[13] issued a discussion paper to obtain initial views and comments on important issues it would consider as it developed an exposure draft of a revised *Conceptual Framework*. The issues discussed in the paper include:

- Definitions of assets and liabilities
- Recognition and derecognition
- The distinction between equity and liabilities
- Measurement
- Presentation and disclosure
- Other comprehensive income

The IASB is not intending to reopen the decisions made in the joint discussion paper issued in 2010 with regard to reporting objectives and qualitative characteristics. However, it will be under pressure to do so. Issues such as stewardship (or accountability), prudence, and reliability are likely to be raised by submitters of comment letters on the discussion paper.[14]

The FASB continues its own projects related to its own Conceptual Framework. There are currently no signs that the two Boards will meet again with the objective of producing one agreed-upon Conceptual Framework.

The Business Entity Concept

We discussed earlier the issues that arise in determining who the users of financial information are, that is, the intended recipients. This created many problems for the two Boards and was never satisfactorily settled. Even more troubling is determining the boundaries of the organization that should produce financial statements.

Financial statements are about the events and transactions of an organization, termed in the standards as an entity. It is evident that there must be complete clarity on what comprises the entity in order to produce the financial statements of that entity to give to the recipients. The main problem is how to define the term entity, particularly when we consider a group of companies.

Entities listed on stock exchanges are usually groups—that is, a number of separate companies either wholly owned or partly owned by a holding company. As users of the financial statements, we are interested in seeing the financial statements for the group, which is the reporting entity.

There are, however, two main theories or perspectives as to what constitutes a group: the proprietary theory and the entity theory.

The proprietary theory views the group from the perspective of the proprietors—the major owners of the group. The financial statements of the group should show the total interest owned by the proprietor. In some of the subsidiaries, the holding company will own the major part of the subsidiary, but not 100 percent, and the minor part will be held by other investors. In this instance, the financial statements of the group will show the total interest owned by the holding company either directly or indirectly via the proportional ownership of the subsidiary.

The entity theory perceives the group as a single economic entity. In these circumstances, the financial statements of the group show the total resources managed by the group for the purpose of providing useful information to all of the group's stakeholders, including those with only the minor ownership.

The deliberations by the FASB and the IASB have tended to avoid this issue, or at least delay its resolution to a later date. However, the FASB produced the following definition of an entity in 2011:

> *A circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders, and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether the management and the governing board of that entity have made efficient and effective use of the resources provided.*[15]

This definition tells us more about the reporting process than the reporting entity itself; however, the FASB document identifies three of the features of an entity:

a. Economic activities of an entity are being conducted, have been conducted, or will be conducted.
b. These economic activities can be objectively distinguished from those of other entities and from the economic environment in which the entity exists.
c. Financial information about the economic activities of that entity should be useful to users making decisions about providing resources and in assessing whether the management and the governing board have made efficient and effective use of the resources provided.

This explanation lacks the preciseness that is required to define an entity and the position is not helped by the final line in the document, which states that these features are *necessary* but not always *sufficient* to identify a reporting entity.

Regulatory Acceptance

Producing annual financial reports is a costly business. The requirements and recommendations of any standard setter for various disclosures of information are tempered by the realization that the costs of reporting information must be at least matched by the benefits the users receive. This costs–benefits equation is difficult to calculate for the following reasons.

- The company may prepare the information but the user suffers the cost in the form of reduced financial returns from the company (e.g., a lower dividend).
- If the needed information is not provided, the user will incur additional costs in obtaining that information by other means.
- Disclosure of financial information that has relevance and faithful representation makes for a more efficient capital market with lower costs for everyone.
- There is no substantial evidence as to the worth of the financial information to the specific users.

In concentrating on the financial disclosures, it is easy to forget that for most companies, the Annual Report and Accounts is a promotional document. For most major companies, possibly, less than one-third of the document contains the financial statements.

Much of the document is concerned with products, corporate strategy, successful projects, charitable involvements, and so on. Most of these disclosures are accompanied by excellent photographs and are printed on high-quality paper. To a large extent, the total cost of the Annual Report and Accounts is in the control of the companies and is little influenced by the disclosure requirements of accounting standards.

Regardless of what the costs–benefits equation demonstrates, experience has shown that without a form of strong accounting regulations, some companies are tempted to mislead investors. Most countries have therefore established an organization with the specific responsibility of regulating financial information disclosed by companies.

