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Global Accounting Standard

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Abstract

The paper attempts to illustrate the importance of a global accounting system and the impact of such a standard on the global market as well as providing the means for comparable financial reporting for decision making by both investors and corporations. This writing provides in depth emphasis on the major differences of a rule-based and principal based accounting system including the benefits and drawbacks of such a shift to a principal based system.

Introduction

To fully understand the impact of a global accounting standard we must first understand the main differences of the rule-based and principal-based accounting system which are currently used by the United States and European Union, respectively. This writing also includes both the cause of the shift to a global accounting standard as well as the benefits and drawbacks of such a movement.

Current accounting environment

International Financial Reporting Standards (IFRS) are standard accounting practices developed and used by the International Accounting Standards Board (IASB). The goal of these standardizations is to help create conformity in preparing financial statements and reporting in a global environment (EY, 2008). IFRS is currently used by many countries around the world. As of August 27, 2008, more than 100 countries including Australia, Singapore, Turkey, and all countries in the European Union required or permitted IFRS reporting. Many other countries are working on adopting IFRS but haven't yet fully transitioned. Canada, Russia, and the United States are still working on plans to implement the use. Canada and Russia expect to require full compliance by 2011, while the United States expects their requirement to go into effect by 2014 (Benson, 2006).

The Securities and Exchange Commission (SEC) has voted to allow early adoption of IFRS by 110 of the largest publicly held companies in the United States, representing approximately 14% of the total U.S. market capitalization. These companies can begin using IFRS for their year 2010 filings (Madziar, 2007). The SEC has agreed to revisit the issue in 2011 to make a final determination whether to require the conversion to IFRS for all U.S. companies or if the rollout should be determined based on the size of the company. (www.ifrs.com)

The SEC has identified seven milestones that would influence their 2011 decision on whether to move forward. These include:

- Limited early use of IFRS
- Improvements in accounting standards
- The accountability and funding of the International Accounting Standards Committee Foundation
- Improvement in the ability to use interactive data for IFRS reporting
- Education and training in the U.S. relating to IFRS
- The anticipated timing of future rulemaking by the commission
- Potential implementation of the mandatory use of IFRS, including considerations relating to whether any mandatory use of IFRS should be staged or sequences among groups of companies based on their market capitalization.

Difference between US GAAP and IFRS

The goal in financial reporting is to produce financial information about the results of the company that is both relevant and reliable, in order for investors and creditors to make informed decisions (Johnson, 2005). For information to be relevant, it needs to be timely, as well as comparable to other companies and to past performance (Shortridge, 2004, August). For information to be reliable, it needs to be "reasonably free from error or bias and faithfully represents what it purports to represent (Johnson, 2005)." The recent scandals have caused the various rule making bodies in the United States, including the SEC and the Financial Accounting Standards Board (FASB), to question whether the current system is sufficient to accomplish the goal of relevant and reliable reporting. The US is currently under GAAP; however it is looking to move towards IFRS, the international accounting standard.

The core of the discussions and debates has been whether a rules-based or principles-based system would result in more effective financial reporting. The US began as a principles-based system, however it evolved into a rules-based system due to the pressures from accountants and auditors for more specific guidance on issues, as well as the FASB "having to make compromises with presumably powerful interest groups that prevented it from implementing its desired principles (Benston, 2006, June)." IFRS, however, is a principles-based system. In a rules-based system, companies can manipulate their financials by focusing on the form of the transaction instead of the underlying substance. As long they can meet certain specific requirements, they are covered to report information in a way that does not clearly show what the transaction is. Enron for example, used special purpose entities to show less debt in the financials than the company really had. They were able to manipulate the rules to present the financials in a misleading way. Under principles-based accounting, there are not as many specific rules defining the details of a transaction. Instead it lays out the objective of the principle, and accountants are required to apply the principles to most accurately represent that objective (Alexander, 2006, June). In response to requirements from the Sarbanes Oxley Act, the SEC was required to look into this issue. What they came up with was that U.S. should move to an objectives-based system, which is basically the same as a principles-based system (FASB Response to SEC Study on the Adoption of a Principles-Based Accounting System, 2004).

The overall goal of principles-based accounting is to create a framework that accountants can use to prepare financials that reflect the true economic substance of transactions, as opposed to following the "letter of the law". Rules-based allows the ability to manipulate the structure of transactions in order to use the form of the rules as a guideline to present information in a way that presents the financials in the best possible light, regardless of whether that presentation may be misleading. With a principles-based system, there are no forms or fixed percentages that can be manipulated. The accountants must present transactions in the way that most accurately represents the true substance of the transaction (Shortridge, 2004, August).

