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Obstacles to International AccountingStandards Convergence

By Jane E. Campbell, Heather M. Hermanson, and John P. McAllister

In Brief

Creating Convergence

Given the recent changes in the international sector, along with the similarities in the conceptual frameworks of the FASB and IASC, the relatively swift convergence of U.S. GAAP and International Accounting Standards is a distinct possibility.

The authors believe convergence is possible, and review three keys areas that could hinder or foster it:

- The general organization, in terms of form and topical content, of the frameworks
- A significant pervasive difference between the frameworks
- Specific differences within the major topical areas of the frameworks.

In its 2000 annual report, the Financial Accounting Foundation stated the following:

The Foundation, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Committee (IASC) have long recognized that in order for international capital markets to function properly, a single set of high-quality, international accounting standards must exist. [p.3]

Many believe that a precondition for this “single set of high-quality, international accounting standards” is convergence between U.S. GAAP and International Accounting Standards (IAS). The key to this convergence lies in the conceptual frameworks that underlie each set of standards. To the extent that the frameworks are consistent, convergence should be easier.

Recent Developments

The board of the International Accounting Standards Committee (IASC), a 13-member (all part-time) organization representing professional accounting groups (e.g., the AICPA) from member countries, promulgated IAS beginning in the mid-1970s. By the end of 2000, the number of IASC member countries had grown from 10 charter members to 134. Effective April 1, 2001, the board of the IASC handed over responsibility for standards-setting to a new organization, the International Accounting Standards Board (IASB), appointed by newly established IASC trustees (see "The New Structure for International Accounting Standards," *The CPA Journal*, May 2000).

Convergence of national and international standards is a key priority, as clearly indicated by the outgoing IASC board in the IASC *Annual Review 2000*:

The path established by IASC's restructuring decisions for achieving agreement on global accounting standards is through *convergence of national and international standards* [emphasis added]. The Board recommends to the new Board the adoption of a plan for achieving this convergence as a top priority. [p.8]

The convergence theme continues with the new IASB. Its third stated objective is to "bring about *convergence of national accounting standards* and International Accounting Standards [emphasis added] to high quality solutions" (www.iasb.org.uk).

Finally, the convergence theme is implicit in the composition of the new organization. The IASB constitution provides for itself to consist of 14 individuals (12 full-time) appointed by the trustees, as follows:

- A minimum of five will have a background as practicing auditors.
- A minimum of three will have a background in the preparation of financial statements.
- A minimum of three will have a background as users of financial statements.
- At least one member will have an academic background.
- Seven of the full-time members will be expected to have formal liaison responsibilities with national standards setters in order to promote the convergence of national accounting standards and IAS.

The significance of this structural change is reinforced by the decision of the G4+1 group of standards setters (from Australia, Canada, New Zealand, the U.K., the United States, and the IASC) in January 2001 to disband because its goals were redundant and might divert resources from the new board. A stated objective of the G4+1 had been to "pursue projects that have the potential to bring about convergence of financial reporting standards across member jurisdictions at a high level of quality" (see "G4+1: A Newcomer on the International Scene," *The CPA Journal*, March 2000).

Likelihood of Convergence: Comparing the Frameworks

Both the SEC and FASB have endorsed the new IASB, and convergence of national and international accounting standards is a common objective of these organizations. The key question becomes the likelihood that such convergence will be realized. Studying the similarities between existing U.S. GAAP and IAS would provide some indication of how close convergence is. The FASB publication *The IASC-U.S. Comparison Project: A Report on the Similarities and Differences Between IASC Standards and U.S. GAAP* (1999) and "What Price Global Accounting Standards?" (*The CPA Journal*, May 2001) provide a comprehensive assessment of differences between U.S. GAAP and IAS, as revealed by the SEC's "Concept Release on International Accounting Standards" (February 2000).

Documenting and understanding the existing differences between individual IAS and FASB standards is important. However, evaluating the conceptual frameworks upon which these standards are based may be more fruitful. Both the FASB and IASC frameworks specify a primary intent to guide standards setting, so one would expect similar frameworks to result in similar standards. And if the frameworks were reasonably similar, one would expect a shorter and smoother road to convergence.

The outgoing IASC board seems to agree with this logic: It recommended that the new IASB conduct a comprehensive review of the IASC's framework (*IASC Annual Review 2000*). In accepting this recommendation, the IASB identified the framework as the first of four "precedential [critical]" projects (*IASB Update*, April 2001).

