
Chapter 3: The IASC's conceptual framework - an obstacle to international harmonisation?

Introduction

Why have the world's leading stock exchanges, the IASB and the EU recently intensified their efforts to harmonise world accounting around IAS? The dominant view amongst academics is that the objective is to "improve the efficiency with which the markets operate by reducing the diversity that exists among the bases on which financial accounts are prepared in various countries" (Bayless, 1996, p.76; see also, Zarzeski, 1996, p.18). We argue in chapter 4 that the evidence does not support this as the underlying aim of harmonisation. In this chapter we ask whether promoting efficient capital markets is what the capital markets should want from harmonised accounts, and whether accounting standards based on this aim is an obstacle to full international harmonisation?

To understand the IASB's harmonisation objective we must understand its conceptual framework. There are two competing conceptual frameworks with two very different objectives for accounting (Ijiri, 1983) - the traditional theory and the asset-liability approach - and, therefore, two very different harmonisation objectives. The traditional objective of accounting is accountability - holding management accountable for the realised rate of return on the capital under their control. The traditional theory says financial reports provide a factual basis for judging management's performance, and this underlies the traditional requirement for a true and fair view.

Since the 1970s the US has adopted the asset-liability framework based on the decision-making objective - providing investors with information for investment decisions - whether to buy, sell or hold financial securities. The FASB completed its framework in 1985. It is important to note, however, that this framework is non-mandatory, and until recently has been relatively little used by the FASB.¹ USA accounting remains mostly traditional. The IASC adopted the FASB's framework in its *Framework for the Preparation and Presentation of Financial Statements* that it published in 1989. The aims were to help the IASC develop new international standards, to review existing standards to reduce the number of alternative treatments allowed, and to assist national standard-setting bodies in developing standards consistent with international standards (IASB, 1989, para.1). Its framework is also non-mandatory and, until recently, was also little used by the IASC, many of whose standards also remain largely traditional. However, we shall see it provides the IASB's taken-for-granted objective of harmonisation to improve the efficiency of the international capital markets - to help international investors predict enterprise cash flows and value the shares of non-Anglo-Saxon companies more efficiently.

¹ FAS133 and IAS39 on accounting for financial instruments represent the most radical departure from the traditional framework so far, but there are other standards where the asset-liability framework is making, or threatens to make, inroads into traditional accounting (e.g., accounting for goodwill and intangibles; lease accounting; pension accounting).

Although, not surprisingly, the IASB neither requires a traditional true and fair view, nor advocates one, it claims its framework is consistent with it:

“Although this framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of...such information” (1989, para.46).

In this chapter we question whether the IASB’s asset-liability approach is consistent with the traditional ‘true and fair’ view, and whether it provides an appropriate framework and objective for harmonisation. In short, we question whether the international capital markets want FASB style asset-liability accounting.

First, we outline the IASB’s framework and criticise it from the perspective of traditional accounting. Second, we examine the IASC’s ‘Comparability Project’, launched in 1988 to reduce the unacceptably large number of options available under IAS, and secure their acceptance by IOSCO on behalf of the world’s capital markets. This project generally moved IAS towards traditional accounting. Third, notwithstanding IOSCO’s endorsement of IAS, we argue the IASC’s conceptual framework has been, and remains, an obstacle to the complete harmonisation of accounting. We shall see in chapter 4 that the evidence does not support the assumption of the IASC’s conceptual framework that the aim of harmonisation is to improve the informational efficiency of the international capital markets. That is, the view of the FASB that “the role of financial accounting and reporting in the economy [is]...to serve the public interest...to provide even-handed financial and other information that, together with information from other sources, facilitates efficient functioning of capital...markets” (1978, Preface). The evidence is consistent with the hypothesis that the capital market’s objective is to eliminate conservative accounting to make management in every country accountable for its capital. We present further evidence in support of this hypothesis in chapter 5, where we examine the fundamental causes of differences in accounting, and in chapters 6 to 11 on accounting in EU countries and Japan.

The IASC’s conceptual framework

Objective

As Benston says, “Long ago, accountants and financial statement users came to the realization that, although measurement and reports of economic market values would be very useful, this was not a task for which accountants had a comparative advantage” (1997, p.52), yet this is precisely the aim of the IASC’s framework. “Financial accounting is, and has always been, a somewhat uneasy mix of two primary demands by users of financial statements. One is for ‘stewardship’ the other is for ‘valuation’”(Benston, 1997, p.52), yet the IASB accepts the FASB’s view that what investors want from accounts is information that is “useful in making economic decisions”. That is, useful to investors for predicting the size, timing, and risk of the future cash flows they will receive from an enterprise:

“The economic decisions that are taken by users of financial statements require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation” (IASB, 1989, para.15).²

In other words, the primary role of accounting is to help investors predict an enterprise’s risk and return so they can decide whether to hold, buy, or sell its securities:

“Information about the economic resources controlled by the enterprise and its capacity in the past to modify these resources is useful in predicting the ability of the enterprise to generate cash and cash equivalents in the future” (para.16).

“Information about the performance of an enterprise, in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in the future” (para.17).

Thus, the IASB’s view that “further harmonisation can best be pursued by focusing on financial statements that are prepared for the purpose of providing information that is useful in making economic decisions” (1989, Preface). However, as Ordelheide said,

“The primary objective of financial accounting and reporting differs between countries. In the United Kingdom and United States, for instance, regulation by the ASB or the SEC and FASB is mainly oriented to providing capital markets with information. The framework of laws that specify accounting rules in continental Europe, especially those on individual accounts, is concerned equally - sometimes mainly with determining how much profit may be distributed to the proprietors without jeopardizing the capital base of the company” (1995, vol.1, p.x).³

In other words, whereas within the asset-liability framework the aim is to help investors to value companies, in the continental European tradition, as in traditional accounting, the objective is to prevent the unwitting payment of dividends from capital. While the *Framework* acknowledges that financial statements also show the results of the ‘stewardship’ of management, or what it calls the ‘accountability’ of management for the resources entrusted to it, in its view this means providing information for economic decision-making:

“Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the enterprise or whether to reappoint or replace the management” (para.14).

² The IASB recognises the existence of other users, e.g., employees, governments, customers, the general public. However, it follows the FASB in arguing that “As investors are the providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy” (IASB, 1989, para.10).

³ We consider what capital ‘maintenance’ means in Germany in a later chapter.

As Benston says of the same view in the FASB's framework, this approach is "sharply at odds with some fundamental principles of accounting (notably, the 'critical event' and 'matching' concepts that govern when income and expenses are recognized" (1997, p.46). Traditional accountants were not happy with this understanding of stewardship when the ASB introduced into the UK's conceptual framework, based on the IASC's Framework. Fearnley and Page saw it creating a "division between those who see the purpose of financial statements as taking economic decisions about the future, and those who see it as a basis for making management accountable" (1996, p.94). As they said, the ASB "attempts to adopt an economist's measure of income as the increase in a company's 'well-offness over an accounting period'" (Fearnley and Page, 1996, p.94). The ASB approach was "a major step away from the traditional approach...where accounts are used to provide evidence of management's stewardship" (Bence, 1997, p.145). Or, as Paterson put it, "By switching the focus to the future rather than the past, the company's results are no longer to be reported as they unfold: instead, guesses about future results are impounded into today's balance sheet, making the outcome more like a valuation model than a report on the outcome of an expired period" (1999, p.90).

Certainly, investors deciding whether or not to hold or sell their investments and to reappoint managers or not, is part of the process whereby managers are held accountable - part of the final process of punishment and reward. However, this does not mean that market discipline is sufficient for accountability. In traditional accounting profitability is an objective report of the results of past transactions and events, and the purpose of assessing stewardship is to influence manager's behaviour *before* reporting the profitability of the enterprise. Managers know they must report in the future on the results of their actions today. Thus, in the traditional view, the effectiveness of accounting in promoting stewardship is its impact on the behaviour of managers *before* reporting in ensuring that profitability is satisfactory. In the traditional view sacking managers for poor profitability is a last resort, and represents a failure of the accountability process to achieve the desired results. By contrast, in the IASC's Framework, which focuses wholly on investment decisions, sacking managers or selling shares is the essence of accountability. In the traditional framework, accountability starts from and depends upon the objective measurement of outcomes. This is why the cornerstones of traditional accounting are the principles that management can only book revenue when it is realised and must carry assets at no more than their recoverable amount (e.g., at the lower of cost or market for inventories). As Ball, Kothari and Robin put it, this 'bias' of traditional accounting towards 'conservatism'

"arises because...information asymmetry between managers and users creates a demand for an income variable that is observable independently of managers. Accounting income thus incorporates only the subset of available value-relevant information that is independently observable, whereas economic income incorporates information that is not independent of managers, such as plans and forecasts.... In other words, accounting income does not attempt to anticipate future cash flows to the same extent as economic income" (2000, pp.6-7).

