

GLOBAL HARMONIZATION OF ACCOUNTING

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Abstract

Many companies raise capital by issuing debt securities and equity securities in foreign countries. In recent years, more than \$400 billion was raised in this way. These companies list their debt securities and equity securities on foreign stock exchanges. The major problem faced by such companies is the vast number of differences existing between many countries' accounting standards and accounting practices. This article examines some of these differences and comments on the need for harmonization.

Income Reserves

In many countries, including the U.S., current net income must be reported in full and cannot be allocated to other years. In some countries, current net income can be reduced by allocating it to reserves on the balance sheet. These reserves are later used to increase net income or decrease net loss in future years.

Pretax Financial Income v. Taxable Income

In the U. S., there are many differences between pretax financial income and taxable income. These differences are classified as temporary differences or permanent differences.

An example of a temporary difference is sales of merchandise on account. According to generally accepted accounting principles (GAAP), revenue is recognized when it is earned and realized or realizable. Therefore, revenue is recorded at the point of delivery of merchandise. Per IRS rules, if the company elects to be taxed on the cash basis, taxable revenue is not recognized unless the accounts receivable are collected in cash.

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Assuming delivery in Year 1 and collection in Year 2, pretax financial income is higher than taxable income in Year 1, and taxable income is higher than pretax financial income in Year 2.

An example of a permanent difference is compensation expense associated with incentive stock option plans, which is a legitimate expense in pretax financial income but is not deductible on the tax return.

In several countries, the pretax financial income follows the taxable income, thus creating harmony between the two.

Research and Development

FASB's Statement of Financial Accounting Standard No. 2 requires that research and development costs be debited to expense in the current accounting period. According to IAS 9, some development costs should be capitalized.

Capitalized Interest Costs During Construction

U.S. GAAP requires capitalization of interest costs incurred during construction of plant assets. This requirement is in line with the matching principle. Interest costs, like all other costs incurred in the construction, are expensed only once the asset is in use.

Contrary to this position, International Accounting Standard (IAS) No. 23 recommends that all these interest costs be debited to expense in the current accounting period.

Inventory Cost Methods

In the U. S., LIFO is a very popular inventory cost method because it normally results in a lower net income, which results in a lower income tax. In some other countries, LIFO is not an acceptable inventory cost method.

Inventory - Lower of Cost or Market

In the U.S., "market" is the middle number of replacement cost, net realizable value, and net realizable value less normal

profit margin. In most other countries, “market” is net realizable value.

Revaluation of Property, Plant, and Equipment

In the U.S. and many other countries, revaluation of plant assets to amounts higher than their original cost is prohibited as being in violation of the historical cost accounting principle. In some other countries, like England, such revaluation is permitted.

Convertible Bonds

According to U.S. GAAP, the conversion feature is not recorded upon issuance and retirement of convertible bonds. For example, when a \$1,000 convertible bond is issued at 97, the entry is:

Cash	970	
Discount on bond payable	30	
Bonds payable		1,000

Thus, only the debt component is recorded. The potential equity component, which will result if the bond is converted to common stock, is not recognized. This treatment is inconsistent with the treatment of bonds issued with detachable stock warrants.

In many other countries, the debt component and equity component of convertible bonds must be recorded individually.

Dividends

In the U.S. and many other countries, when the corporation’s board of directors declares dividend, the entry is, debit Retained Earnings, credit Dividends Payable. In some countries, the entry is made when the dividends are proposed before the declaration.

Extraordinary Gains and Losses

In the U.S., as well as in many other countries, extraordinary gains and losses are those gains and losses that result

from events that are both unusual and infrequent. Gains and losses, which result from events that are either unusual or infrequent but not both, are part of other (non-operating) gains and losses in income before extraordinary items. For example, takeover of property by a foreign government is considered as an extraordinary item, while losses due to labor strikes, gains and losses from sales of plant assets are not. Every country has its own way of classifying events as extraordinary. Different countries account for such items differently.

Statement of Cash Flows

In the U.S., the statement of cash flows is a required financial statement. It explains the increase or decrease in the cash account from the beginning of the accounting period to the end of the accounting period. It is made of three parts: Cash flows from operating activities, Cash flows from investing activities, and Cash flows from financing activities.

In some countries, a statement of funds flow is required in lieu of statement of cash flows. Some countries do not require either a statement of cash flows or statement of funds flow.

Loss Contingencies

In the U.S., losses resulting from events that have not taken place yet but are likely to take place in the future must be recorded along with an estimated liability in the current accounting period. If these events are not likely but only possible, no entry is recorded and only disclosure is required.

In some countries, an entry accruing loss and liability is made even if the events are not likely but just possible.

