Content available at: https://www.ipinnovative.com/open-access-journals

Journal of Management Research and Analysis

Journal homepage: https://www.jmra.in/

Original Research Article

Convergence of accounting, problems and progress

R.K. Srivastava[1,*]

[1]*Imperial School of Agricultural Business (ISAB), Uttar Pradesh, India*

ARTICLE INFO

Article history:
Received 10-10-2023
Accepted 18-11-2023
Available online 25-11-2023

Keywords:
Convergence
IFRS
IASB
FASB
Inventory
Leasing

ABSTRACT

Today's economies depend on cross-border transactions and free international flow of capital. These capital allocation decisions require assessment of company's value. Financial reports are integral and fundamental to such a valuation exercise. However, because of different legal political and economic systems, measurement, analysis, and reporting of many business and financial transactions is country specific. Differences in accounting rules and principles add cost, complexity, and risk for both the companies preparing financial statements and the investors making economic decisions. Such differences complicate comparison of accounting statements prepared under different regimes. This article approaches the problem from two perspectives. The historical perspective helps understand the evolution of accounting into an important business tool and the need to have common accounting practices across the globe. The second perspective looks at the progress made till date to achieve convergence and important areas of economic activity where differences exist. The findings have been arrived at with the help of an in-depth review of available literature. They help conclude that the much sought after convergence is still work in progress as there are large number of economic activities whose accounting treatment differs in different areas of operation.

1. Introduction

The establishment of the Institute of Chartered Accountants of Scotland in the 1880s brought a paradigm shift to the way the language of accounting was perceived and used by fund providers and other stakeholders. Audited results of companies by qualified members of the Institute were more trustworthy than ever before. During those times, large single product companies were the order of the day. The era was witness to a second wave of industrialisation, accompanied with a new group of innovations like the use of assembly lines and mass production, the electrical grid systems, the manufacturing of machine tools, the production of steel etc. Large scale manufacturing was carried out in steam powered factories with the help of advanced machinery. For this to be possible, companies required large capital investments , funds for which were frequently raised from the well-established stock markets by issue of fresh equity or otherwise through the taking of long-term loans from bankers or the general public.

The newfound credibility because of audit led to the increased use of accounting results by both prospective lenders and shareholders when deciding to lend or buy. Audited financial results were directly affecting share prices. Financial accounting was playing a major role in determining market capitalisation. The relation between the audited bottom line, share price and the loan appetite led to the increasing importance and relevance of this business language.[1] Soon accounting in different countries was being administered and managed by laws which were made according to the needs of the countries business

* *Corresponding author*.
E-mail address: concepts.rajeev@gmail.com (R. K. Srivastava).

https://doi.org/10.18231/j.jmra.2023.040

environment. These laws would frequently be country specific and suffice for the requirements of that country. However, when domestic companies started becoming international, differences in accounting practices in different areas of operations started impairing decision making. This change in business environment highlighted the need of convergence of accounting.

1.1. Convergence – A historical perspective

Differences in accounting practices existed even in those countries which had active share markets through which listed companies would finance their CAPEX. For example, post-world war 2, the UK Australia and New Zealand allowed the revaluation of property plant and equipment in the balance sheet while the US and Canada did not. Instead, laws in these countries required the use of historical cost.[2] Similarly, the US allowed for the use of last in first out method for inventory valuation whereas Canada allowed this only in specific industries.[3]

Unlike the developed ,developing countries like India and China had minimum disclosure requirements. Most of the times such requirements were the same as provided by the colonial masters. In India the Institute of Chartered Accountants of India was established by a parliament act in the year 1949 however it took more than 25 years to have an Accounting Standard Board whose primary responsibility would be of issuing Accounting Standards which would define accounting practices in India.