We cannot expect management to choose appropriate actions in anticipation of the IASC's financial reports because it defines profitability as the change in current and future cash flows. Forecast future cash flows are subjective. It is not possible to hold management accountable for - that is, measure its performance by its impact on - subjective expectations of the future, but only for objectively measurable outcomes of the past and the present

“Accountability and...decision usefulness are not compatible. Forward-looking decisions require forecasts of future cash flows, which in the economic model are what determines the value of assets. These values are too subjective to form the basis of accountability” (Fearnley and Page, 1996, p.94).

In the traditional view, only by being held accountable for the things they control in the present does accounting have an influence on the future.

Neither the FASB, ASB nor the IASC discuss the traditional idea of accountability. The FASB, however, admits that in its framework financial reports cannot hold management accountable in the economic sense (1978, para.53), because an enterprise's economic value is the joint product of managements' behaviour (decisions, actions, inactions) and the state of the environment (particularly, expectations of the future). It is impossible for accounts to distinguish management's specific contribution to economic value and to hold it accountable for delivering it. Certainly, we can contrast an entity's share price performance with that of its sector, but this still leaves us with a forecast for the entity as such, not necessarily only management's contribution. Even if the market has specific expectations about management's contribution we cannot hold management accountable for subjective expectations; we can only hold management accountable for its performance against the market's requirements. If accounting gives the market an objective record of an entity's results, it can identify management's contribution to realising the return on capital by comparing one enterprise with other enterprises sharing the same environment. Other things being equal, the residual returns are attributable to management's behaviour.⁴ Thus, insofar as the IASC's Framework allows management subjective choice in accounting it will to that extent be less accountable for its performance.

Qualitative characteristics

The IASC derives the qualitative characteristics of financial statements from the decision-usefulness objective. It again follows the FASB. It says to be useful for forecasting, accounting information must have 'relevance', 'reliability' and 'comparability'. Only information that has all three characteristics is useful in predicting future cash flows and their risk:

⁴ This may explain why share analysts invariably compare companies with sector averages, and why comparability of accounts is the goal of the International Accounting Standards Committee (IASC, 1998, p.45).

“Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations” (para.26).

“Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance.... To have predictive value, information need not be in the form of an explicit forecast” (para.28).

“Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent” (para.31).

“Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position and performance...[and] also be able to compare the financial statements of different enterprises” (para.39).

In short, to be useful to investors in predicting expected cash flows and their risk, accounting information must have ‘predictive value’ even though based on past information; must clearly be free from error or bias, and must be relevant and reliable through time and across different enterprises.

Traditional accounting defines financial information as ‘relevant’ and ‘reliable’ if it gives a true and fair view of the enterprise operating cycle. Objective information on the sources, uses, and change in capital is relevant, reliable, comparable, and understandable, gives more benefit than it costs. This information is by definition ‘material’ and cost-effective because the level of accuracy investors and creditors want in accounts, the real issue for traditional accountants, because they (collectively, and on average) decide how much management can spend on accounting. Because it is factual it is also unambiguously a ‘faithful representation’ (accurate description) of capital, is ‘neutral’ (not slanted to a particular interest), ‘complete’ (provides the information investors and creditors need to hold management accountable), consistent and understandable. Traditional accounting therefore does not require management to strike any ‘balance’ between the various characteristics. By contrast, as in the IASC’s framework management report assets and liabilities defined as future cash flows, it must attempt to define these qualities independently of each other so as to provide a framework to limit management’s subjectivity.⁵ Unfortunately, the ASB’s definition of ‘reliability’ is clearly circular. As UK GAAP said, “The definition of reliability used in [the 1995 SOP] is retained, as is its circularity: ‘information is reliable if it can be depended upon...to represent what it purports to represent’. Put another way, information is reliable if it is reliable” (1999, p.129).

⁵ From the “sophisticated” asset-liability perspective only the “more simple-minded users might be surprised at the omission of accuracy from the list of desirable characteristics” (Lewis and Pendrill, 1996, p.16). According to Lewis and Pendrill the phrase ‘faithful representation’ conveys to the sophisticated the inherent subjectivity and potential inaccuracy of accounting information. However, in their view, ‘accurate’ means ‘certain’, ‘the absolute of total accuracy’(Lewis and Pendrill, 1996, p.16). According to their definition, scientists, who realise that all measurement is subject to inaccuracy, could never claim to have ‘accurate’ measurements!

Whereas in traditional accounting information must be objective, using the asset-liability framework “In practice a balancing, or trade off, between qualitative characteristics is often necessary” (para. 45), which is subjective. As the current chairman of the IASB (Professor Sir David Tweedie) said, while relevance and reliability are the main characteristics of useful information, “The problem is that these characteristics are not always compatible and...a trade-off is required” (Tweedie, 1992, p.7). As the IASC Framework says,

“Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment” (para.46).

Another “pervasive constraint” on the relevance and reliability of accounting information is that “The benefits derived from information should exceed the cost of providing it”. However, whereas in traditional accounting the benefits of accounting are necessary and are not traded off against the costs, the IASC’s Framework admits that “The evaluation of benefits and costs is, however, substantially a judgmental process”, and that it is “difficult to apply a cost-benefit test in any particular case” (para.44).

The elements of financial statements

In the IASC’s view, to be useful for forecasting, a balance sheet must be a statement of ‘assets and liabilities’, a statement of ‘financial position’:

“The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined as follows:

- (a) An *asset* is a resource controlled by an enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.
- (b) A *liability* is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.
- (c) *Equity* is the residual interest in the assets of the enterprise after deducting all its liabilities” (para.49).

By “future economic benefits” the IASC means “the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the enterprise” (para.53). Thus ‘assets’ are expected cash inflows, and ‘liabilities’ are expected future cash outflows. Equity is therefore the residual interest in the enterprise, its ‘assets’ minus its ‘liabilities’, and profit or loss, the change in this interest during the period, is measured as the change in net ‘assets’:

“The elements of income and expense are defined as follows:

- (a) *Income* is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
- (b) *Expenses* are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or in currencies of liabilities that result in decreases in equity, other than those relating to distributions to equity participants” (para.70).

Recognition

To be consistent with the definitions of assets and liabilities as potential cash flows, management should recognise all expected cash inflows and outflows arising from past events ‘controlled’ by an enterprise. However, allowing this would clearly introduce an unacceptable level of subjective judgment into accounting. As the IASC accepts,

“In certain cases, the measurement of the financial effects of items could be so uncertain that enterprises generally would not recognise them in financial statements; for example, although most enterprises generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably” (para.34).

As the IASC says, the problem is that

“The definitions of an asset and a liability identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised on the balance sheet. Thus, the definitions embrace items that are not recognised as assets or liabilities in the balance sheet because they do not satisfy the criteria for recognition” (para.50).⁶

In other words, to prevent the recognition of such assets as internal goodwill, the IASC requires that before an asset is ‘recognised’, “the expectation that future economic benefits will flow to or from an enterprise must be sufficiently certain to meet the probability criterion” (para. 50).

“An item that meets the definition of an element should be recognised if:

- (a) it is probable that any future economic benefit associated with the item will flow to or from the enterprise; and

⁶ In other words, for the IASC and the FASB, unique in the social sciences, definitions and measurement are separate issues. Compare Edey’s view that before ‘profit’ and ‘value’ “can be conceived at all in any precise way they must be defined in such a manner that the definition contains within itself, or implies clearly, a method of calculation that could be followed in practice” (1971). The FASB/IASC definitions clearly do not do this.

- (b) the item has a cost or value that can be measured with reliability” (para.83).

However, this does not remove subjectivity. We can objectively base ‘cost or value’ on “reasonable estimates” (para.86). However, by ‘probable’ the IASC merely means a “sufficiently” low “degree of uncertainty that the future economic benefits associated with the item will flow to or from the enterprise” (para.85).⁷ In other words, for recognition as an asset an inflow merely has to appear to the management and auditors to be ‘sufficiently probable’. Similarly, “A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation” (para.91).

