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SEMINAR UPDATES ON INTERNATIONAL FINANCIAL REPORTING STANDARDS

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FINANCIAL REPORTING CONTEXT

1 Business Context

The measurement of business and economic activity is essential to the assessment of the performance of the entity. The publication of financial information has provided a means of producing an account of the way in which resources have been utilised within a business.

In modern and sophisticated capital markets, financial reporting has become, for large companies at least, a key raw material on which investors base their decisions to supply funds.

Over time, different practices and regulations have evolved to meet the requirements of national economic, financial and legal systems. The challenge of international harmonisation is to reduce or eliminate the differences, to produce a level playing field for financial reporting and to help create more efficient international capital markets.

2 Chapter Objectives

This chapter looks at the background to the development and application of international harmonisation through financial reporting standards. It includes the process by which harmonisation has arisen and, more specifically, a description of the structure and bodies within which the International Accounting Standards Board (IASB) operates.

On completion of this chapter you should be able to:

- understand the nature, concepts and purposes underlying the international harmonisation of financial reporting and progress made;
- demonstrate a knowledge of the regulatory and institutional structure within which the IASB operates and of the major bodies within that structure;
- understand the structures in the European Union (EU) as they relate to international financial reporting; and
- understand the IASB's approach to continuing its period of stability for the implementation of IFRS.

3 From National Accounting to International Harmonisation

Accounting standards are effectively the 'user manual' for how to translate an entity's financial performance into a set of coherent and succinct financial statements. The end result is designed to be a set of financial statements that is the basis for a variety of users to make informed economic investment decisions.

Entities across the world prepare financial statements with this same objective in mind. However, the 'user manual' in each national jurisdiction may vary to take account of the local environment in which entities operate. Consequently the same business transaction may be accounted for in a number of different ways depending on which version of the 'user manual' is used, for example the one for the UK, for the US, for Australia or for Japan.

Factors influencing these variations in national practices and regulation of financial reporting include:

- differences in the way that legal systems operate;
- different political systems, for example the degree of central government control;
- different capital markets;
- international variation in the type and scale of economic activity, from agricultural to financial services and from developing economies to industrialised economies;
- the degree of international influence and openness of an economy;
- the stability of the economy and inflation rates;
- cultural differences;
- the influence of the accounting profession; and
- national differences in corporate governance (the exercise of power over and responsibility for an entity) structures and practices.

While national variations in accounting practices have endured for many years, more recently there has been pressure to harmonise financial reporting practice and regulation on a global basis in order to reduce such inconsistencies. In short, it is becoming less acceptable to report the same transactions differently according to where they occur. Accounting practices and financial reporting should be a universal language.

Illustration 1 – Daimler Benz

A good example of inconsistent national financial reporting is that of German car manufacturer Daimler-Benz AG (prior to its merger with Chrysler).

Daimler-Benz obtained a listing of its shares in the US in 1993, and in so doing needed to report under both US generally accepted accounting practices (GAAP) and German GAAP.

While one might expect that the profit reported would be similar (as it was exactly the same set of economic transactions being presented), this was not the case. The company reported a huge loss of $1 billion under US GAAP, while at the same time reporting a profit of $370 million under its own domestic German GAAP.

This difference was simply the result of different accounting practices being used by different countries. Such significant differences undermine the usefulness of financial statements.

There have been a number of primary drivers encouraging worldwide harmonisation of financial reporting, including increased globalisation of trade and capital markets. The rapid pace at which information technology has developed has, amongst other things, led to the easing of the electronic movement of funds across national boundaries and increased investor willingness to invest across national borders.

With international barriers being broken down there has been a move to increased internationalisation of non-accounting regulation, for example international banking agreements (such as the Basel Accord) and international agreements by securities regulators.

As a reflection of the movement towards international harmonisation of financial reporting there has been increased usage of International Financial Reporting Standards (IFRS) worldwide. This trend matches the growing internationalisation of business.

There are now around 80 countries that require the use of IFRS for the preparation of financial statements of some, or all, of their domestic listed entities. There are at least another 20 countries that permit the use of IFRS for the preparation of such financial statements. In addition to these countries which have already made the move to IFRS there are a number of important others who are pursuing a formal policy of convergence with IFRS.

By 2005, convergence with IFRS included the European Union, Australia, Hong Kong and South Africa, while Japan and the United States continued to work closely with the IASB to converge their standards. New Zealand permitted adoption of IFRS from 2005, but more importantly required its domestic entities to comply with what it describes as "New Zealand converged IFRS" by 2007.