Derivatives

In the U.S., unrealized holding gains and losses on cash flow hedges are not classified as income statement accounts. Instead, they are considered to be other comprehensive income, which affects stockholders' equity.

Assume, for example, that on 10/1/X1, market price of steel is \$2,000 per ton. A is obligated to purchase from B by 1/31/X2 100 tons of steel at \$2,000 per ton.

On 12/31/X1, market price of steel is \$2,100 per ton.

On 1/1/X2, A purchases the steel.

A's journal entry on 12/31/X1 is:

Future's contract [(\$2100-\$2000) x 100 tons]	10,000	
Unrealized holding gain/loss - equity		10,000

A's journal entry on 1/1/X2 is:

Steel inventory (\$2100 x 100 tons)	210,000	
Future's contract		10,000
Cash (\$2000 x 100 tons)		200,000

Accordingly, A records Steel Inventory at the \$210,000 market value and not at the \$200,000 cost. Under International Accounting Standards, A does not record other comprehensive income. Instead, A records Steel Inventory at the \$200,000 cost.

Holding of 20%-50% of Another Company's Outstanding Common Stock

U.S. GAAP requires that an investor that owns between 20% and 50% of an investee's outstanding common stock must record the investment using the equity method. International Accounting Standards allow such an investor to use either the equity, or cost, or fair value methods.

Pensions

In the U.S., when a pension plan is initiated or amended, prior service costs are not charged to expense. Instead, they are capitalized and later amortized during the remaining years of service of the employees under the plan. In some countries, prior

service costs are charged to expense when the pension plan is initiated or amended.

Consolidated Financial Statements

In the U.S., consolidated financial statements are required when one company controls another company. “Control” is the ability to elect the majority of the other company’s board of directors. This control can be achieved either legally or effectively. It is achieved legally when one company owns more than 50% of the other company’s outstanding common stock. It is achieved effectively if one company owns less than 50% of the other company’s outstanding common stock and the remaining common shares are owned by many investors, thus giving the company the central power in managing the other company’s affairs.

FASB Statement of Financial Accounting Standard No. 94 requires consolidated financial statements even when the parent and the subsidiary are in different lines of business. One of the rare exceptions to this requirement is when a subsidiary files for bankruptcy. Since filing for bankruptcy puts the subsidiary under the control of the District Court, the parent’s control is lost, and consolidated financial statements are not allowed.

In contrast, International Accounting Standard No. 27, “Consolidated Financial Statements and Accounting for Investments in Subsidiaries”, allows more exceptions to the consolidation requirement.

Each country has its own exceptions to the consolidation requirement. In England, consolidation is not required when the subsidiary is in a different line of business, is relatively insignificant, and the parent’s control is restricted. In Germany, consolidation is not required when the subsidiary is relatively insignificant, the parent’s control is restricted, the parent intends on selling the subsidiary, and consolidation will cause incurrence of unreasonable expenses. In France, consolidation is not required when the subsidiary is in a different line of business, is relatively insignificant and is unable to prepare its financial statements prior to the consolidation.

Partially owned Subsidiaries

Full consolidation rather than proportional consolidation is required when a subsidiary is partially owned (owned by the parent and other investors). Accordingly, non-controlling interest, also known as minority interest, is recorded for the subsidiary's net income and net assets, and is not recorded for the subsidiary's individual accounts like cash, accounts receivable, inventory, sales, cost of goods sold, expenses, etc. Full consolidation is required in most countries.

However, differences between countries exist in the manner of presenting NCI (non-controlling interest) in Net Assets in the consolidated balance sheet. In the U.S., the manner of presenting NCI in Net Assets in the balance sheet can be in one of two ways using two different concepts, the economic unit concept or the parent company concept.

Under the economic unit concept, the parent (the controlling interest) and the NCI are treated equally. Consequently, NCI in Net Assets is part of stockholders' equity, even though it has an account, which is separate from the other stockholders' equity accounts.

Under the parent company concept, the parent's share in the subsidiary's net income and net assets is given priority over the NCI's shares. Thus, the NCI is treated as an outsider. Two ways are used in presenting NCI in Net Assets in the consolidated balance sheet under the parent company concept, as a separate account between liabilities and stockholders' equity or as a separate account inside the liabilities section.

In the present author's opinion, the economic unit concept is sounder than the parent company concept and, therefore, should be the only concept allowed. The NCI are legitimate owners of the subsidiary and their ownership should be presented in the stockholders' equity section. International Accounting Standard No. 27 merely requires NCI in Net Assets in the consolidated balance sheet to be recorded separately from liabilities and the parent stockholders' equity.