As the IASC accepts, these recognition criteria could significantly expand the range of assets and liabilities recognised compared with traditional accounting. For example, as the IASC says,

“In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses” (para.91).

In traditional accounting a purchase commitment does not create an asset. Until management actually purchases the use-values under the contract they are not under actual or potential control and there is no cost to recover, and do not create a liability until an enforceable obligation arises to pay for assets received or for damages for breach of contract. Similarly, as there is no enforceable obligation, in traditional accounting a decision by an enterprise to rectify faults in its products even when these become apparent after the warranty period has expired would create a provision from profits. By contrast, in the asset-liability view “the amounts that are expected to be expended in respect of goods already sold are liabilities” (Cairns, 1995, p.1687).

Income and expenses

While in traditional accounting revenues and capital gains and expenses and capital losses are different in nature, under the IASC’s definition of ‘income’ as ‘increases in economic benefits’, increases in expected cash inflows,

“Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as constituting a separate element in this framework” (para.75).

Thus, the IASC defines revenues as arising “in the course of the ordinary activities of an enterprise”. It defines gains as “other items that meet the definition of income and *may, or may not*, arise in the course of the ordinary activities of an enterprise” (paras.74-75, emphasis added). The same applies to the definition of “expenses”

⁷ We consider the IASC’s definitions of ‘cost or value’ below.

which also “encompasses losses” (para.78). From the asset-liability point of view the distinctions between revenues and gains and expenses and losses follow from their relevance for economic decision-making:

“Income and expenses may be presented in the income statement in different ways so as to provide information that is relevant for economic decision-making. For example, it is common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the enterprise and those that do not. The distinction is made on the basis that the source of an item is relevant in evaluating the ability of an enterprise to generate cash and cash equivalents in the future; for example, incidental activities such as the disposal of a long-term investment are unlikely to recur on a regular basis” (para.72).

From the traditional point of view, whether the sale of fixed assets ‘recurs’ ‘regularly’ is irrelevant to classifying their outcomes as either capital gains or losses.

And, of course, starting from the IASC’s definition of assets, for example, the definition of ‘gains’ that could be recognised is much wider than under traditional accounting. “The definition of income also includes *unrealised gains*; for example those arising on the revaluation of marketable securities and those resulting from increases in the carrying amount of long-term assets” (para.76, emphasis added). Within traditional accounting, of course, management should not recognise *unrealised* increases in assets as income. The asset-liability view also allows recognition in income of unrealised losses - for example, on foreign exchange liabilities. From the traditional point of view, increases from revaluing long-term assets and decreases in foreign currency loans from retranslation into domestic currency, are both capital maintenance adjustments.

Measurement and concepts of capital maintenance

The traditional rules of valuation specify the ‘cost or value’ required by the IASC’s recognition criteria. However, following the FASB the IASC leaves open the questions (a) whether management should measure assets and liabilities at historical cost, current cost, net realisable value or present value, and (b) whether it should use the financial or physical ideas of capital maintenance! It merely notes that management should choose the measurement bases and idea of capital maintenance to ‘balance’ ‘relevance’ and ‘reliability’ in investors’ interests:

“A number of different measurement bases are employed to different degrees and in varying combinations in financial statement.... For example, inventories are usually carried at the lower of cost and net realisable value, marketable securities may be carried at market value and pension liabilities are carried at their present value” (paras.100-101).

“The selection of the appropriate concept of capital maintenance by an enterprise should be based on the needs of the users of its financial statements. Thus, a financial concept should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invested capital or

the purchasing power of invested capital. If, however, the main concern of the users is with the operating capability of the enterprise, a physical concept of capital should be used” (para.103).

“The selection of measurement bases and concept of capital maintenance will determine the accounting model used in the preparation of financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas, management must seek a balance between relevance and reliability” (para.110).

Underlying assumptions

Although the IASC mentions the traditional postulates of the ‘accrual basis’ and ‘going concern’ as “underlying assumptions”, and ‘prudence’ and ‘consistency’ as aspects of reliability, these are barely discussed, and are therefore to be understood in terms of expected cash flows. Thus, whereas in traditional accounting the accruals basis means allocating revenues, expenses, gains and losses to the periods in which they arise, under the asset-liability approach “the application of the matching concept...does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities” (para.95). In other words, it does not allow entries for any items that are not ‘reasonably expected’ future cash flows. Thus, the IASC’s framework would prevent traditional internal provisions for reclamation, maintenance, etc., as not being ‘commitments’ for ‘liabilities’, and therefore not ‘reasonably expected’. The IASC’s framework would also disallow traditional ‘deferred charges’. A deferred charge is an asset whose value management recovers by reducing the future charge required to discharge the liability.⁸ More worryingly, as we have seen, is the many new ‘assets’ and ‘liabilities’ these definitions invite.

We have seen that from the traditional view ‘prudence’ means accounting to ‘conserve’ or ‘preserve’ the enterprise’s capital. By contrast, from the asset-liability view ‘prudence’ is “the inclusion of a degree of caution in the exercise of judgments needed in making the estimates required under conditions of uncertainty” (para.37). That is, we must be ‘reasonably cautious’ in making ‘judgments’ about expected future cash flows! As we have seen, traditional accounting says *how* management must preserve capital and *when* it must write it off or expense it. By contrast, in effect all we get from the IASC is the exhortation to be ‘cautious’ - to see to it that “assets or income are not overstated and liabilities and expenses are not understated”! However, in contrast to SSAP2, for the IASC, as for the FASB, “the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability” (para.37). In other words, in the IASC’s conceptual framework there is no ‘inconsistency’ between prudence and accruals.

⁸ A deferred charge may represent recoverable assets earmarked to discharge a particular liability (e.g., an unrealised loss on an advanced payment). Deferred charges also arise when the enterprise hands over assets before receiving a service or commodity. For example, a prepayment for electricity is a deferred asset because the enterprise has an enforceable claim for the service (or a refund) which management can only use to discharge the liabilities that will arise from consuming the electricity. It strains language to call this inflow of services a cash inflow.

Finally, as we saw earlier, the IASC defines consistency as consistently relevant and reliable, not as consistent with the facts.

Conclusion

As David Solomon's, influential past member of the FASB admitted, the idea of "economic resources" or "economic reality" that underlies the asset-liability accounting "is incapable of precise definition". Thus, using this idea it is perfectly possible that "what one observer sees as a reflection of reality may, to another observer, be a distorted view of the world" (1986, p.92). Many observers believe the major problem with the US/IASC conceptual framework is its failure to deal decisively with the issues of recognition and measurement (e.g. Solomon's, 1986, p.124; Davies, Paterson and Wilson, 1992, pp.47-49). In other words, its failure to specify precisely when management should report assets and liabilities and, if so, at what amount!

These weaknesses in its conceptual framework appear to have hindered the IASC's attempt at significantly reducing the number of options available under IAS through its Comparability Project.

The IASC's Comparability Project

In January 1989 the IASC responded to the widespread criticism that its standards gave too much choice, and it was "relying on the pressure created by the increasing globalisation of markets and the growing need for comparability of financial statements on an international scale to force the issue". With "backing...from securities commissions, financial analysts, stock exchanges and chambers of commerce" (*Accountancy*, January, 1989, p.7), the IASC launched a campaign to reduce international diversity in accounting. The first step was *E32, Comparability of Financial Statements* (IASB, 1989). This exposure draft identified 29 issues where IAS allowed alternative accounting treatments. It concluded comparability would improve by having one required or preferred treatment, having some permitted options and eliminating others. It proposed that enterprises that say they conform to IASs, but which used any of the "permitted" accounting practices, reconcile the reported net income and shareholders' interests to those they would have reported if they had used the "preferred" treatments instead.

To decide the required, preferred or eliminated accounting alternatives, the IASC used the following criteria:

- (a) current world-wide practice and trends in national accounting standards, law and generally accepted accounting principles;
- (b) conformity with the proposed IASC *Framework for the Preparation and Presentation of Financial Statements*;
- (c) the views of regulators and their representative organisations, such as the International Organisation of Securities Commissions; and

- (d) consistency within an International Accounting Standard and with other IASs.