In 2007, the Accounting Standards Board of Japan (ASBJ) agreed to work with the IASB to eliminate major differences between International Standards and Japanese GAAP by 2008. Any remaining differences at that time will be removed by the middle of 2011. The convergence goal is for all standards that are effective prior to 2011, and hence new standards currently being worked on by the IASB will not be within this remit. However, both boards have agreed to work closely with each other in order that the international approach will be acceptable to the ASBJ.

The Council of the Institute of Chartered Accountants of India also agreed in mid 2007 to fully converge with IFRS for accounting periods commencing on or after 1 April 2011.

China made a similar commitment to bring about convergence of Chinese accounting standards and IFRS. The first step towards convergence in China was the release of Chinese Accounting Standards for Business Enterprises and Auditing Standards for Certified Public Accountants in February 2006. This marked the establishment of an accounting system for business enterprises and introduced accounting principles that are familiar to investors worldwide, hence encouraging investor confidence in China's capital markets. In addition, the Government of the People's Republic of China announced that its domestic listed entities would apply a set of accounting standards that are substantially converged to IFRS in 2007.

4 The Pathway to Financial Reporting Harmonisation

4.1 The International Accounting Standards Committee (IASC)

The IASC, which was the predecessor body to the IASB, was founded in June 1973. It was set up as a result of an agreement by accountancy bodies in ten national jurisdictions which constituted the original board, being Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the UK, Ireland and the US.

The IASC subsequently expanded to include representatives from over 100 countries and by 2000 the membership included 143 bodies in 104 countries, representing over two million accountants.

The IASC developed and issued International Accounting Standards (IAS).

In 2001, the IASC was superseded by the IASB, which had a new structure of associated bodies and significantly increased financial resources.

The IASB issues IFRS, but has adopted all the IASC's IAS. Any reference in these chapters to IFRS should be taken as including IAS, unless there is a specific statement to the contrary.

4.2 The International Organisation of Securities Commissions (IOSCO)

In 1995, the IASC embarked on a mission to complete what had been defined as the 'comprehensive core set of standards'. This was motivated by an agreement made with IOSCO.
IOSCO is an international body of security commissions, each of which is responsible for regulating investment markets in its own country.

The agreement between the IASC and IOSCO committed the IASC to the completion of revisions to the standards that IOSCO deemed essential if it was to permit IAS-based financial reporting in the securities markets under its members' control.

In 2000, IOSCO endorsed the use of 30 selected IAS for the purposes of crossborder securities registrations and the financial statements of multinational entities.

IOSCO's membership currently stands at in excess of 180 members (including the Securities Exchange Commission (SEC) in the US) and continues to grow. The organisation's members regulate more than 90 per cent of the world's securities markets and IOSCO is today the world's most important international cooperative forum for securities regulatory agencies.

4.3 The Financial Accounting Standards Board (FASB)

A significant milestone towards achieving the goal of having one set of global standards was reached in October 2002 when the Financial Accounting Standards Board (FASB), the US standard setter, and the IASB entered into a Memorandum of Understanding – the 'Norwalk Agreement'.

This Agreement was a significant step towards the US formalising its commitment to the convergence of US and international accounting standards. In the Press Release that announced the Agreement, Robert H. Herz, chairman of the FASB commented *"The FASB is committed to working toward the goal of producing high quality reporting standards worldwide to support healthy global capital markets".*

The Agreement set out a number of initiatives, including a move to eliminate minor differences between US and international standards, a decision to align the two Boards' future work programmes and a commitment to work together on joint projects.

Since the publication of the Norwalk Agreement, the IASB and FASB have been working together with the common goal of producing a single set of global accounting standards and this resulted in a further formal Memorandum of Understanding being published in February 2006. The Memorandum of Understanding set out a number of goals that should be completed by 2008:

- ***Short-term convergence*** – major differences in a number of specific areas should be eliminated. The specific areas include, among others, impairment, income tax, joint ventures and fair value; and

- ***Other joint projects*** – progress should have been made in a number of other areas where one of the Boards has identified the need for improvement. These topic areas include, but are not limited to, business combinations, consolidation, performance reporting and revenue recognition.

The debate surrounding the publication of accounting standards based on principles rather than rules continues to be one that has no straight-forward answer. While the IASB prefers standards to be based on principles, it is finding that preparers of financial statements are asking for more guidance rather than less. Both the FASB and IASB agree that standards are becoming too complicated, and they have therefore agreed to discuss how they might be simplified by focusing on the principles of what the standard is trying to achieve. Such an approach will mean that judgement has to be applied when interpreting the principles.