As standard setters, the FASB cannot claim unique characteristics that are not shared by other standard setters. It is well resourced and has extremely knowledgeable people working for it—as do other organizations but possibly with not so much resourcing. However, it can be argued that other countries have followed U.S. GAAP for reasons other than the excellence of the standards.

First, there was the requirement for many years that foreign companies wishing to list in the United States had to comply with U.S. GAAP. Although that requirement has changed, we discussed in Chapter 3 the reasons for foreign companies on American stock exchanges not moving to IFRS.

Second, the size of the U.S. capital markets has historically attracted companies and investors. That position has weakened during some periods. This observation is not meant to minimize the strength of the U.S. markets, but to note that the international competition is becoming stronger.

Third, the United States has many international companies and extensive business involvement with several countries. U.S. GAAP had, therefore, become the lingua franca of accounting.

What the United States has been able to offer, which is missing in some countries, is strong compliance and enforcement procedures. Nearly every research study that examines the application of IFRS emphasizes that the extent of compliance is not due to the defects of the standards but the lack of rigorous enforcement of the standards. Countries can copy the requirements of U.S. GAAP or IFRS, but this does not mean that domestic financial statements are truly convergent with IFRS.

A study[16] of four countries identified three dominant factors that are barriers to accounting convergence. These are:

1. The nature of business ownership and the financial system
2. Culture
3. The level of accounting education and the experience of professional accountants

We discussed these factors in Chapter 2, but the above findings highlight the fact that it is not necessarily the regulations set by the standard setters that are the issue, but the environment in which they are being applied. As long as the standards are considered to be of high quality, it does not matter whether the FASB or the IASB sets them; the crucial ingredient is the structure within a country that ensures organizational compliance.

Given the failure of U.S. GAAP and IFRS to converge, the question is what the next step is. It is evident that the IASB has decided to follow its own path. This does not mean the exclusion of U.S. involvement but convergence is no longer an aim. There is a range of options open to the United States and we discuss this in our final section.

The Way Forward

The formal convergence project has not vanished completely, but has reached a stage where recovery is improbable. The SEC has not, as was widely anticipated, made a public announcement on a firm date on adopting IFRS. In fact, the silence is taken as an indication of their decision to remain with the present accounting regime in the United States. There are many signs, however, that U.S. accounting regulations will continue to be influenced by international practices.

There are several scenarios for the future of accounting in the United States. Some of these can be applied to many countries, not only the United States. Whichever scenario the United States adopts is bound to have consequences on the financial information disclosed by companies, and may be even more profound with the possibility of structural and procedural changes.

Scenario 1: Withdraw

Concentrate solely on U.S. GAAP with no attempts at convergence. The problem would be that as U.S. regulations and IFRS are revised by their respective Boards, the two sets of regulations may move further apart. The gains made from convergence may be lost as the two Boards work separately, and the United States' ability to influence international affairs may be weakened.

Scenario 2: Continuous Convergence

Over an extended period of time, to attempt to bring U.S. GAAP to a point where the amounts reported in the financial statements are the same as those in IFRS financial statements. This route seems highly improbable as the SEC shows no appetite for complete convergence with IFRS, no matter what the time period.

Scenario 3: Choice

Allow domestic companies, as is now permitted with foreign companies listed in American stock exchanges, to use either U.S. GAAP or IFRS. This is an unlikely scenario as it would be very confusing for the users and expensive for the companies.

Scenario 4: Reconciliation

Allow domestic companies to use IFRS, but also perform reconciliation with U.S. GAAP. This scenario is unlikely for the same reasons as in Scenario 3, although Scenario 7 offers an alternative.

Scenario 5: Encourage Use of U.S. GAAP

Strongly encourage the use of U.S. GAAP by other countries so that it is a serious competitor to IFRS. One suspects that it is too late to adopt this strategy.

Scenario 6: Compromise, Not Convergence

Continue to work with international bodies to achieve similarity with IFRS, but not complete convergence. This will entail compromises by the FASB and the IASB if a substantial degree of similarity is to be achieved. There does not appear to be the desire to follow this route.

Scenario 7: Let Companies Decide

One possibility is to retain U.S. GAAP with no attempt at convergence and companies can also report using IFRS if they wish. This practice is already taking place in some parts of the world, as shown in the following example.