For some issues the IASC noted a conflict between its conceptual framework, based on the US asset-liability approach, and current world-wide practice. In these cases the IASC says it chose a treatment that “follows current world-wide practice and trends rather than one that conforms most closely with the definitions of, and recognition criteria for, the elements of financial statements in that proposed Framework” (1989, para.20).

The IASC embarked on wide consultation with the preparers and users of financial statements, including IOSCO and national standard setters. It proposed using the comments on E32 to revise individual IASs, which it would then reissue, possibly after further exposure for comment (Cairns, 1989, p.25). To gain IOSCO’s approval for its accounting standards the IASC had to complete this work by the end of 1993. By December 1989 it had received a record 160 responses from more than 20 countries. E32 was generally welcomed by large multinational companies (*Accountancy*, March 1990, p.12) and by the ASC (*Accountancy*, February 1989, pp.179-192), although the ASC had a number of detailed reservations about some of its specific proposals (ASC, September 1989).

In response to the comments received on E32, in July 1990 the IASC issued a *Statement of Intent* indicating that it would press ahead with the project with the following modifications:

- It dropped the requirement for a reconciliation statement.
- It proposed calling the “preferred” option the “benchmark” option.
- It adopted 21 of the proposed changes without change, changed 3 and re-exposed for comment, and deferred 5 for further consideration.

Except for *E40: Financial Instruments*,⁹ in November 1993 the IASC approved the final revisions to the 10 IASs covering the issues in E32, which became effective from the beginning of 1995.

- *IAS2 Inventories.*
- *IAS8 Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies.*
- *IAS9 Research and Development Costs.*
- *IAS11 Construction Contracts.*
- *IAS16 Property, Plant and Equipment.*
- *IAS18 Revenue.*
- *IAS19 Retirement Benefit Costs.*
- *IAS21 The Effects of Changes in Foreign Exchange Rates.*
- *IAS22 Business Combinations.*
- *IAS23 Borrowing Costs.*

⁹ This deals with measurement of long-term investments, measurement of marketable equity securities held as long-term investments, measurement of current investments, and recognition of increases and decreases in market values of current investments in profit or reserves.

The IASC published the new standards in February 1994. *E49: Income Taxes*, was issued in December 1994. *E48: Financial Instruments* in February 1994, and *IAS32: Financial Instruments: Disclosure and Presentation* in May 1995. A standard covering recognition and measurement of financial instruments was under consideration. In June 1995 the IASC issued *E50: Intangible Assets*.

The IASC's conceptual framework: solution or problem?

The implementation of these changes in 1995 concluded the *Comparability and Improvements Project*. Many thought this meant that IOSCO's promised review could take place at the end of 1994. Many thought IOSCO would recommend that its members accept financial statements drawn up according to IASs without restatement. However, IOSCO found only 14 of the 24 standards on the IASC's agreed list of 'core' standards acceptable. Notwithstanding "strong criticism" from its outgoing chairman, IOSCO would only agree to recognise IASC standards (with the exception of *IAS7, Cash Flow Statements*), when all 24 standards were acceptable (*Accountancy*, November 1994, p.18).

In early 1995, speculation revived that the EU was reconsidering establishing its own standard-setting body. John Mug, the director general of Directorate General XV in charge of the internal market and financial services explained why. In his view, "It would not be acceptable for Europe to delegate the setting of accounting standards to the US". This was an obstacle to the acceptance of IASs as "Brussels believes the committee has drifted towards US GAAP in its recent revisions and publications" (*Financial Times* April 20 1995). Also, "Representatives of Britain's Accounting Standards Board have been disappointed with the IASC's preference for American treatments". Furthermore, "IOSCO, whose reviews of International Accounting Standards have highlighted a number of European and Japanese issues which it believes are outstanding" (David Cairns, *Financial Times* May 11 1995).

To meet these concerns, Sir Bryan Carlsberg, former UK academic, member of the FASB, and director general of the OFT, agreed to become the secretary-general of the IASC. Furthermore, it appointed Sir David Tweedie, chairman of the ASB, as part of a plan "to make the IASC stronger by including national standard-setters on the board as well as large users of accounts". These appointments appear to have been made to meet Brussels's complaint that the "IASC's code is overly influenced by...US regulators and [is] therefore unacceptable" (*Financial Times* May 19 1995). In July 1995 the IASC agreed to undertake a four-year programme to "up-grade its rule-book to the satisfaction of IOSCO and by implication the Securities and Exchange Commission". This was in return for "companies preparing their accounts according to the IASC's rules will be able to list their shares on any of the world's capital markets" including the US (*Financial Times* July 12 1995). In this context, Germany's government,

"pushed by German businesses eager to raise capital on international markets...[,] until now wary of any dilution of its own traditions of accounting[,]...said it will tolerate the use of international accounting

standards for those multinationals seeking a foreign listing” (*Financial Times* July 11 1995).

As we saw in the previous part, Japan has also implicitly accepted IASs, and the EU withdrew its threat to set up its own accounting standards committee in return for greater input into the IASC’s standard-setting process (*Financial Times* July 24th 1995). Sir Bryan Carlsberg surmised that underlying this turnaround was the EU’s recognition of the demands of the capital markets. As he put it, “global trends are conspiring to remove what had appeared to be intractable barriers. Globalisation of capital markets, and increasing competition between them, has increased demands for transportable accounts” (*Financial Times* July 24th 1995).

In August 1995 the IASC agreed a work programme with IOSCO for what it called a ‘comprehensive core set of standards’ by the middle of 1999. The IASC agreed to produce 16 standards that IOSCO would endorse as a whole if it found them acceptable. In the light of this agreement Sir Bryan said he was “cautiously optimistic” that European standard-setting was no longer on the agenda (*Accountancy*, August 1995, p.12). In September 1995 the French government announced it was to strengthen the French standard-setting process and provide for recognition of IASs, and the German government decided to allow Deutsche Telecom to prepare its accounts in accordance with US GAAP (*Accountancy*, December 1995, p.31). In December 1995 the European Commission was reported to have “bowed to pressure and abandoned its long-cherished plan to set European standards”, and as having agreed to “allow companies to prepare their consolidated accounts in accordance with international accounting standards when raising capital on international markets” (*Accountancy*, December 1995, p.13). It accepted that international capital markets did not accept accounts prepared according to European directives, and that allowing the use of IASs for consolidated accounts would avoid the preparation of two sets of accounts. The Commission became more involved with the IASC and IOSCO and the standard setting process. Its Contact Committee on Accounting Directives now included representatives from non-governmental national standard-setting bodies. It reviewed the current directives on accounting, and commented on IASC exposure drafts. However, EC Commissioner Mr Mario Monty, made it clear that “This new approach does not mean that the EU is abandoning the field of accounting harmonisation”, and that the Commission’s objective was that “companies seeking listings on the US and other world markets will be able to remain within the EU accounting framework and that US GAAP, over which they and their governments can exercise no influence, is not the only option” (*Accountancy*, December 1995, p.13).

According to Herbert Biener, for 30 years the German government’s chief voice on accounting, “In Germany there is a strong view that...Anglo-American Standards”, “should not be adopted in this country” (1994, pp.339, 340). As he said, underlying these standards was the “Sac’s capital markets approach in accounting”, i.e., the asset-liability approach that had spawned some seriously “imprudent” creative accounting in the UK. Nevertheless, a survey published in July 1995 by C&L Deutsche Revision, Germany’s second largest firm of accountants, found that 65% of German managers “expected US GAAP to become the accepted international standards of the future, rather than German principles, in spite of the fact that most are sceptical of US

accounting principles” (*Accountancy*, July 1995, p.17).¹⁰ In May 1996 Vega, Germany’s leading conglomerate, announced it was following Daimler-Benz in becoming the second German company to list on the NYSE and file its accounts according to US GAAP. Also in May 1996, possibly to head-off a stampede by European companies to US GAAP, the IASC agreed an accelerated timetable to meet its commitment by March 1998, i.e., before the adoption of a single European currency and the hoped for development of the European capital market. The IASC’s programme of work to meet its commitments to IOSCO was as follows:

IAS CONSIDERED CORE AND ACCEPTABLE TO IOSCO IN THEIR FORM AS AT 1995

IAS2 Inventories
 IAS7 Cash flow statements
 IAS8 Net profit or loss for the period, fundamental errors and changes in accounting policies
 IAS11 Construction contracts
 IAS16 Property, plant and equipment
 IAS18 Revenue
 IAS20 Accounting for government grants and disclosure of government assistance
 IAS21 The effects of changes in foreign exchange rates
 IAS22 Business combinations
 IAS23 Borrowing costs
 IAS24 Related party disclosure
 IAS27 Consolidated financial statements and accounting for investments in subsidiaries
 IAS28 Accounting for investments in associates
 IAS29 Financial reporting in hyperinflationary economies
 IAS31 Financial reporting of interests in joint ventures

IAS CONSIDERED CORE AND UNACCEPTABLE TO IOSCO IN THEIR FORM AS AT 1995

IAS9 Research and development costs
 IAS10 Contingencies and events occurring after the balance sheet date
 IAS17 Accounting for leases

IAS CONSIDERED CORE BUT ALREADY SUBJECT TO REVIEW BY IASC AS AT 1995

IAS1 Disclosure of accounting policies
 IAS5 Information to be disclosed in financial statements
 IAS12 Accounting for taxes on income
 IAS13 Presentation of current assets and current liabilities
 IAS14 Reporting financial information by segments
 IAS19 Retirement benefits costs
 IAS25 Accounting for investments

IAS NOT CONSIDERED CORE BY IOSCO AS AT 1995

IAS4 Depreciation accounting
 IAS15 Information reflecting the effects of changing prices
 IAS26 Accounting and reporting by retirement benefit plans
 IAS30 Disclosures in the financial statements of banks and similar financial institutions
 IAS32 Financial instruments: disclosure and presentation

The IASC completed this schedule on time. However, it added *IAS33: Earnings per share* and *IAS34: Interim financial reporting* (effective 1 January 1999). In April 1998, “recognizing the urgency of the matter”, it added the recognition and measurement of financial instruments (IASC, 1998, p.15). The “controversial”

¹⁰ In 1994 Bayer announced it would use IAS for its consolidated accounts. In December 1995 Deutsche Bank followed suit, and by September 1997 there were 10 German companies using IAS in their consolidated accounts.

exposure draft on financial instruments “scraped through with the minimum of 12 votes required” at the December meeting of the IASC, and two others - on events after the balance sheet date and investment properties - remained uncompleted (*Accountancy*, February 1999, p.10). IOSCO said it would go ahead without them.

The IAS on financial instruments immediately provoked an attack from UK bankers. On 14th December 1998 the *Financial Times* reported:

“UK banks will today launch an unprecedented attack on plans to harmonise international financial reporting of derivatives and financial instruments in an attempt to impose US rules that could undermine provision of long-term finance to borrowers....The outspoken attack comes as the IASC meets today in Frankfurt to agree a new standard on financial instruments and complete a core package of rules that will then be considered by IOSCO, the club of world stock market regulators.... If endorsed, the rules will govern cross-border listings for multinational companies seeking capital in the US, Canada and Japan. IASC rules are already accepted in all other leading stock markets, including London.... The IASC recently won the backing of the G7 and International Monetary Fund in efforts to forge a single financial reporting language for all companies.... The new standard is designed to increase disclosures of financial instruments and to measure them using ‘fair value’. In some cases, changes of value will be reflected in reported profits. The banks object to the use of such methods to account for non-trading activities”.

The adoption of marking financial instruments to market is a move away from traditional accounting. *Accountancy* also reported the “International banking community is up in arms over what it sees as the IASC’s attempt to impose US requirements globally, ‘especially when the measures are incoherent and continue to be heavily criticised’” (January, 1999, p.12).¹¹ The banker’s particularly disliked the non-traditional requirements to account for derivatives at fair value and to take gains and losses on hedged, non-derivative financial instruments to the profit and loss account. However, the trend was not one-way. “The G4+1, the powerful club that includes the standard setting bodies in the US and UK” proposed banning merger accounting (*Financial Times*, 15th December 1998), and the FASB has banned it (*Accountancy*, May 1999, p.8).¹² The IASB proposes banning merger accounting (ED3).

¹¹ See, for example, Macve’s criticisms of how easy management can manipulate it (*Accountancy*, May 1999, p.89).

¹² G4+1 includes the standard-setters of Australia, Canada, New Zealand, UK, and US, plus the IASC.

The battle for control of the IASC

We defer an assessment of the IASC's drift away from traditional accounting to the conclusion. First, we look at the battle for control of IAS that began again in earnest in 1998 with the prospect of IOSCO's possible acceptance of the IASC's standards. This was enhanced in October 1998 when

“a declaration by the Finance Ministers and Central Bank Governors of the G7 countries called on IOSCO ‘to carry out a timely review’ of core standards.... The G7 Finance Ministers and Central Bank Governors also committed themselves to endeavour to ensure that private sector institutions in their countries comply with internationally agreed principles, standards and codes of best practice. They called on all countries which participate in global capital markets similarly to commit to comply with these internationally agreed codes and standards” (www.iasc.org.uk/frame/cen1.htm, p.1).

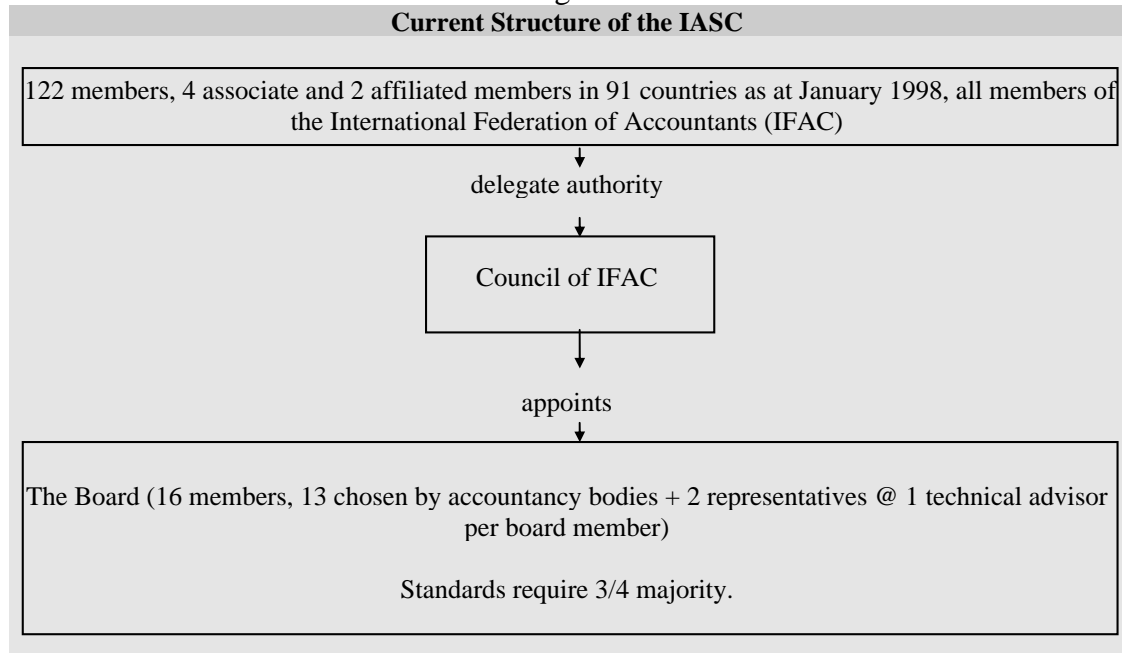
The lines of battle drawn for control of world accounting standards were around allegiance or not to the ‘capital markets approach to accounting’. That is, allegiance to decision-relevance or to accountability. Again, we argue, this shows us that the IASC's conceptual framework may ultimately be a barrier to complete international harmonisation.

The German Accounting Standards Committee (GASC) was formed in March 1998 as a private-sector standard-setter to be eligible for a seat on the proposed new IASB's Board (discussed below). Its first secretary general was Herbert Biener whose criticisms of the capital markets approach we noted above. Mr. Biener wanted the GASC to make a “contribution to the development of the core package of standards” presented to IOSCO (*Financial Times*, Thursday June 11 1998). We may judge the kind of contribution he had in mind by his view that the IASC

“will lose its chance to be accepted worldwide as a standard setter if, on demand of IOSCO, it becomes a major proponent of the SEC capital markets approach in accounting. ...The capital-market approach is not to the benefit of all interests concerned and is not approved by them. I therefore doubt whether the EEC and its Member States will be able to rely generally on IAS” (1994, p.340).