General Organization

Form and topical content. The FASB framework consists of a series of five Statements of Financial Accounting Concepts (SFAC) related to this topic:

- Objectives of Financial Reporting by Business Enterprises (SFAC 1)
- Qualitative Characteristics of Accounting Information (SFAC 2)
- Elements of Financial Statements (SFAC 6; replaced SFAC 3)
- Recognition and Measurement in Financial Statements of Business Enterprises (SFAC 5)
- Using Cash Flow Information and Present Value in Accounting Measurements (SFAC 7).

With the exception of SFAC 7, which was issued in February 2000, the SFACs were issued from 1978 through 1985.

In 1989, the IASC issued "Framework for the Preparation and Presentation of Financial Statements." Six major sections of that document are relevant here:

- The objective of financial statements
- Qualitative characteristics of financial statements
- The elements of financial statements
- Recognition of the elements of financial statements
- Measurement of the elements of financial statements
- Concepts of capital and capital maintenance.

At least on the surface, the subject of the frameworks appear to be similar, and would not create an impossible hurdle for convergence.

Pervasive Difference

Level of detail. The most apparent difference between the two frameworks is the level of detail. The FASB framework includes much more extensive discussion of the underlying logic for its choices than does the IASC framework. For example, SFAC 2 (Qualitative Characteristics) includes 170 paragraphs, while the comparable discussion in the IASC framework includes only 23 paragraphs, with the difference reflected mostly in the amount of explanation and analogy. While the IASC framework provides only a relatively brief definition of each characteristic, SFAC 2 draws analogies to traffic laws, cartography, weather prediction, and drug reliability to explain its choices.

The FASB framework's comparatively lengthy discussions serve to clarify differences between the qualitative characteristics and provide an underlying rationale. For instance, SFAC 2 contains a discussion of traffic laws to highlight the need to impose some minimum or maximum standard while allowing for some flexibility.

Because the IASC framework simply states its conventions, the reader is often left to interpret why a certain objective or characteristic was chosen.

The comparative lack of detail throughout the IASC framework (both in defining terms and disclosing the logic behind choices) may hamper the ability of the IASB to use its framework in the development of future standards. National standards-setters that refer to the IASC framework may not find the conceptual guidance to critically review their existing standards or develop new standards. The outgoing IASC Board apparently shares this concern regarding the lack of detail, stating in the *IASC Annual Review 2000*:

IASC's present Framework was written several years ago and, in several sections, *the possibility now exists of giving more guidance* in the light of more recent experience in developing accounting standards. Equally, recent work has highlighted a number of areas where difficulties exist and the resolution of the difficulties would be helped by further development of the conceptual framework. [p. 11; emphasis added]

This pervasive difference in level of detail could hamper convergence. If the IASC framework is not specific enough to guide development of standards, inconsistencies in standards may proliferate.

Topical Differences

Objectives. Although both frameworks focus on providing information that is useful in making economic decisions, the FASB framework establishes the objectives of financial reporting and the IASC framework specifies the objectives of financial statements. This difference may be critical, given the changing nature of business and related pressures to improve the information provided to financial statement users.

For example, in recent years many people have called for ways to provide more information about a company's intellectual capital. Given concerns about the reliability of measurements of these assets, their disclosure as supplementary information outside the traditional financial statements and notes may be more appropriate. Another example is the suggestion to modify the current U.S. reporting system to provide more information in more detail, perhaps even to the extent of providing Internet access to a detailed database that users can manipulate and analyze.

The IASB could conclude that, given its framework's focus on financial statements, standards for reporting information outside those statements are outside its scope. FASB, on the other hand, could conclude that, given its framework's focus on financial reporting, standards for reporting outside financial statements are very much within its purview. Concern in this area has been significantly tempered by the new IASB's decision to designate its standards as *International Financial Reporting Standards* (IFRS), which clearly echoes the broader focus of the FASB framework. It is expected that this will be one of the major changes considered in the IASB's framework review project and that it will not hinder convergence.

Qualitative characteristics: Form and content. The IASC framework identifies four principal qualities that make information useful:

understandability, relevance, reliability, and comparability. The FASB framework also identifies these characteristics, but it imposes a hierarchy on them. Relevance and reliability are considered primary decision-specific qualities, while comparability is considered a secondary and interactive quality. Understandability falls in a separate category because it is a user-specific quality. FASB imposes this hierarchy on the qualities in order to improve their usefulness when deciding among accounting alternatives.

The IASC framework does not prioritize the four principal characteristics. Furthermore, it includes no comment regarding the use of the characteristics to make accounting choices. In fact, the IASC framework includes the comment that "the relative importance of the characteristics in different cases is a matter of professional judgment."

