Chapter 8—International Accounting Harmonization

Harmonization is the process by which differences in financial reporting practices among countries are reduced with a view to making financial statements comparable and decision-useful across countries. Improving comparability enhances international capital flows and reduces the cost of preparing financial statements for MNCs. Accounting regulation harmonization and accounting practice harmonization are often called formal harmonization (or de jure harmonization) and material harmonization (de facto harmonization). Material harmonization refers to harmonization between practices irrespective of whether or not the practices are influenced by regulations.

Accounting harmonization has four essential aspects:
Rationale for Harmonization

The primary economic rationale in favor of harmonization is that major differences in accounting practices act as a barrier to capital flowing to the most efficient users.

Among those who oppose harmonization, there are some who consider it to be unnecessary and others who even view it as being harmful. Opponents argue that full harmonization of international accounting standards is probably not practical nor truly valuable. Investors and issuers can make investment decisions without the presence of international accounting standards. Another argument against the need for harmonization is that investors are rational enough to spend the necessary time and money to correctly analyze investment opportunities and focus on real economic results.

Opponents also cite

Horau considers the current harmonization process to be aimed at conformance to the Anglo-Saxon accounting model and its focus on the stockholder as the primary stakeholder. While most developed countries such as France have the political will and clout to act in their perceived national interest including in the arena of accounting harmonization, a number of industrializing and economically developing countries lack the resources to develop their own standards. The concern is that these developing countries might adopt IAS in an effort to gain global respectability for their financial reporting without considering whether these standards are suitable for their economies. Critics have portrayed harmonization as a form of colonialism with the accounting standards of the developed countries becoming the de facto standards regardless of whether they are suitable for developing nations.
Pressures for Harmonization

Current pressures to harmonize are

**Investors**
The surge in cross-border securities listings has increased the number of investors who use financial reports of foreign firms. Since accounting standards are still determined on a nation-by-nation basis,

**MNCs**
Much of the new foreign investment by MNCs occurs in developing nations, which may have very different accounting regimes from developed nations. This results in MNCs having to devote greater resources to preparing consolidated financial statements due to the differences between financial reporting in their domiciles and those in the foreign nation in which the new investment is taking place. MNCs can reap additional benefits from harmonization such as the reduced cost of preparing consolidated financial statements, ease in monitoring subsidiaries abroad, more meaningful managerial accounting reports, and more relevant performance evaluation methods with harmonization than without it.

**Regulators**
While one way of coping with this might be to simply require foreign firms to provide financial statements that conform to the host country's requirements, there is considerable debate as to the wisdom of this approach.
Securities Industry and Stock Exchanges

Another aspect of the dramatic increase in cross-border listings has been that many stock exchanges now look to foreign companies for much of their growth in listings and the volume of securities transactions within their markets. Since there is evidence which suggests that accounting differences impose costs on companies seeking to list abroad, it is not surprising that stock exchanges and other securities industry participants have been strong supporters of accounting harmonization.

Developing Countries

A number of nations are attempting to switch to market-oriented economic policies. To attract foreign capital, they are often called upon to implement accounting standards that inspire confidence in foreign investors. Few of these countries have the time or the economic resources to devise accounting standards from scratch. Drawing upon IAS can save them the time-consuming task of coming up with their own standards.

Obstacles to Harmonization

There remain a number of obstacles to global accounting harmonization which have thus far prevented it from becoming a reality.

Nationalism represents a political obstacle to harmonization. Countries are wary of ceding control of their accounting regulation to outsiders, particularly if it is perceived as replacing their own accounting regulations with those of other nations. It helps if the external standards originate in a supranational organization such as the IASB since it is politically more palatable for nations to adopt international standards rather than the standards of another nation.
Another political obstacle to harmonization is

Other obstacles to harmonization include the divergence between the needs of MNCs and smaller businesses in developing nations, difficulties in coordinating change among the large number of IASB members, and emotional resistance to change proposed. The fact that there are significant differences between MNCs, who primarily report to investors and creditors, and smaller businesses whose primary audience tends to be regulators and other stakeholders has been an obstacle to international harmonization.

There is a view that accounting standards that are primarily designed for behemoth MNCs are not relevant nor cost effective for use by smaller firms. The degree of harmonization attainable is thus contingent on the limited ability of member bodies to see that ISAB standards are adopted within their own country.

Another obstacle to harmonization is emotionalism. An example is Germany's opposition to accounting for inflation on the grounds that it institutionalizes inflation.