In November 2007 the US Securities and Exchange Commission (SEC) agreed to remove with immediate effect the requirement for non-US entities reporting under IFRS (as issued by the IASB) to reconcile their financial statements to US GAAP. Prior to this announcement there was a need for US Registrants to prepare a reconciliation between their financial statements and certain key figures such as earnings and net assets under IFRS with their equivalents under US GAAP.

Illustration 2 – GlaxoSmithKline

GlaxoSmithKline plc is an English public limited company that has its shares listed on the London Stock Exchange and the New York Stock Exchange.

It prepares its financial statements in accordance with IFRS. Prior to the SEC removing the need for a reconciliation to be prepared it was required to present both US GAAP and IFRS key financial information.

For its year ended 31 December 2006, GlaxoSmithKline reported profits of £5,389million under IFRS, which fell to £4,465million under US GAAP, and equity shareholders' funds (net assets less non-controlling interests) increased from £9,386million under IFRS to £34,653million under US GAAP.

4.4 EU Regulation

EU Accounting Directives were issued to establish a minimum level of harmonisation within Europe for the preparation of financial statements. Following a change in focus the goal posts moved to international harmonisation rather than within Europe alone. As a result, the European Commission published an EU Regulation in June 2002 that required the adoption of IFRS in member states for the preparation of the consolidated financial statements (i.e. the group financial statements) of listed entities.

The Regulation applied to financial periods beginning on or after 1 January 2005 for entities incorporated in a member state and whose securities, debt or equity, were traded on a regulated market in the EU. The significance of this requirement being issued as a Regulation was that it immediately had the force of law in member states. Its adoption was not dependant

on it being incorporated into national legislation, so there was consistency in both timing and application of the requirements.

The European Commission made what it described as a "gamble" because the successful implementation of IFRS should lead to reduced costs for multi-national groups with one GAAP applied across the whole group. Lower costs of raising capital, improved access to funding and better opportunities for investors should flow from enhanced comparability of financial statements.

Extract from the financial statements of France Telecom 2004

"IMPLEMENTATION OF IFRS WITHIN THE FRANCE TELECOM GROUP

ORGANIZATION OF THE CONVERSION PROCESS

This project is part of a broader program that aims to enrich management reporting and implement a new consolidation tool and a new set of references common to the entire group. To ensure the homogeneity of the accounting policies and their implementation within the group, the IFRS conversion project is led by a central team that is managing the entire project for the Group and its sub-groups."

Consistent application and enforcement continue to be one of the biggest challenges facing entities within the EU. Unfortunately, consistent application does not necessarily mean "identical" application". With 27 Member States all having a different starting point, consistent application across the EU was never considered to be a straight-forward exercise.

In an attempt to overcome some of the challenges surrounding consistent application the European Commission formed a "Roundtable on Consistent Application of IFRSs" in February 2006. The Roundtable was formed so that "common concerns" of application of IFRS are identified and where necessary referred to the International Financial Reporting Interpretations Committee (IFRIC). "Common concerns" are described as where application of standards is divergent, significant and widespread.

The Roundtable gathers its views from audit firms, standards setters and other interested bodies in each Member State and met for the first time in May 2006. The Roundtable itself has no authority to issues interpretations, instead it is a vehicle used to identify and discuss differences in interpretation across the EU.

While in favour of harmonisation, the European Commission did not wish to delegate unconditionally the process of accounting standard setting to a private sector organisation over which it had little influence and no control. It therefore set up an endorsement mechanism to assess new standards and approve them for use in the EU.

The body given responsibility for endorsement is the Accounting Regulatory Committee (ARC), which is a statutory body composed of representatives of member states and chaired by a member of the Commission. Technical views are received from EFRAG (the European Financial Reporting Advisory Group), a group composed of accounting experts from the private sector, including preparers, users, members of the accounting profession and national standard setters.

In addition to its Technical Expert Group, EFRAG also has a Supervisory Board which oversees the work of the Technical Expert Group to guarantee the representation of the full European interest.

4.4.1 The Committee of European Securities Regulators (CESR)

If international standards are to be mandatory, then their application should be enforced in some way. Enforcement can take place at a number of different levels, for example through governments, securities regulators or other regulatory bodies where appropriate.

Within the EU it was felt that harmonisation of accounting standards would be improved through the harmonisation of enforcement, hence providing member states with a level playing field.

The European Commission in conjunction with the Committee of European Security Regulators (CESR) has therefore set up a common approach to enforcement. This common approach is based on a number of principles covering key areas such as the definition of enforcement, the selection techniques for the financial statements to be examined and the powers of the enforcers.