A second significant difference in the area of qualitative characteristics concerns reliability. SFAC 2 asserts that an important ingredient of reliability is verifiability ("several measurers are likely to obtain the same measure"). The IASC framework does not refer to verifiability, a quality that has long been of major importance to financial reporting and auditing in the United States.

Both the presence or absence of a qualitative characteristic hierarchy and the presence or absence of the verifiability characteristic must be addressed in order to facilitate convergence.

Elements of financial statements. The FASB framework defines 10 elements of financial statements for business enterprises, while the IASC framework defines only five. Close review, however, shows the only significant difference to be comprehensive income.

As balance sheet elements, both frameworks identify and similarly define assets, liabilities, and equity. The FASB framework also defines investments by owners and distributions to owners as separate balance sheet elements. The IASC framework does not define these separately, but refers to them in the section on equity.

The FASB framework identifies and defines five income statement elements (performance): revenues, expenses, gains, losses, and comprehensive income. The IASC framework identifies only two elements: income (the definition encompasses both revenues and gains) and expenses (the definition encompasses losses).

Because both frameworks seem to acknowledge both the conceptual similarity of revenues and expenses to gains and losses and also the importance of differentiating ordinary and unusual activities, this difference is not significant.

Comprehensive income requires further analysis. SFAC 6 defines comprehensive income as "the change in equity (net assets) of a business enterprise during a period from transactions and other events and circumstances from nonowner sources." Issued in 1997, SFAS 130 requires the reporting of comprehensive income.

The IASC framework does not define comprehensive income or its equivalent; however, IAS 1, *Presentation of Financial Statements* (revised in 1997), requires that—

> an enterprise present, as a separate component of its financial statements, a statement showing: a) the net profit or loss for the period; b) each item of income and expense, gain or loss which, as required by other Standards, is recognised directly in equity, and the total of these items; and 3) the cumulative effect of changes in accounting policy and the correction of fundamental errors dealt with under the Benchmark treatments in IAS 8. [para. 86]

Thus, IAS 1 requires the reporting of "comprehensive income" even though the IASC framework does not acknowledge it as a financial statement element. Even though the frameworks are clearly different in this area, the FASB and the IASC, as a practical matter, take virtually the same position, benefiting convergence. This will probably be one of the major changes considered in the IASB's framework review project.

Capital maintenance concepts. SFAS 6 includes a brief discussion of the difference between financial capital maintenance and physical capital maintenance, and it asserts that financial capital maintenance is the traditional view and the one used in U.S. GAAP. The IASC framework devotes a section to the financial and physical capital maintenance concepts, specifying that the enterprise should select the appropriate concept of capital based on the needs of financial statement users. These approaches are significantly different, and both are flawed.

The FASB framework is flawed in that it acknowledges that financial capital maintenance is the traditional view but does not indicate when it is conceptually acceptable. The IASC framework is flawed in that it leaves the selection of capital maintenance to the preparer (based on users' needs). Neither position will facilitate convergence.

As the IASC framework notes, the principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities. Because so many controversial accounting issues are related to either recording price changes or the changes' effect on income, the difference between specificity (the FASB framework) and flexibility (the IASC framework) will hinder convergence.

Recognition and measurement. The FASB framework and IASC framework are quite similar in the areas of recognition and measurement. One difference is that FASB considers relevance (the information is capable of making a difference in user decisions) to be a recognition criterion, while the IASC does not. As mentioned earlier, however, the IASC framework does include relevance as a qualitative characteristic that makes information useful. SFAC 5 points out that reliability, not relevance, is the major focus of recognition criteria.

Although recognition encompasses the consideration of relevance and comparability, increased reliability is the primary aim of recognition criteria, conventions, and rules. These limited differences in the recognition and measurement areas of the frameworks will not hinder convergence.

Cash flow and present value information. SFAC 7 asserts that present value techniques should be used to estimate fair value and recommends using an expected cash flow approach. The IASC framework discusses present value only as one of the measurement bases employed in financial statements. The IASC added a present value project to its agenda in 1998, however, and this is one of the in-progress areas the IASC board has recommended the IASB continue. The IASB has tentatively designated it as one of eight leadership projects. It is likely that this difference between the frameworks is probably temporary and will not negatively affect convergence.

Time to Review and Discuss

FASB and the IASB would be wise to review and discuss these key divergent areas of their respective conceptual frameworks within the context of convergence and changes in the business environment since issuance. In particular, agreement on a single capital maintenance concept is critical. With a FASB liaison serving as a member of the IASB, starting this conversation should be easier than ever.

View the Exhibit for this article.

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