Measuring Harmonization

Accounting scholars draw a distinction

Accounting scholars also distinguish between harmony and uniformity, which are states, and harmonization and standardization, which are processes.
Supranational Organizations Engaged in Accounting Harmonization

The IASC is an independent private sector organization that was established in 1973 by professional accounting organizations from ten countries. Over the past 25 years, the IASC has evolved into the most prominent international accounting standard-setting organization.

The IASC’s early standards were criticized for being too broad and allowing too many alternative accounting treatments. Critics charged that as a result comparability was lacking in financial statements that claimed to be in compliance with IASC standards.

Since the IASB lacks the authority to enforce its standards globally, it has sought the backing of IOSCO for its standards in nations that are members of IOSCO. In an effort to gain acceptance of its standards by securities regulators, the IASB has adopted a work plan to produce a comprehensive core set of standards. The work plan is referred to as a “core standards” program.

International Federation of Accountants

IFAC is a body of national professional accounting organizations that represent accountants employed in public practice, business and industry, the public sector, and education, as well as some specialized groups that interface frequently with the profession.
International Organization of Securities Commissions

IOSCO was formed in 1983 and is comprised of securities regulators from more than 115 securities regulatory agencies from around the world, representing coverage of 85 percent of the world's capital markets.

Recent Efforts Toward Harmonization

Recently, the progress toward attaining a global financial reporting framework has accelerated, and many significant steps have been taken. The most important step is the formation of the IASB, which replaces the IASC, as part of a comprehensive restructuring of the international accounting standard-setting organization. At the end of 1999, the IASC completed the set of "core" IAS required in its agreement with IOSCO and they were accepted as the basis for cross-border filings of registration statements and listings of securities exchanges by IOSCO in May 2000. The IASC was replaced by the IASB in March 2001.

The IASC's work on the core standards was geared toward global harmonization and the project dramatically reduced the number of differences between IASs and US GAAP from the 255 items detailed by FASB in 1994.

During the development of the core standards, FASB began its movement toward international convergence with the issuance of SFAS 128—Earnings Per Share which was designed to be similar to IAS 33. The harmonization effort has continued in the US since the issuance of the core standards.

The SEC took a major step in defining its leading role in securing the globalization of financial reporting when it issued its Concept Release in Feb. 2000. In
this release, the SEC states that it is increasing its involvement in a number of forums to develop a globally accepted, high quality financial reporting framework.

More importantly, the concepts release moves beyond the current issue of accepting IAS to focus on the infrastructure required to support a global financial reporting framework in the long run.

The primary elements required for an infrastructure for IASs includes:

The restructuring of the IASC culminated in March 2001 when the IASB assumed the responsibility of its predecessor. IASs issued by the IASC are effective until superseded and that the international accounting standards will now be known as International Financial Reporting Standards (IFRS).

The restructuring plan clearly addresses five of the six characteristics identified by the SEC in its Concept Release as necessary in a high quality standard setter. The notable shortfall is in oversight. The IASB lacks the resources and the legal authority for effective enforcement actions.

US regulators frequently experience enforcement problems with the foreign subsidiaries of US multinationals.
The most significant holdouts to convergence prior to 1998 were the US, UK and Japan. While the US still has not accepted most IFRSs without reconciliation, the US has been heavily invested in the restructuring of the IASB. The primary impediment to full US acceptance of IFRSs is the SEC’s concern with oversight.

Has the SEC’s concern about oversight lost any of its force in light of the Enron and WorldCom scandals?

**Harmonization Scenarios**

Bilateral or mutual agreements consists of two or more nations negotiating agreements which involve mutual recognition of each other’s standards with certain additional disclosures or reconciliations as part of the arrangement. The Multijurisdictional Disclosure System (MDS) is a bilateral agreement negotiated between the SEC and Canadian regulatory authorities. The MDS was created to

The immediate elimination of the requirement to reconcile Canadian GAAP financial statements to US GAAP for investment grade debt and preferred stock but not common stock for eligible Canadian firms was supposed to be another source of cost savings to firms. The MDS became effective July 1, 1991, after six years of often difficult negotiations. The actual evidence since its passage indicates that it falls short of being perceived as facilitating entry or reducing costs for Canadian firms. Since very few Canadian firms list securities other than common stock in US markets, most Canadian firms are still subject to the requirement to provide a reconciliation to US GAAP (Form 20-F).
World Class Issuer

This harmonization scenario is primarily advocated by the NYSE. It involves establishing specific quantitative criteria to define a special category of companies as "world class issuers." Non-US companies that qualified as world-class issuers would be permitted to register securities with the SEC using their home nation financial statements without the need for a reconciliation to US GAAP.

