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Development of the International Financial Reporting Standard

By Ravi Kumar

Abstract

International convergence of accounting standards is not a new idea. The concept of convergence first arose in the late 1950s in response to post World War II economic integration and related increases in cross-border capital flows.

Initial efforts focused on harmonization—reducing differences among the accounting principles used in major capital markets around the world. By the 1990s, the notion of harmonization was replaced by the concept of convergence—the development of a unified set of high-quality, international accounting standards that would be used in at least all major capital markets.

International Financial Reporting Standards (IFRS) is a set of accounting standards developed by an independent, not-for-profit organization called the International Accounting Standards Board (IASB).

The goal of IFRS is to provide a global framework for how public companies prepare and disclose their financial statements. IFRS provides general guidance for the preparation of financial statements, rather than setting rules for industry-specific reporting.

History of Standards

The International Accounting Standards Committee, formed in 1973, was the first international standards-setting body. It was reorganized in 2001 and became an independent international standard setter, the International Accounting Standards Board (IASB). Since then, the use of international standards has progressed. As of 2013, the European Union and more than 100 other countries either require or permit the use of international financial reporting standards (IFRSs) issued by the IASB or a local variant of them.

The FASB and the IASB have been working together since 2002 to improve and converge U.S. generally accepted accounting principles (GAAP) and IFRS. As of 2013, Japan and China were also working to converge their standards with IFRSs. The Securities and Exchange Commission (SEC) consistently has supported convergence of global accounting standards. However, the Commission has not yet decided whether to incorporate International Financial Reporting Standards (IFRS) into the U.S. financial reporting system. The Commission staff issued its final report on the issue in July 2012 without making a recommendation.

The following is a chronology of some of the key events in the evolution of the international convergence of accounting standards.

- The 1960s—Calls for International Standards and Some Early Steps
- The 1970s and 1980s—An International Standard-Setting Body Takes Root
- The 1990s—The FASB Formalizes and Expands its International Activities
- The 2000s—The Pace of Convergence Accelerates: Use of International Standards Grows Rapidly, the FASB and IASB Formally Collaborate, and the U.S. Explores Adopting International Accounting Standards

Need of Standards

Having an international standard is especially important for large companies that have subsidiaries in different countries. Adopting a single set of world-wide standards will simplify accounting procedures by allowing a company to use one reporting language throughout. A single standard will also provide investors and auditors with a cohesive view of finances.

The International Accounting Standards Board (IASB) was established in 2001 and is the independent standard-setting body of the IFRS Foundation, an independent, private sector, not-for-profit organisation working in the public interest. Its principal objectives are:

- to develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted international financial reporting standards (IFRSs) based upon clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and other users of financial information make economic decisions;

- to promote the use and rigorous application of those standards;
- in fulfilling the objectives associated with (1) and (2), to take account of, as appropriate, the needs of a range of sizes and types of entities in diverse economic settings; and
- to promote and facilitate adoption of IFRSs, being the standards and interpretations issued by the IASB, through the convergence of national accounting standards and IFRSs.

The governance and oversight of the activities undertaken by the IFRS Foundation and its standard-setting body rests with a geographically and professionally diverse body of Trustees, who are also responsible for safeguarding the independence of the IASB and ensuring the financing of the organisation. The Trustees are publicly accountable to a Monitoring Board of public authorities. The IASB is an independent group of experts with an appropriate mix of recent practical experience in setting accounting standards; in preparing, auditing, or using financial reports; and in accounting education. Broad geographical diversity is also required. Members are appointed by the Trustees through an open and rigorous process that includes advertising vacancies and consulting relevant organisations. The IASB has 14 full-time members. The IASB develops and maintains a set of accounting requirements collectively referred to as International Financial Reporting Standards (IFRSs). IFRSs are a set of high quality, understandable, enforceable and globally accepted Standards based up on clearly articulated accounting principles. The IASB has no authority to impose those Standards. However, entities that wish, or are required by a particular jurisdiction, to assert compliance with IFRSs must comply with all of the individual IFRSs (Standards) and IFRS Interpretations (Interpretations) issued by the IASB. The individual IFRSs and Interpretations that comprise the collective IFRSs are 41 Standards (issued as at 1 January 2014: 13 IFRSs and 28 International Accounting Standards developed by its predecessor, the IASC, and adopted by the IASB) and 25 current IFRIC Interpretations (17 developed by the IFRS Interpretations Committee (formerly the International Financial Reporting Interpretations Committee) and 8 developed by its predecessor, the Standing Interpretations Committee). IFRSs generally contain principles and accompanying application guidance, both of which are mandatory and carry equal weight. Some

Standards also include illustrative examples or implementation guidance, neither of which is part of IFRSs. They are therefore not mandatory. Each Standard and Interpretation has a basis for conclusions that explains the IASB's reasons for developing the particular requirements. The basis for conclusions is not part of IFRSs and is therefore also not mandatory. Additionally, the IASB has a Conceptual Framework for Financial Reporting (the Framework). This Framework is designed to help the IASB develop IFRSs. The Framework is also designed to help those applying IFRSs address matters not covered by IFRSs. However, the Framework is not a Standard and the accounting requirements in an IFRS take precedence over the Framework. The IASB develops IFRSs in the public interest. Through the IASB's due process, it consults and engages with investors, regulators, business leaders and the global accountancy profession at every stage of the process, whilst maintaining collaborative efforts with the worldwide standard-setting community. In developing IFRSs and Interpretations the IASB publishes and seeks public comment on Discussion Papers and Exposure Drafts. Those documents are not part of IFRSs. The IFRS Interpretations Committee is the interpretative body of the IASB. The Interpretations Committee has 14 voting members appointed by the Trustees, and its members are drawn from a variety of countries and professional backgrounds. The Interpretations Committee's mandate is to review on a timely basis widespread accounting issues that have arisen within the context of current IFRSs and to provide authoritative guidance (IFRIC Interpretations) on those issues. The Interpretations Committee also develops proposals for narrow scope amendments to IFRSs on behalf of the IASB. In developing Interpretations and narrow scope amendments, the Interpretations Committee follows a transparent, thorough and open due process. However, it is the IASB that issues Interpretations and narrow scope amendments and the IASB that considers and votes on each Interpretation and narrow scope amendment before it is issued. As well as IFRSs, the Board has issued IFRS for SMEs, to meet the needs and capabilities of small and medium-sized entities (SMEs) and users of their financial statements. Any company of any size is eligible to use the IFRS for SMEs, provided it does not have public accountability. An entity has public accountability if it is publicly traded, or if it is a financial institution or similar entity. The IFRS for SMEs is based on IFRSs but is much less complex.

What are the new standards and how have they evolved?

International Financial Reporting Standards (IFRS) were developed by the International Accounting Standards Committee (IASC) and its successor organization, the International Accounting Standards Board (IASB). Because of the standards' identification with these bodies, IFRS is sometimes referred to as IAS GAAP. A note about terminology: Generally Accepted Accounting Principles (GAAP), either U.S. or IAS, are a set of documents that specify the accounting principles and guidelines that companies use to prepare their financial statements, which are the main way companies communicate with their investors and other stakeholders. GAAP documents give guidance on what component statements should be shown within the published financial statements, how the figures in the financial statements should be calculated, and what notes and additional details should be included.

Although it seems like a major step to replace one set of accounting principles with another, it should be noted that any GAAP is a constantly evolving set of principles. Over the last 10 years, U.S. GAAP has seen complete rewrites in the accounting for mergers and acquisitions and in the accounting for derivatives and hedges, as well as major changes in 28 other areas.

Will the Roadmap Happen?

The SEC has been fairly aggressive in pursuing a convergence agenda thus far. Since November 2007, the SEC has allowed foreign firms to report under IFRS only, without requiring any U.S. GAAP adjustments, a move estimated to have saved affected firms as much as 2.5 billion Euros over time. To be fair, requiring foreign firms to supply less data is never going to foment much opposition. The next stage actively compelling U.S. firms to change their reporting method will be more difficult to achieve.

For investors, the new standards will require an adjustment in how they interpret earnings numbers. For government, it will require ceding some regulatory power to an international body. The gain will be improved access to international capital; however, this is no benefit to the many smaller firms uninterested in international capital, which, in any case, is a difficult benefit to quantify. Adopting IFRS will also require businesses to conduct a one-off reworking of accounting records (at an administrative cost), and it may increase corporate tax payments, due to the "last in, first out" (LIFO) conformity rule, which will be discussed below. Companies with multinational operations will benefit by saving on the ongoing costs of annually converting their foreign reports to U.S. GAAP, but purely domestic companies will have no such countervailing benefit.

With many participants in the process quite committed, change looks more likely than not. But the political process, including the forthcoming general election, may delay or even halt the transition. The SEC’s roadmap includes one obvious “get out” clause: the commission will decide in 2011 whether convergence is “in the public interest and would benefit investors.”[2]

How Will IFRS Differ from U.S. GAAP?

Principles over Rules

IFRS is characterized as more “principles based” than U.S. GAAP, which is seen as largely “rule based.” However, it should be noted that any GAAP is, by definition, a set of principles. U.S. GAAP gives substantial discretion to managers in determining the assumptions behind their accounting statements, even on such basic items as depreciation timescale and inventory costing methods, decisions that can influence annual income by hundreds of millions of dollars for large firms.

The age of U.S. GAAP (resulting in a larger body of policy than that of the younger international accounting standards organizations) and the voracious appetite of U.S. accounting practitioners for official guidance and clarifications of standards (principally as an insulation against liability in the highly litigious United States) are responsible for much of the rule-based characteristics of U.S. GAAP. If IFRS is adopted in America, the demand for guidance will likely not abate. As companies seek guidance on specific situations, standard-setters may feel pressured to expand the IFRS rulebook, thus eroding its principles-based nature. It may also create additional demand for accountants and accounting experts.

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