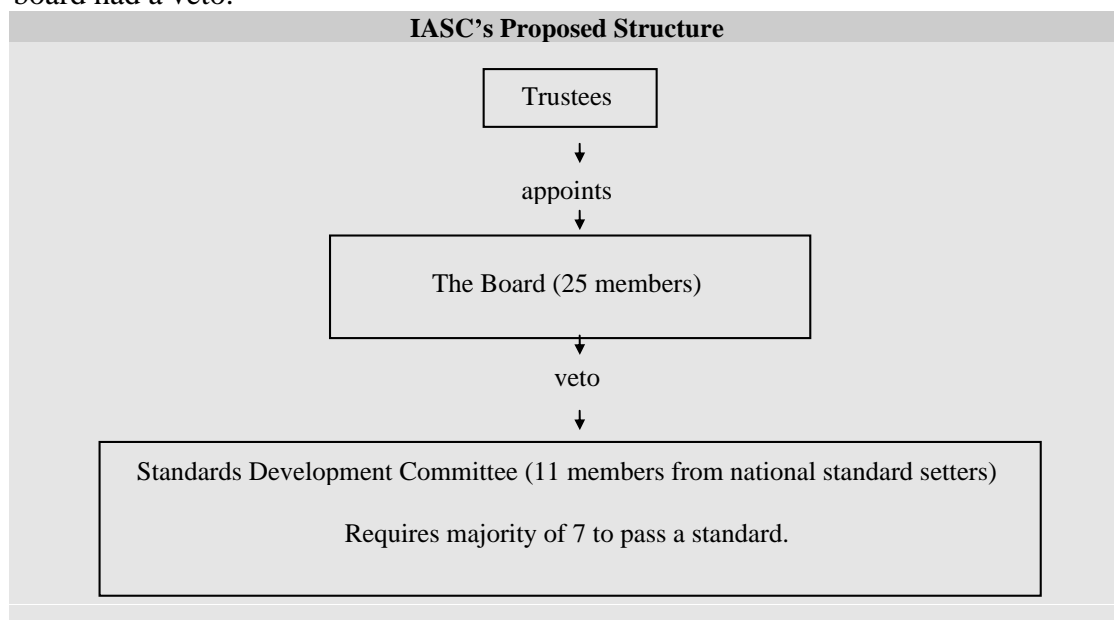
In August 1998 Mr Biener “voiced what a lot of Europeans think: ‘There is a strong need for a European standard-setter - without one it is not possible to bring IASs down to the national level because we have to follow EU directives’...”. Karel Van Hulle, head of internal markets and financial services at the European Commission supported him (*Financial Times*, August 13 1998, p.9). If a European Accounting Board's approval was required before an IAS could be enforced at national level to all companies, European standard-setters would get more say over the IASC's standards. One consequence of this, Jim Kelly of the *Financial Times* thought, was that “the IASC's capital markets approach may come under pressure from continental European accounting practice” (August 13 1998, p.9).

In December 1998 the IASC published *Shaping IASC for the Future* outlining proposals for reforming its current structure, shown below. The IASC was created by the accounting profession, not the world's national standard setting bodies, whose commitment to IAS is essential for their rigorous enforcement.



As McGregor said, “European members of the IASC Board effectively possess a veto power over IASC decisions by virtue of the present composition of the Board and the present voting thresholds” (1999, p.160).

Shaping IASC for the Future proposed expanding the Board from 16 to 25 members, and forming a separate Standards Development Committee (SDC) of 11 members of national standard setters requiring a ‘super-majority’ of 7 out of the 11 to pass a standard. Although the G4+1 standard setters would dominate the SDC, the IASC’s board had a veto.



This structure accepts the need for national standard setters to play a central role within the IASC, and EU's desire to protect the board that would have several European seats.

A number of European Board members did not want to change as they feared exclusion from the SDC as they had no independent national standard setters. However, in anticipation of its creation, "it is interesting to note the recent establishment of national standard-setting bodies in France and Germany and talk of a European Accounting Standards Board" (McGregor, 1999, p.163). The EU "want[ed] a body with political legitimacy, not one dominated by the US or with seats for former standard setters with little economic clout, like New Zealand" (*Financial Times*, 10th April 1999). Thus, under this model it would be possible that a reformed IASC board could veto standards based on US accounting, and pass standards based on 'continental European practice' and require the FASB to enforce them. The FASB opposed this 'political' element in the IASC's proposals. It wanted a completely independent standard setter, just like itself.

In response to the IASC's proposals the FASB issued *International Accounting Standard Setting: A Vision for the Future*. It argued a structurally changed IASC 'might' succeed, but floated the option of building a successor to the IASC based on G4+1 or of modifying the FASB's structure to make it more acceptable internationally (*Financial Times* January 7 1999, p.12). The latter options presumed the SEC would not approve the IASC's core standards. Given its commitment to levelling-up to US GAAP, the SEC's acceptance of IAS, if ever, was uncertain. In 1996 the SEC said that for it to accept IAS they must:

- include a core set of accounting pronouncements that constitute a comprehensive, generally accepted basis of accounting;
- be of high quality and result in comparability and transparency and provide for full disclosure; and
- be rigorously interpreted and applied (McGregor, 1999, p.,166).¹³

In its vision statement the FASB said that "A reasonably complete set of unbiased accounting standards that require relevant, reliable information that is decision useful for outside investors, creditors and others who make similar decisions would constitute a high-quality set of standards" (quoted by McGregor, 1999, p.166). In other words, for the FASB to accept IAS as 'high-quality' they must be consistent with its conceptual framework. As *Accountancy* said, some believe that focusing on "high-quality" standards is a way of cloaking the desire to impose US-style...accounting standards on the rest of the world" (October 1999, p.5).

The FASB found 255 variations between US GAAP and IAS (FASB, 1996), and there are a number of the IASs that the SEC has said it will want to amend (*Accountancy*, January 1999, p.14).¹⁴ Jim Leisenring, vice chairman of the FASB gave his 'personal' view that IASs did not make the grade as global standards (*Accountancy*, January 1999, p.16). As the *Financial Times* said, "The US financial reporting regulator has set the stage for what is likely to be a long-running battle for control of global accounting standards" (January 7 1999). However, it was at least clear that

¹³ See Leavitt (1998) for a fuller statement.

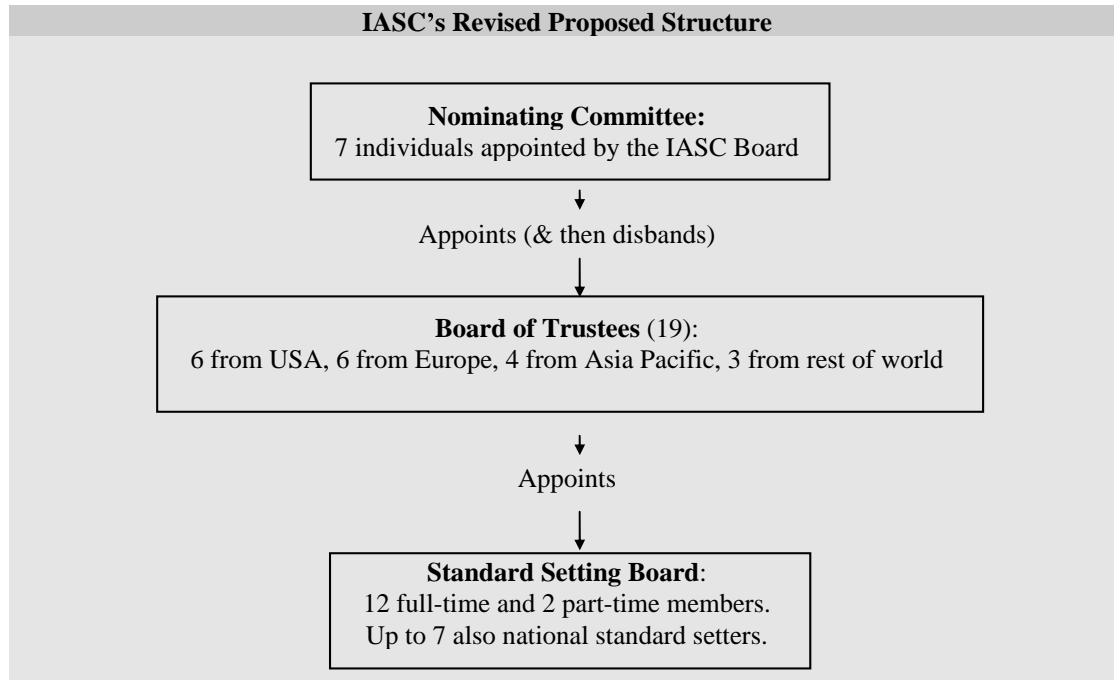
¹⁴ In April 1999 the SEC let it be known it did not think the new IAS were "sufficiently rigorous" making IOSCO's endorsement 'look elusive' (*Accountancy*, April 1999, p.14).

international accounting was central to the FASB's vision of the future (McGregor, 1999, p.164). It wanted to participate in establishing a new structure for setting and enforcing IASs. It said it would devote "substantial resources" and, if necessary, change its structure to accommodate an international constituency (*Accountancy*, February 1999, p.11).