GlaxoSmithKline

Directors are required to prepare the Group financial statements in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union. In preparing the Group financial statements, the Directors have also elected to comply with IFRS, as issued by the International Accounting Standards Board (IASB)

When predicting the future, it is wise to leave all options open, so any one of the seven aforementioned scenarios is a possibility. However, there are parameters that can be drawn that limit the number of options. First, it is evident that the FASB and the SEC intend to continue their roles in a U.S. GAAP environment. Recently, Golden, who now heads the FASB, stated that he could envision global standard setting in which FASB, IASB, and other major capital market standard setters coexist and cooperate to issue converged standards, while simultaneously meeting the needs of their home markets. He added, however, that FASB's first priority is to improve financial reporting for the benefit of investors and other users of financial information in U.S. capital markets.[17]

It is very doubtful that expanding the decision makers from the current two, the FASB and the IASB, to include other standard setters will make decisions any easier. It may bring about similarities in national standards, but not total convergence.

However, there is still an international role for the United States. The trustees of the IFRS Foundation recently established an Accounting Standards Advisory Forum. The objective of the ASAF is to provide an advisory forum where members can constructively contribute toward the achievement of the IASB's goal of developing globally accepted, high-quality accounting standards. More specifically, the ASAF is established to:

- Support the IFRS Foundation in its objectives, and contribute toward the development, in the public interest, of a single set of high-quality, understandable, enforceable, and globally accepted financial reporting standards to serve investors and other market participants in making informed resource allocations and other economic decisions;
- Formalize and streamline the IASB's collective engagement with the global community of national standard setters and regional bodies in its standard-setting process to ensure that a broad range of national and regional input on major technical issues related to the IASB's standard-setting activities are discussed and considered; and
- Facilitate effective technical discussions in sufficient depth, primarily on the IASB's work plan, but which may include other issues that have major implications for the IASB's work.

The following were elected to membership in 2013.

- South African Financial Reporting Standards Council, supported by the Pan African Federation of Accountants (PAFA)
- Group of Latin American Standard Setters (GLASS), represented by the Brazilian Committee of Accounting Pronouncements
- Canadian Accounting Standards Board
- United States Financial Accounting Standards Board (FASB)
- Accounting Standards Board of Japan (ASBJ)
- Australian Accounting Standards Board (AASB)
- Chinese Accounting Standards Committee (CASC)

- Asia Oceania Standard Setters Group (AOSSG), represented by the Hong Kong Institute of Certified Public Accountants (HKICPA)
- Accounting Standards Committee of Germany (ASCG)
- European Financial Reporting Advisory Group (EFRAG)
- Spanish Accounting and Auditing Institute
- United Kingdom Financial Reporting Council (FRC)

One could argue that the United States has lost its favored position as a partner of IASB in setting standards and now is a member of a committee with 11 other countries present. These will have their own aims and concerns and represent a mosaic of conceptual frameworks. The U.S. influence has definitely declined.

Conclusions

The search for convergence has ended, and the United States has decided to follow its own course. It will still retain an international accounting presence, but the emphasis will be on satisfying the needs of its domestic market.

The signs that the FASB and the IASB were going to be unsuccessful in completing full convergence were apparent with the projects we discussed in Chapter 5. In this current chapter, we have examined two fundamental issues that have always been present and have never been resolved: the rules-based and principles-based approaches and the conceptual frameworks.

No matter how we describe it and attempt to make accommodations, the U.S. approach is rules based and the IASB principles based. These approaches are mutually exclusive. Although the early signs of a joint Conceptual Framework were promising, as several years passed, any hopes of agreement faded. Some would even argue that the two Boards were even unable to produce an agreed list of who are the users of financial statements.

In looking at the reasons for the demise of the convergence project, it should not be forgotten that many achievements were also made. In Chapter 4, we discussed the changes in U.S. regulations and there have also been changes in IFRS. Because of the work of the two Boards, accounting regulations have been greatly improved.

In this chapter, we have discussed various scenarios for the future. It is apparent that the United States will not have the influence it previously had on the accounting world, but it still intends to remain active at the international level. The future may be uncertain, but we leave our concluding words to R. Hertz,[18] a former Chair of FASB:

> *Geo-economic and geo-political forces, coupled with the growing acceptance of IFRS around the world as the recognized set of international accounting standards, will continue to exert pressure on the United States (and other countries) to either adopt IFRS or to continue to move their standards closer to IFRS.*

It would seem that the future of U.S. accounting regulations will be either convergence or compromise with international accounting standards. Our opinion is that it will be the compromise option with the United States having a strong international influence but maintaining firm control of its own standard-setting structure and processes.

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