Another benefit to principles-based accounting is the inherent flexibility. Rules-based systems attempt to define each possible scenario, however they are poorly equipped to deal with emerging issues or new situations. In a principles-based system, the broad principles can give guidance to existing situations, as well as be applied to any emerging or changing accounting issues. For example, when companies started dealing with increased software development, the rules-based GAAP had to quickly come up with new standard to detail how to account for it. Under a principles-based system, this additional guidance would not have been necessary.

A Major drawback of the current rules-based system is the complexity of the rules. For a company that is encountering an accounting issue for the first time, the ability to find the definitive ruling can be difficult. With the hierarchy of GAAP and all the various levels of authoritative literature, it is difficult and time consuming to find the appropriate rules and be confident that there have not been any other pronouncements that have modified those rules for the company's specific situation (FASB Response to SEC Study on the Adoption of a Principles-Based Accounting System, 2004). Under a principles-based system, the guidance is much less complex and easier to use. The accountant does not need to search through a multitude of various pronouncements looking for specific rules. If they understand the overriding principle, then they can apply that to their situation. For example, to account for lease transactions, including various interpretations and pronouncements, the IASB has seven documents referencing leases, compared to seventy-eight under US GAAP (Shortridge, 2004, August).

Although the US is amongst the majority of countries currently utilizing the rule-based accounting system, a shift to a more principal-based system or international standard has begun to gain momentum.

What's causing the shift to the IFRS?

Currently around 100 countries follow IFRS. The SEC and other U.S. entities are aware of the benefits of participating in an international standard. Ten years ago, harmonization of worldwide accounting standards was considered to be an unachievable goal even though it was regarded as a worthy idea. Currently, the convergence is on the near horizon and soon the SEC is expected to provide a timeline of allowing and/or requiring financial reports in the U.S. stock exchanges to be in accordance with IFRS (EY, 2008).

Many countries have or had their own national GAAP and because of the acceleration of globalization the IFRSs are progressively replacing them. The European Council of Ministers gave the already growing IFRS a boost of participation in 2002 when they passed regulation requiring all European Union corporations listed on a market to prepare reports in accordance with IFRS beginning January 2005 (Deloitte, 2003).

The SEC and European Commission both welcome the idea of a convergence/harmonization because of the potential for a single worldwide set of high-quality principals bred from the best ideas from each set of standards and the hope for a dramatic improvement in the efficiency of global capital markets. It is hoped that international investors from the EU and elsewhere will be more inclined to invest in U.S. and other world markets and securities if they can more easily make educated comparisons. An increase in the comparability of international entities will make analysis more accurate and increase efficiency of the world's capital markets. Additionally U.S. investors will be able to better diversify their investments with the benefit of easier international portfolios. International companies will have an easier time reducing their financial reporting costs in hopes of being foreign takeover targets if they hope to be bought out (Katz, 2007).

Once a harmonization or acceptance of two different accounting standards is in place, it is certain that a complete adoption of one standard is in the near future. This is because the cost of having two sets of standards is not sustainable and one global standard has long been the goal. First, standardization of training programs for accountants and experts from IFRS must be implemented, but the potential exists for a certified accountant to be eligible to practice not only across state borders, but international borders as well. Educating and training for both the system changes and knowledge required to operate under IFRS will make up the most significant costs associate with a convergence. A switch to different IT systems, the acquisition of experts by firms, and temporary audit cost increases will add to a short term burden on many companies

(PWC, 2008). Although like any another major implementations, regulating bodies as well as companies must consider both the benefits and drawbacks of such an undertaking.

Benefits of having a global accounting standard

The movement towards a global accounting standard has been prompted by many things. The integration of the world's economy is occurring at a fast rate and the international market has helped the accounting profession to move closer to a global reporting standard. With the joint pledge from the IASB and the FASB, this global accounting standard will become a reality within the next few years. (Gill, 2007) There are multiple benefits from having a global accounting standard in today's global market.

The first major benefit of a global standard is the ease of comparability of financial reports. Currently, there are various ways to arrange and prepare financial reports. "One of the obstacles that investors have to overcome in making investment decisions is the different ways that this information can be reported." (Cox, 2007) Each country has their own requirements and processes that they must follow. As the world becomes globalized, this causes a problem for foreign investors. To review financials prepared under different standards can be a great challenge. Investors need to be able to compare like kind investments with reports prepared utilizing one single standard in order to make an informed decision. As more and more businesses turn global, companies that adopt one global accounting standard "will be able to compare their financial reporting to that of their international competitors." (KMPG, 2008)

Another benefit to a global accounting standard is that the cost of investing in other markets would decrease. "They'd also lower costs for issuers, who would no longer have to incur the cost of preparing financial statements using different sets of accounting standards."