Each country has its own manner of presenting NCI in Net Assets in the consolidated balance sheet. In Germany, NCI in Net Assets is part of the subsidiary's stockholders' equity section. In Spain and Italy, NCI in Net Assets is recorded between the liabilities section and the stockholders' equity section. In England and France, companies can choose between these two ways of presenting NCI in Net Assets in the consolidated balance sheet.

Goodwill

Goodwill is the excess of the acquiring company's cost of acquisition over the current value of the acquired company's net assets. Thus, if the acquiring company paid \$1,000,000 to acquire another company, the current value of the acquired company's assets is \$1,500,000, and the current value of the acquired company's liabilities is \$700,000, goodwill is recorded at \$200,000. On the consolidated balance sheet, goodwill is an intangible asset. Since, per FASB Statement of Financial Accounting Standard No. 142, "Goodwill and Other Intangible Assets", goodwill is not amortized to expense, it has no impact on the income statement except for its deductibility for tax purposes and its being found to be impaired. According to the 1993 Revenue Reconciliation Act, goodwill is tax deductible over a period of 15 years. In contrast, International Accounting Standard No. 22 requires that goodwill be capitalized and amortized over a maximum period of 5 years.

In practice, each country has its own way of handling goodwill. In Germany, goodwill does not have to be capitalized. If it is capitalized, it is amortized over a period of 4 years. It is tax deductible over a period of 15 years. In Canada, goodwill is capitalized and amortized over a maximum period of 40 years. Only $\frac{3}{4}$ of goodwill is tax deductible. In England, goodwill reduces stockholders' equity. It does not have to be recorded if the acquiring company and the acquired company have a similar size. It is not tax deductible.

Prior Period Adjustments

Prior period adjustments are mainly corrections of errors that were made in prior accounting periods and discovered in the current period. In the U.S. and many other countries, the corrections of these errors do not affect the current income statement. The current accounting period's correcting entry is made solely of balance sheet accounts. The correction is reported directly in the statement of retained earnings.

Assume, for example, that the total depreciation expense recorded in 2001 and 2002 was \$180,000. In 2003, the company discovered that errors were made in calculating the 2001 and 2002 depreciation expense, and the correct amount of total depreciation expense in 2001 and 2002 should have been \$150,000. As a result, 2001 and 2002 net income was understated by \$30,000. As a result, income tax expense in 2001 and 2002 was also understated. Assuming a 40% income tax rate, the entry in 2003 is:

Accumulated depreciation	30,000	
Income tax payable		12,000
Retained earnings		18,000

In the statement of retained earnings, \$18,000 is added to the beginning balance to arrive at the adjusted balance. In a few countries, like Germany, the corrections of prior accounting periods' errors affect the current income statement. Accordingly, the entries are:

Accumulated depreciation	30,000	
Depreciation expense		30,000
Income tax expense	12,000	
Income tax payable		12,000

Leases

In the U.S. and most other countries, distinction is made between operating leases and capital leases. In Italy, all leases are recorded as operating leases regardless of their characteristics.

The Alternatives

Viewing the above differences between countries in accounting standards and accounting practices, we can conclude that there are three alternatives: (1) Each company will issue its financial statements in conformity with the accounting standards and accounting practices existing in the company's home country; (2) Each company will issue two sets of financial statements: one set in its home country in conformity with the accounting standards and the accounting practices existing in the company's home country, and another set in a foreign country where it raises capital and lists its debt securities and equity securities in the foreign securities exchange in conformity with the foreign country's accounting standards and accounting practices; (3) Create uniform accounting standards and apply them in each and every country.

In my opinion, the third alternative is not just the best solution but also the *only* solution for the diversity in accounting standards and accounting practices that exist in the world.

The first alternative creates confusion and uncertainty in the investing public. When investors are faced with choosing a company to invest in, they need to compare the financial position and results of operations of several companies. If one company's balance sheet and income statement are based on U.S. GAAP and the other company's balance sheet and income statement are based on either International Accounting Standards or one foreign country's accounting standards, comparison is lost, because the same business transactions will result in different balance sheets and different income statements.

The second alternative, though being superior to the first alternative, has its serious shortcomings. First, it is time consuming and expensive to issue two or more sets of financial statements, especially when the vast majority of multinational companies have many subsidiaries. Second, psychologically investors' confidence

in the reliability of financial statements diminishes when they realize that the same business transactions can be recorded in two different ways, which result in different financial statements.

The third alternative will boost the investors' confidence in the financial statements and enable true comparison between various companies' financial position and results of operations. The only present problem with the third alternative is its implementation.

Each country has its own governmental requirements and legal system. Each country uses its own process to create and implement accounting standards.