The 1950s saw the growth of international trade and foreign direct investment as companies started doing business in countries other than their origin. Country specific accounting laws would frequently have different measurements and disclosures requirements in different countries. Users of financial information had trouble gauging the financial position of foreign companies because the accounting rules were different.[4] Without a standard set of rules, the playing field was unfair, and not all scorecards reported the same thing. Consider the following scenario,

ABC Limited manufacturers rectifiers and has two similar plants in countries X and Y. The currencies and conversion costs of both countries have absolute purchasing power parity (APPP) and both plants carry the same amount of opening inventory worth $2 million each. This amount of raw material is sufficient to make 2 million rectifiers. Subsequently, inventory to manufacture another 4 million rectifiers is purchased in two batches. Both batches contain equal quantities of raw material. The first batch costs $4 million whereas the second one comes at $6 million. During the year both plants manufacture and sell 5 million rectifiers. However, the plant in country X has reported $200000 higher before tax profit than the plant in country Y. Why?

The $200000 difference happens because of different methods adopted for inventory valuation. The accounting practices in country X allow the use of FIFO (First in First Out) whereas the accountant in country Y has used LIFO (Last in First Out) for inventory valuation.

Assume further that plants in country X and country Y have incurred research and development (R&D) cost of $500000($ 300000 for research $ 200000 for development). Whereas in country X, accounting laws allow the development cost to be capitalized over 10 years' time , laws in country Y require it to be expensed. This further increases the profits earned in country X by another $ 180000.

The $380000 difference in the reported profits could easily mislead any stakeholder into believing that the plant in country X has performed better than the plant in country Y. This misunderstanding would not have happened if both countries had similar rules and principles for accounting inventory and development expenditure.

As shown in the above example, the emergence of multinational companies highlighted the difficulties in comparing and consolidating financial results of parents and subsidiaries operating in different regimes having country specific accounting practises. In 1962 the American Institute of Certified Public Accountants (AICPA) launched an International Congress of Accountants with a view to investigate the accounting and auditing practices across the globe. Two years later, in 1964 the AICPA issued a booklet containing accounting practices in 25 countries. This was possibly the first attempt globally to look at accounting practices in different countries under a single umbrella.

2. Facilitating Convergence

Another development which happened almost simultaneously was the establishment of the Financial Accounting Standards Board (FASB) in the USA. Today the FASB along with SEC (Security Exchange Commission) is responsible for setting and enforcing all accounting laws for publicly listed companies in its country. These are known as the US Generally Accepted Accounting Principles (US GAAP).

It was understood early that the strong legal environment prevailing in almost all European and Anglo-American countries plus Japan would help multiply the benefits of similar accounting practices. With this in mind , the International Accounting Standards Committee (IASC) was set up as early as 1973 with an objective of promoting the harmonisation of accounting laws and standards across the globe. Representatives from Australia, Canada, France, Germany, Japan, Mexico, Netherlands, United Kingdom, Ireland, and the United States joined the IASC.

In the year 2001, the IASC was replaced by the International Accounting Standards Board (IASB), an independent private sector body responsible for developing and approving accounting laws known as the International Financial Reporting Standards (IFRS).

The year 2002 saw the IASB and the FASB signing a memorandum of understanding which established a timeline for the making of a global financial reporting model. The objective was to reach a set of principles and rules which would be such that compliance of IFRS would automatically ensure the compliance of US GAAP even if the standards were not the same.[5] A lot of success was achieved in this endeavor. Standards issued by the two bodies on fair value measurement, revenue from contracts with customers, borrowing costs, discontinued operations, fair value option, operating segments, and share-based payments were remarkably close to each other. In the year 2007 the SEC allowed foreign registrants to report under IFRS without reconciling their reports with the US GAAP. The convergence attempts finally came to a halt in the year 2012 when SEC published its staff report summarizing issues which remained to be resolved for allowing IFRS to the US issuers.