(Cox, 2007) This benefit would be realized from the reduction of additional work that is normally required to review foreign markets' financial records. There would be no need to reformat financial reports and simplification would occur. Multinational entities could also "streamline reporting and reduce related costs by developing common reporting systems." (KMPG, 2008) The expenses related to pay a firm to convert different accounting reports to one that is readable and comparable could be saved and applied to additional investments.

One last benefit that would be realized with the use of a global accounting standard would be the increase of global activities. With the ease of comparability and the decrease in the costs to do business internationally, more companies would be inclined to devote their money to additional international transactions. "Global accounting standards would improve investor confidence in the market, so long as the standards are high-quality, comprehensive and rigorously applied." (Cox, 2007) These companies could have access to invest, set up franchises and ventures, acquire or even create new industries in foreign countries. (KPMG, 2008) The incentive would be fewer complications in setting up accounting records and an ease of understanding these reports. Investor confidence would improve with these new standards. (Gill, 2007) This would also increase the US market and open it up to new investors who currently lack the desire to convert activity to the required GAAP principles now in place in the US market.

The benefits for one accounting standard are seen in various areas of the business environment and were exemplified in the prior paragraphs. As with all things, there are also drawbacks to only having one accounting standard.

Drawbacks to Shift towards Global Accounting Standards

There are many skeptics who believe that a global accounting standard would be very complex with regard to legal and regulatory issues. The International Accounting standards are young and still very much evolving; however Securities regulators feel with our growing economy to such a standard will be inevitable (Iwata, 2008). There are still many questions; what will the true convergence of GAAP and IFRS look like? The global standard would be a merging of a comprehensive or ruled-based system and a principle-based system respectively.

An adoption of a principles-based standard means that there is room for interpretation on how accounting rules should be applied. This could potentially lead to inconsistencies with a country's reporting. This in fact may be a deterrent for countries to take part in this globalization effort – this may limit activities within a particular industry sector. Many accountants seem to prefer rules-based standards, possibly because of their concerns about the potential for litigation over their exercise of judgment in the absence of concise rules. The number of requests for implementation guidance received by FASB has always been high, and their significance resulted in the formation of the Emerging Issues Task Force. If financial statements conform to accepted rules, the bases for a lawsuit are diminished The CPA Journal. (Myrning, 2004).

The European Commission, the executive branch of the European Union, launched a public consultation on the endorsement of IFRS. Eumedion, the corporate governance forum for institutional investors expressed concern with regards to a transition to the principled-based system. Eumedion advised they cannot issue complete endorsement of IFRS sighting drawbacks. The forum has expressed that there is the inherent risk that negative information may not be shared with board members at its early stage as this would potentially trigger public disclosure. This could be ultimately a corporate governance risk. The forum has also sighted the lack of objectivity, loss of comparability, loss of risk and reward override, loss of geographic information and finally inconsistent measurement criteria. (Madziar, 2007)

Another concern that is not often discussed is the impact to those who practice faith-based finance, such as Muslims. The modern history of Islamic finance is often dated to the 1970's, with the launch of Islamic banks in Saudi Arabia and the United Arab Emirates. Islamic finance is practiced on the roots of Islamic law or Sharia. Sharia mandates that there is no separation between church and state. Sharia has an emphasis on justice and partnership. In the Western world of finance, that translates into a ban on the charging of interest. Muslims claim that Islamic finance is virtuous as well as vigorous. It frowns on speculation and ambiguity and applauds risk sharing. IFRS could not service capital that must be Sharia compliant, but the thought is that Islamic finance could potentially satisfy everyone in all industries. Sharia compliant countries battle with their own differences between jurisdictions such as Saudi Arabia and a more liberal Malaysia (Manama, 2008).

When reviewing the aforementioned issues and globalization of markets it seems that multinational corporations will exist into the near future. Multinational corporations operate in a number of countries and adjust products and practices to each. The goal of IFRS is to promote global corporations that operate with resolute consistency. There is still much work to be done.

Conclusion

It is without argument that a global accounting system is the goal of many corporations. In fact, some countries are already following IFRS and others have pledged to be compliant with the standard in the next few years. Our research has led us to the topic of a rule-based accounting system such as US GAAP and the IFRS which is a principal-based system. Regardless of your view point on the accounting systems, we believe that a global accounting system would allow investors as well as corporations to make informed investment and business decisions utilizing reports that are comparable across the globe. These decisions include foreign direct investment and global expansion. Although there are short term costs associated with the transition to a global accounting system, the benefit far exceed the drawbacks.

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