In spite of the logic behind global harmonization of accounting and its attractiveness, some accountants fiercely oppose it. The opponents of global harmonization of accounting have presented the following arguments:

1. There is no international body vested with the power to create global accounting standards and enforce them in each and every country. As will be discussed later, the IASC (International Accounting Standards Committee), which in 2001 became IASB (International Accounting Standards Board), created international accounting standards, which allowed companies to choose one out of two or more different accounting methods. As a result, even if companies follow these international accounting standards the investing public finds it very difficult to compare the financial statements of the various companies. Since IASC and later IASB never had the power to enforce their international accounting standards, many countries, including the U.S. continue to create, enforce and follow their own accounting standards.

2. Creation and enforcement of international accounting standards are political acts. Those who voice this argument argue that such global harmonization of accounting in its true sense is tantamount to creation of one government that rules the entire globe, and thus is no more than a utopian dream, as very few countries will give up their sovereignty, freedom and independence. However, this analogy is doubtful. Creating and maintaining professional uniformity does not interfere with any

country's freedom to conduct its own political and economic affairs.

3. FASB has been slow in creating Statements of Financial Accounting Standards, which means that an international body will be even slower in creating international accounting standards. This argument should raise eyebrows if we examine the history of FASB Statements of Financial Accounting Standards. Since its inception in 1973 until the end of 2002, FASB created 148 Statements of Financial Accounting Standards, as follows: 1 in 1973, 2 in 1974, 9 in 1975, 2 in 1976, 6 in 1977, 4 in 1978, 10 in 1979, 10 in 1980, 9 in 1981, 18 in 1982, 7 in 1983, 4 in 1984, 6 in 1985, 3 in 1986, 6 in 1987, 4 in 1988, 3 in 1989, 2 in 1990, 2 in 1991, 5 in 1992, 4 in 1993, 2 in 1994, 5 in 1995, 3 in 1996, 4 in 1997, 3 in 1998, 3 in 1999, 3 in 2000, 4 in 2001, 4 in 2002. Most notably in recent years were Statements of Financial Accounting Standards No. 141 and No. 142, both in June 2001. No. 141 eliminated the pooling-of-interests method of business combinations despite strong objections, which came from many corporations that resented the fact that the purchase method usually results in lesser net income than the net income resulting in the pooling-of-interests method. FASB nevertheless did not succumb to the pressure and proved its creativity, sound judgment and independence. No. 142 eliminated goodwill's systematic amortization to expense over a period of up to 40 years. In summary, FASB was not slow at all in creating Statements of Financial Accounting Standards. There is no reason to believe that an international body composed of top accounting professionals will not achieve similar success.

4. Despite the diversity in many countries' accounting standards, the global capital market not only did not suffer but also continued to grow. This argument discards the fact that investors are entitled to make correct interpretations and make the right decisions based on financial statements without being confused or misled by different accounting standards employed by various countries. The continued growth of the global capital market should not constitute a reason to avoid global

harmonization of accounting. On the contrary: it should serve as an impetus to globally harmonize accounting standards.

5. A central global authority in accounting, which dictates accounting standards, is bound to be unsuccessful as much as a central global authority in economics and economic systems. This analogy is senseless. Centrally planned economic systems fail because they do not respond to consumer demands. The regulators simply do not know what the consumers want. But a centrally planned accounting system will succeed because the regulators know what the investors want: one accounting language, which will enable them to compare financial statements of multinational companies and, based on this comparison, enable them to make the right decisions in which companies to invest. Financial position and results of operations of various companies are different, but the accounting language, which reports them, must be the same.

The first serious effort to achieve global harmonization of accounting was made in 1973 when the IASC (International Accounting Standards Committee) was created. Its membership included more than 100 countries. It issued 41 international accounting standards. Some of them were later revised.

The members of the IASC were not independent because as part-timers they had their full-time positions in corporations. Besides, prior to being hired they did not have to meet any requirements regarding their education and work experience.

In 2001, the IASB (International Accounting Standards Board) replaced the IASC. Its board of directors is composed of 14 members, out of which 12 members are full-time and are not allowed to have a job elsewhere.

There are two major problems existing with the international accounting standards: 1. Most of them offer more than one accounting method, a disadvantage that defeats the goal of achieving accounting uniformity; 2. The standards cannot be enforced.

Many countries allow foreign companies to list their securities on their stock exchanges if these companies' financial statements are based either on international accounting standards

or on local accounting standards. In the U. S., foreign companies are allowed to list their securities on U.S. stock exchanges only if they issue financial statements based on U.S. GAAP or financial statements reconciled to U.S. GAAP.

One accounting language will benefit the global economy in two ways: 1. It will enable investors to make the right decisions to invest in multinational companies; 2. It will increase global merging of multinational companies.

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