3. Barrier to Convergence

One of the major reasons why convergence has not been achieved till now is the difference in approach adopted by the IASB and the FASB in formulating accounting standards. The IFRS are principle-based accounting standards whereas FASB prefers the rule-based approach. A Principle-Based Accounting Framework provides guidelines, rather than rules, under generally accepted practices. Principle-based practices give discretion to accounting professionals allowing them to decide which accounting policy is most relevant to their situation.[6] In other words, accounting practices are heavily reliant on professional judgment and allow for significant differences in interpretation of these principles depending on the business environment in which the transaction takes place. This freedom of discretion has made for the smooth, widespread adoption of IFRS by many countries. In comparison, the US GAAP is rule-based, in which standards are rigid and narrowly defined. The stark difference between the two – a Principle-Based Accounting System and a Rule-Based Accounting System, is in the value of the information it provides investors.[7] The freedom allowed under a principle-based accounting system gives an opportunity to the accountants to determine accounting policy based on what is most beneficial to their organization.

Other reasons which come in the way of convergence happening include but are not limited to the following,

Governance of financial reporting, parliamentary legislations, need of translating standards in domestic language, operation of stock exchanges, complex standards, non-availability of qualified professionals etc.

3.1. Current status

At the time of writing this over 27000 domestically listed companies across the globe use IFRS for financial reporting. Approximately 120 nations and reporting jurisdictions permit or require IFRS for domestic listed companies, and approximately 90 countries have fully conformed with IFRS and include a statement acknowledging such conformity in audit reports.[8] It is worth noting that large economies like India, China and Japan have not adopted the IFRS yet. India and China have their own accounting standards known as IND AS (Indian Accounting Standards) and CAS (Chinese Accounting Standards). In Japan, IFRS Standards are one of four permitted financial reporting frameworks. The others are Japanese GAAP, Japan's Modified International Standards (JMIS), and US GAAP. The United States of America (U.S.) has been "more cautious in converging with IFRS".[9] Till date, US companies are not allowed the use of IFRS. They are required to follow the US GAAP. However, IFRS Standards are permitted for listings by foreign companies in the US. Currently, more than 500 foreign SEC (Security Exchange Commission) registrants, with a worldwide market capitalization of US$7 trillion, use IFRS Standards in their US filings.

3.2. Areas yet to be converged

Between the US GAAP and IFRS, differences in accounting practices start from the conceptual framework itself. Because IFRS is a more principles-based regime, with potentially different interpretations for similar transactions, the Conceptual Framework has a higher relative importance for IFRS than for US GAAP. Other areas where accounting practices differ amongst these two sets of regulators are as follows,

Inventory Valuation **-**The accounting practices which dictate the valuation of inventory as recommended by the IFRS are less conservative than the practices prescribed by the US GAAP. IFRS allows the use of the FIFO and Weighted Average methods, however, unlike the US, LIFO is not permitted . In addition, IFRS applies the lower of cost or net realizable value principle whereas US GAAP allows the lower of cost or market value as the rule to be followed while valuing inventory. The term "market, for this purpose, is understood as current replacement cost which shall not exceed the net realizable value (selling price less costs of completion and disposal) or be less than a floor of net realizable value less a normal profit margin".[10] Another major area of difference in the prescribed accounting practice relates to the reversal of write-downs as selling prices rise. Such reversals are allowed by the IFRS but not permitted in the US GAAP.

Tax laws in the US require that if a particular method e.g. LIFO is used for tax reports then the same should also be used while preparing financial reports. There was a significant amount of inflation during the time when this law was passed in the US. However, the environment of today and the recent yester years has witnessed minimal amount off price rise happening in the country. Many companies subject to US tax law have voluntarily stopped using LIFO.[11] This increases the chances of U.S. companies choosing methods other than LI FO for financial reporting and thereby also complying with IFRS. This, despite the fact that the US law has not changed. If the US income tax law is changed so that inventory methods do not have to be the same in both income tax and financial statements, then converging IFRS and US GAAP would be far easier.

Leasing - Leasing transactions happen frequently during business operations and the practices adopted to report them in financial statements have a significant impact on the bottom line and the valuation of all assets and liabilities. The FASB and IASB, worked jointly for over eight years to update the lease accounting standards. IASB launched International Financial Reporting Standards (IFRS)16 the same year as FASB issued its new Accounting Standards Update (ASU) 2016-02 (Topic 842) on leases. Although FASB and IASB ended up issuing two different lease accounting standards, they did reach a fundamental agreement on the lessee's capitalization of any leases of 12 months or longer.[12] Both IFRS and US GAAP require lessees to report most of their leases on-balance sheet, as assets and liabilities, however, differences exist in scope, measurements, recording and disclosures.

IFRS on Leasing applies to leases of property, plant and equipment (PP&E), and other assets, with limited exclusions. In comparison the US GAAP has a much broader scope with regard to exclusions that include leases of inventory, leases of assets under construction (when the lessee does not control the asset before the lease commencement date) and leases of all intangible assets. Under IFRS, a lessee may apply for a recognition exemption for leases of 'low-value' assets. Such exemptions are not permitted in the US GAAP. IFRS allows a lessee to use a single on-balance sheet lease accounting model whereas the US GAAP permits a dual classification on-balance sheet lease accounting model containing both finance leases and operating leases. Another differing treatment pertains to the discount rate permitted for computing present values. In case where implicit rate in the lease agreement is not possible to be identified, the IFRS allows the use of the incremental borrowing rate whereas the US GAAP recommends a risk free rate.

Consolidation- Consolidation and its importance as an accounting practice came to light when Enron used hundreds of SPEs to manipulate income which resulted in many investors losing their lifetime savings. The IASB and FASB started a joint project with the intention of coming up with an improved standard. The collaboration ended with each of the organization coming up with an independent standard of its own. Although the standards provided by the two are substantially converged a few important differences exists.

While the US GAAP recommends two models for consolidation the IFRS prefers one single model for all entities. The two models suggested in the US GAAP are the voting interest entity model and the variable interest entity model. Also, both the US GAAP and IFRS define the world control differently. This frequently results in a situation where entities consolidated under one standard are not consolidated under the other.[13] This more conservative approach towards accounting for consolidations could be the result of the many financial scams and the financial crisis faced by the US during the decade following the Enron scandal.

*Revaluation Model-*Under the IFRS property plant and equipment and intangible assets can be accounted for at fair value the increase or decrease being routed through the profit and loss. The US GAAP on the other hand takes a more conservative approach in which market price reduction are allowed to be accounted for however, increases are not allowed to be recorded.

Non-financial liabilities - Both the US GAAP and the IFRS agree that non-financial liabilities like contingencies depend upon the probability of some happening. However, the world probable has been differently described by the IASB and the FASB. The word probable as understood by the IFRS is related with a 50% or more chance of happening whereas the FASB attaches a 75% or more value to the same word. This increases the chances of earlier recognition of Liabilities in the IFRS.

Investment property for rental income or appreciation- This special category is only allowed by the IFRS. Increase or decrease in value of such property is allowed to be routed through the profit and loss account with the asset being shown at fair value. The property is initially measured at cost.

Development cost- IFRS allows the capitalization of development costs in cases where the technical, economic feasibility of a project has been demonstrated in accordance to certain pre-defined criteria. Such capitalisation is not permitted under US GAAP. It requires all development costs to be necessarily expensed except for a few like website development and computer software.

*Impairment-*The US GAAP prescribes testing of impairment of goodwill at the reporting unit level, whereas the IFRS demands impairment test at the cash generating unit level. Both the US GAAP and the IFRS allow for the accounting of impairment when the market value of long-lived assets declines, however, when conditions change, the IFRS allows for reversals (except goodwill) whereas the US GAAP takes a conservative position.

*Non-financial information-*Prospective owners and debt providers need to assess the risk and opportunities which arise out of environmental, social and governance (ESG) issues faced by companies in which they intend to invest in. Reporting of such issues is known as sustainability reporting. At present, several different frameworks for reporting such information are in circulation across the globe. These include frameworks produced by the Climate Disclosure Standards Board, International Integrated Reporting Council, Group Reporting Index, International Sustainability Standard Board (ISSB) and others. The appearance of sustainable investment funds highlights the significance of such information.[14] However, almost all the reports regarding sustainability are not linked to financial performance The diverse practices adopted by companies to report issues related to ESG without taking into cognizance the financial performance raises questions about the quality and comparability of such information.

4. Conclusion

The evolution of accounting as an important tool for business management has happened alongside changes in global business environment. Growth of multinational businesses has necessitated the need of similar accounting practices to be followed across the globe so that performance and financial health of corporates operating in different business environments can be easily compared to each other. Post World War 2, large number of efforts have been made to achieve similarity in accounting practises across the globe, however, despite some success, lot many differences still remain. The following reasons can be attributed towards the failure of achieving the objective of convergence.

1. Many countries have either adopted IFRS or issue their own accounting standards which are based on principles laid down in the IFRS. Principle-based accounting allows flexibility and does not ensure same accounting treatment of economic transactions by different users.
2. The SEC does not permit the use of IFRS by domestically listed companies. This results into the US companies issuing financial statements using US GAAP which unlike the IFRS are rule based and more conservative in approach. These different approaches result in different guidelines being provided by the two frameworks.

5. Source of Funding

None.

6. Conflict of Interest

None.

References

1. Kaplan RS, Johnson HT. Relevance Lost: The Rise and Fall of Management Accounting. Boston: Harvard Business School Press; 1987. p. 296.
2. Zeff SA. The SEC rules historical cost accounting: 1934 to the 1970s. *Int Accounting Policy Forum*. 2007;37:49–62.
3. Skinner RM. Accounting Principles: A Canadian Viewpoint. Toronto, Canada; 1972. p. 483.
4. Lam H, CMC Senior Theses Paper 1066. Why does the U.S. Continue to Use GAAP and Will it Ever Converge to IFRS? 2015;Available from: https://scholarship.claremont.edu/cmc_theses/1066/#:~:text=It%20is%20very%20unlikely%20that,education%20of%20auditors%20and%20accountants..
5. Pacter P. What Have IASB and FASB Convergence Efforts Achieved? *J Accountancy*. 2013;215(2):218448.
6. Hail L, Leuz C, Wysocki P. Global accounting convergence and the potential adoption of IFRS by the U.S. (part I): Conceptual underpinnings and economic analysis. *Accounting Horizons*. 2010;24(3):355–94.
7. Shamrock S, Shamrock SE. Ifrs and us gaap: a comprehensive comparison; 2012. Available from: https://ebookcentral.proquest.com.
8. Who uses IFRS Accounting Standards? Available from: https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/.
9. Irvine H. The global institutionalization of financial reporting: The case of the United Arab Emirates. *Accounting Forum*. 2008;32(2):125–42.
10. Doupnik T, Perera H. International accounting. 3rd ed. New York: McGraw-Hill Irwin; 2012. p. 493.
11. Gray D. IFRS and US GAAP convergence progressing: As taxpayers voluntarily stop using LIFO. *Int Bus Econ J*. 2013;12(4):451–6.
12. Fajardo CL. Convergence of accounting standards worldwide: An update. *J Appl Business Econ*. 2016;18(6):148–60.
13. Tomaszewski SG, Larson RK. New consolidation requirements under IFRS. *R Business*. 2014;35(1). Available from: https://www.ifrs.org/issued-standards/list-of-standards/ifrs-10-consolidated-financial-statements/.
14. Koellner T, Weber O, Fenchel M, Scholz R. Principle for sustainability rating of investment funds. *Bus Strategy Environ*. 2005;14(1):54–70.

Author biography

R.K. Srivastava, Professor-Finance & Accounting
https://orcid.org/0000-0002-4512-7254

Cite this article: Srivastava RK. Convergence of accounting, problems and progress. *J Manag Res Anal* 2023;10(4):238-242.