By March 1999 the EU Commission had produced a paper outlining options for future accounting policy. The paper accepted there were too many options in the EU's directives and national inconsistencies with IAS. One option was to repeal the accounting directives and leave accounting to the market. The downside was that the accounts of the 3 million European companies that do not use the capital markets would become less comparable. Another option would be to withdraw the directives and require all companies to use IAS. The downside was the high cost of compliance with IAS. The third option, preferred by the Commission, was to keep the directives for companies who do not raise capital from public markets, and require or permit IAS for listed companies. By June 1999 political pressure from member states persuaded the Commission not to require listed EU companies to use IAS.¹⁵ The Commission promised a communication on accounting policy by the end of 1999.

At a conference in April 1999 the EU's Karel van Hulle made clear the EU's opposition to the IASC's restructuring plans. "The SDC should not be dominated by the G4", he said (*Accountancy*, May 1999). Whereas on this basis the EU supported the IASC's restructuring plans, the US objected to the IASC's proposal that the board could veto a standard agreed by the SDC. The US wanted independent standards setters chosen by their technical competence; the EU wanted the board, largely made up of standard setters, to work with the SDC in writing standards (*Accountancy*, June 1999, p.7). By August the IASC board had accepted the US proposals. Karel van Hulle responded by saying the Commission "would not be happy with a hard core of full-time standard setters able to pass standards without recourse to the wider representation of the part-time members" (*Accountancy*, August 1999, p.5). Meanwhile, the SEC vetoed the idea of part-time members, and a revision of its comparison of IAS with US GAAP convinced the FASB that IASs were not sufficiently 'high quality' (*Accountancy*, November 1999, p.5). In November the IASC board unanimously agreed what Sir Bryan called a 'compromise' that included an element of geographical representation:

¹⁵ For example, the ASB does not support voluntary use of IAS by UK companies as it believes its standards are in most cases superior (*Accountancy*, June 1999, p.6).



The EU wanted the standard setters be appointed by nationality and for the part-timers to have a veto on standards. The IASC's 'compromise' rejected both proposals. As the *Financial Times* said, "The agreement has added to suspicions in the EU that the US wants to mould global standards into a replica of its own rules" (19th November, 1999). The EU wanted the new body to represent the international capital markets and the major trading blocs. An EU official complained that the IASC had negotiated only with the US. "We were not part of that negotiation" (*Financial Times* 19th November 1999). In November the IASC announced the names of the Nominating Committee "apparently aimed at pleasing financial market regulators" (*Financial Times*, 16th November 1999). The members are president of the World bank, James Wolfensohn, the regulators from the US, France, Hong Kong and Germany, Karl-Hermann Baumann of Siemens, and Jim Copeland, chief executive officer of Deloitte Touche Tohmatsu. The IASC had talked of appointing an EU Commissioner. The EU's "Commission was reported to be dismayed" by these appointments (*Financial Times*, 6th January 2000). It had not yet formally responded to the IASC's proposals. The membership of the IASC would decide its future structure at a general meeting in Edinburgh in May 2000.

Although the IASC was steaming ahead, its future remained uncertain. While some thought it would be possible for it to rework its standards yet again if the SEC rejected them, some thought it more likely that G4 would take over as global standard setter (*Accountancy*, October 1999, p.5). As McGregor said, "Already other countries, for example Germany, have been making tentative inquiries about the criteria for admission to G4. In addition, ...the G4 has begun to act more like a standard-setting body than a discussion group" (1999, p.167). Or, as Hans Haverman, chairman of the German Accounting Standards Committee put it, "If the IASC really fails - which I do not want, but it could happen - then G4+1 is one of the options" (*Accountancy*, October 1999, p.5). If this happened, many thought, it increased the

likelihood of the EU forming a European Accounting Standards Board creating difficulties for the European members of G4+1.

IOSCO's endorsement and the 'New IASC'

On the 17th May 2000 the President's Committee of IOSCO announced its decision to "recommend that IOSCO members permit incoming multinational issuers to use the IASC core standards to prepare their financial statements for cross-border offerings and listings" (IASC News Release).

IOSCO s recommended IAS	
	Framework: Framework for the preparation and presentation of financial statements
IAS1	Presentation of financial statements
IAS2	Inventories
IAS4	Depreciation accounting
IAS7	Cash flow statements
IAS8	Net profit or loss for the period, fundamental errors and changes in accounting policies.
IAS10	Events after the balance sheet date
IAS11	Construction contracts
IAS12	Income taxes
IAS14	Segment reporting
IAS16	Property, plant and equipment
IAS17	Leases
IAS18	Revenue
IAS19	Employee benefits
IAS20	Accounting for government grants and disclosure of government assistance
IAS21	The effects of changes in foreign exchange rates
IAS22	Business combinations
IAS23	Borrowing costs
IAS24	Related party disclosures
IAS25	Accounting for investments
IAS27	Consolidated financial statements and accounting for investments in subsidiaries
IAS28	Accounting for investments in associates
IAS29	Financial reporting in hyperinflationary economies
IAS31	Financial reporting of interests in joint ventures
IAS32	Financial instruments: disclosure and presentation
IAS33	Earnings per share
IAS34	Interim financial reporting
IAS35	Discontinuing operations
IAS36	Impairment of assets
IAS37	Provisions, contingent liabilities and contingent assets
IAS38	Intangible assets
IAS39	Financial instruments: recognition and measurement

IOSCO excluded the following IAS:

IAS15	Information reflecting the effects of changing prices (non-mandatory)
IAS26	Accounting and reporting by retirement benefit plans
IAS30	Disclosures in the financial statements of banks and similar financial institutions
IAS40	Investment property

Excluding the non-mandatory framework and the above standards leaves 30 standards endorsed by IOSCO in 2000 (it accepted IAS7 in 1994).

IOSCO's endorsement of IAS was "less than wholehearted" (*Accountancy*, June 2000, p.7). IOSCO said use of IAS could be "supplemented by reconciliation, disclosure and interpretation where necessary to address outstanding substantive issues at a national or regional level" (IASC, Press Release). For example, a concept paper from the US SEC suggested it could require reconciliation of internally-generated intangible assets, the valuation of property, and for use of the true and fair override (*Accountancy*, June 2000, p.7). In "exceptional circumstances" IOSCO's resolution also "allows room for waivers of 'particular aspects' of a standard 'without requiring that the effect of the accounting method used be reconciled to the effect of applying the IASC method'" (*Accountancy*, June 2000, p.7). Some, particularly the EU Commission, feared this could allow local versions of IAS. According to the *Financial Times* "It views as disastrous a decision to allow countries a series of opt-out from global rules" (June 6 2000), seeing it as a way of the IASC allowing "the SEC to keep up the protective attitude it adopts towards its standards" (*Financial Times* June 6 2000).

A week after IOSCO's decision, the IASC pushed through its restructuring plan regardless of the EU's opposition to appointing the standards board on the basis of technical expertise rather than nationality. Many feared

"Another potential obstacle in the way of global rules [wa]s the European Commission. ...Some enthusiasts for global rules are concerned about a Commission plan to introduce an endorsement mechanism for proposed standards. They fear this could allow the Commission an effective veto on accounting standards that might prove politically difficult to apply" (*Financial Times*, May 18 2000).

A summit of the European Heads of Government held in Lisbon in April 2000 agreed to develop the European capital market as a matter of priority. The summit "acknowledged...that the adoption of a single reporting framework for the EU was a vital element in this process" (Ernst & Young, GAAP News, August 2000, p.2).

In early June 2000 in *EU Financial Reporting: the Way Forward* the EU announced its proposal to require all EU listed companies to prepare their consolidated accounts using IAS by 2005 at the latest. This proposal applies to around 6,700 EU companies of which only 275 claimed to follow IAS. As Frits Bolkstein, European Commissioner for the internal market put it, IAS "is vital because a single set of accounting standards will help to reduce the cost of capital and make EU capital markets more attractive for companies outside the EU. European accounts will be standardised and cross-border comparisons made simple" (*Financial Times*, June 14 2000). However, he added,

"To ensure that IAS enjoy the necessary legal certainty and technical approval to be made obligatory in the EU, the EU will need a mechanism to endorse, at both the political and technical level, new standards and interpretations of IAS. In this respect, European accounting experts and securities regulators have an important role to play" (*Financial Times*, June 14 2000).

Karel van Hulle summed up the EU's proposals:

“all listed EU companies prepare their consolidated accounts in accordance with International Accounting Standards by 2005 at the latest. The standards to be applied will be introduced into the European legal environment through an endorsement mechanism to be set up at EU level. It is further proposed to ensure rigorous application of the standards by improving the enforcement infrastructure. Last, but not least, the Commission proposes to update the accounting directives” (*Accountancy*, August 2000, p.108).

As David Cairns, former secretary-general to the IASC says,

“Perhaps the most controversial aspect of the regulation is the endorsement mechanisms. IASs/IFRSs will apply to EU listed companies only if they have been endorsed by a two tier endorsement mechanism that consists of:

- the Accounting Regulatory Committee which will operate at the political level under established EU rules...and will be chaired by the Commission and composed of representatives of Member States; and
- the European Financial Reporting Advisory Group (EFRAG) which is a private-sector initiative that includes users, preparers, the accounting profession and the national standard setters and which will assess IASs/IFRSs on a timely basis and provide input into the IASB’s standard setting process” (2002, p.63).

The EU has said that it will only allow companies to adopt an IAS if:

- It is not contrary to the principles of the Fourth and Seventh Directives, particularly the need for a ‘true and fair view’.
- It is conducive to the European public good.
- It meets the criteria of understandability, relevance, reliability and comparability required of financial information needed for making economic decisions and assessing stewardship of management.

The explicit, apparently separate need for stewardship means the EU has left some room for traditional interpretations of IAS.

The EU wants listed companies to use IAS by 2005 at the latest, and may extend them to non-listed companies and individuals. As the President of the ICAEW put it, “It does not seem to have been noticed how revolutionary the Commission’s proposals are. Once listed companies are complying with IAS, it will be odd for other companies to be preparing their accounts using a different set of standards, with different disclosures, different ways of measuring profit, and so on” (*Accountancy*, July 2000, p.30). The EU allows member states to require IAS for non-listed companies, and in 2001 revised the Fourth and Seventh Directives to allow companies to use the fair value accounting for financial instruments required by IAS39.

The universal application of IAS in Europe is now on the horizon, and in the view of Sir Bryan Carsberg the IASC should “look for universal accounting standards” (*Accountancy*, September 2000, p.1). That is, he thinks the IASC should now work

towards ensuring that all businesses, governments and individuals in the world use IAS. However, the problems the IASC faced in securing agreement amongst the rich industrialised countries are nothing compared with those it faces in effectively implementing IAS in the under-developed countries. These countries are barely represented on the IASC's trustees (only Brazil has a member), with the majority reserved for the US and Europe, and only two for Japan. Not surprisingly, perhaps, of the 150 or so national members only 65 from the biggest economies voted on the IASC's structural reforms (*Financial Times*, June 1 2000). Another problem is the very low quality of financial reporting in many underdeveloped countries that allows "businesses to profit at the expense of local people and international investors" (*Financial Times*, June 1 2000).

In late November 2000 a survey by PwC of 717 chief financial officers of listed companies in various states in the 15 EU members plus Switzerland overwhelmingly supported the EU's decision to require listed companies to use IAS. However, it also "revealed a split in attitudes towards Commission proposals to introduce a filter mechanism to analyse the acceptability of IASC rules on political and technical grounds" (*Financial Times*, November 27 2000). As the *Financial Time* put it, "More than half of those surveyed opposed the creation of a European version of IASC rules" (November 27 2000). In other words, something a bit less than 50 per cent of chief financial officers of major European companies *do* want a European version of IAS. The EU has said it will not 'pick and choose' between IAS but will become actively involved in creating new standards (van Hulle, 2000, p.108). It says it will only intervene when it thinks IAS "contain material deficiencies or have failed to cater for features specific to the EU environment" (*Financial Times*, July 6 2000). As national standard setters will have no role under the IAS/EU proposals, in a few years we will be left with the EU as the only European standard setter facing the FASB/SEC in the US. Who will give way is unclear.

Of possibly great significance,

"Major changes, potentially very significant, are also taking place in the USA. The collapse of Enron and subsequent further 'scandals' have shaken the complacency of American regulation to the core. Early accusations against Enron did not accuse the company of not following US GAAP, merely of following it in an inappropriate manner" (Alexander, Britton and Jorissen, 2003, p.46).

"In the USA the credibility of US GAAP was damaged in the Enron scandal. Highly prescriptive standards were shown to be ineffective and even the SEC started talking about preferring principles-based standards in the style of IFRS" (Raffournier and Walton, 2003, p.42).

While some, particularly the IASB and the EU have blamed the US desire for ever more detailed rules and argued that statements based on general principles would be better, it is arguable that Enron's accounts *were* based on 'general principles', those of asset-liability accounting, that allowed it to follow US rules in an 'inappropriate manner' (Bryer, 2002).

So far the SEC has refused to accept accounts based on IAS instead of accounts based on US GAAP. Foreign companies using IAS must reconcile earnings and equity to US GAAP. The IASB and the FASB have, in the 'Norwalk Agreement' agreed to converge their standards, but where this will lead is unclear.

Conclusions

The IASC's Comparability Project narrowed choice in IASs, and in some ways shifted IAS towards traditional accounting and its emphasis on accountability. The process of tightening up and reducing options continued with the review of core standards found unacceptable by IOSCO, with a number of further moves towards traditional accounting. For example, the new stress in IAS1 on the need for accounting policies to improve comparability. IAS17's requirement for lessors to use the net investment method for income recognition thus banning the more flexible net cash investment method. IAS23's benchmark requirement for all borrowing costs to be charged to expense in the period incurred. IAS14's definition of reporting segments according to the organization's internal reporting structure, and the recent proposal to ban merger accounting. Accountability, however, is not the objective of the IASC's conceptual framework, and in other areas it has introduced asset-liability accounting (see, IAS22, IAS37, IAS38 and IAS32 and IAS39). Which tendency will win? While the EU is in a weak political position to reject IAS (Haller, 2002), the answer must depend in part on the real objective of international harmonisation.

Is the real objective of the international capital markets to improve the informational efficiency of the international capital markets, or is it to improve the level of accountability of management from countries with conservative and secretive accounting systems? We argue in chapter 4 that the evidence supports the latter hypothesis. We provide further support in chapter 5 where we show that we cannot explain differences in accounting by differences in 'culture', but only by differences in systems of accountability or 'corporate governance'. This conclusion is important, not least because different views of the objective of harmonisation underlies the divergence of view between the IASC and those who complain that "the IASC is under Anglo-Saxon influence", under the "view of accounting as oriented towards the [decision] needs of capital markets". Many in Europe and elsewhere in the non-Anglo-Saxon world apparently believe that the "priority given to the Anglo-Saxon conception of accounting is probably a major obstacle to the development of the influence of the IASC". Thus, at the level of the individual firm, it may be that "Countries belonging to other traditions (Germany, France, Japan) will not agree to align their standards with IAS if they cannot make their own views heard more effectively" (Raffournier, 1998, pp.36-37).

In chapters 6 to 11 we take traditional accounting as the 'benchmark' against which to judge progress towards the international harmonisation of accounting. Our fundamental question is to what extent the accounting regulations and practices of the world's major economies produce accounts showing a 'true and fair' view? There are significant differences in disclosures, and some clear deviations from traditional accounting. However, we shall see that there is wide acceptance of the traditional model itself, and there has been significant progress towards its more rigorous application in the key erstwhile conservative countries.

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