IASC/IOSCO Initiative

One of the last major hurdles to global acceptance of IAS or IFRS is their endorsement by IOSCO which, in turn, is largely dependent on the SEC's acceptance of IAS/IFRS. Despite this hurdle, convergence is already taking place with countries such as France and Germany already accepting IASs not just for foreign firms but also for domestic companies. Only the US, Canada, and Japan do not allow IASs for cross-border listings.

In the long term the US cannot afford to be the only nation not accepting IASs. As other capital markets become more globalized, there is less need for firms to list on US exchanges. Firms are increasingly able to tap US capital and increase their investor base in the US without having to list on US exchanges.

Some argue that the IASB has a ways to go before becoming the global standard setter. One argument relates to the quality of IASs. Critics argue that the IASB is sacrificing quality for the sake of convergence and that IASs do not make the grade as global standards. Critics also contend that a global standard setter needs to be a full-time, independent, technically skilled decision-making body with adequate due process, staffing and funding.

Current Evidence on Harmonization

Global

There has been very little empirical research that measures the success of harmonization at the global level. There is some anecdotal evidence which suggests that there has been a surge in de jure harmonization globally in the past 12 years. One measure of this is the number of stock exchanges that accept financial statements prepared using IASs in lieu of the stock exchange's domestic standards. Over 35 stock exchanges now accept IAS-based financial statements instead of domestic-based
statements. It may be more appropriate to examine accounting practices de facto rather than accounting regulations to get a true measure of the level of harmonization.

The IASB is aware of more than 500 firms from over 50 nations (many Swiss and German firms) that cite their use of the IASB's standards. This still represents a fairly small fraction of the universe of companies in IASB member nations. A recent study by Street, Gray, and Bryant (1999) provides evidence indicating that among firms that claim to prepare their financial statements in accordance with IASs, the actual level of compliance is rather sketchy. It appears that auditors

Garrido, Leon, and Zorio (2002) provide one of the few empirical studies available on the acceptance and progress of IASs (or harmonization progress). Three different stages can be identified in the harmonization strategy followed by the IASB. During the first phase from 1973 to 1988, the IASC issued 26 generic standards, allowing multiple options and prescribing only minimal disclosures. In 1988, the IASC became concerned about the comparability levels reached with IAS. This marked the beginning of a new phase, that is, the second stage, from 1989 to 1995. The IASC reviewed
This study focuses on the IAS without considering whether such treatments are accepted or not by other regulatory authorities, such as stock exchanges worldwide. The results indicate there has been a substantial reduction of alternative treatments with regard to development costs, construction contracts, income taxes, and revenues. An improvement has also been seen in research costs, postemployment benefits, and borrowing costs. This study also points to the need for the IASB to continue working towards greater formal harmonization, extending its standard-setting concerns by issuing new standards that address the projects on its current agenda (e.g., insurance, extractive industries, emerging markets, and discounting).
Another study compared harmonization of accounting regulations and accounting practices of Australia and New Zealand. These two nations are consciously pursuing a program of harmonization on their own. The study results highlight several points:

1. Firms with different characteristics (e.g., large vs. small firm) will adopt different disclosure and measurement practices.

2. A positive association between the level of practice harmony and regulation harmony for both mandatory disclosure and mandatory measurement.

3. Practice harmony is lower when there is less regulation harmony.

4. Size and ownership concentration seemed not to be associated with practice harmony for mandatory disclosure but were associated with voluntary disclosure. Overall, the association between firm characteristics and practice harmony is higher for voluntary items than for mandatory items.

5. The number of subsidiaries was negatively associated with practice harmony.

One implication of this study is that caution needs to be exercised in aiming to achieve practice harmony through regulation harmony. Regulators cannot overlook firm specific characteristics in harmonizing accounting standards.

Another group of researchers looked at the level of harmonization in accounting measurement practices among eight members of the EU. They found that accounting for foreign currency translation of assets and liabilities, treatment of translation differences, and inventory valuation are harmonized while accounting for fixed asset valuation, depreciation, goodwill, research and development costs, inventory costing, and foreign currency translation of revenues and expenses remain diverse. They also found some evidence that there is greater harmonization among fairness-oriented countries than among legalistic countries. This type of evidence is one reason why the EU nations agreed to require the IAS for consolidated financial statements by 2005.

In the US, there has some discussion about introducing competition into the accounting standard setting process by allowing individual corporations to issue financial reports prepared in accordance with either IASB or FASB rules. The reasons for supporting the status quo are:
Arguments in favor of competition between the two sets of standards are: