

# Harmonization of Accounting Standards

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## < EXECUTIVE SUMMARY >

◆ International community has long back recognised the need for moving towards harmonisation of the accounting standard across the globe. Obviously on individual country is always entitled to customise the existing international accounting Standards according to its specific needs. Among other advantages of harmonisation of accounting standards,

the two benefits which tops the list are (a) systematic review and evaluation of the performance of the multinational company having subsidiaries and associates in various countries wherein each country has its own set of GAAP and (b) It provides a level playing fields where no country is advantaged or disadvantaged because of its GAAP.

### What is Harmonization of Accounting Standards?

Just as the words connote, “harmonization of accounting standards” can be defined as the continuous process of ensuring that the Generally Accepted Accounting Principles (GAAP) are formulated, aligned and updated to international best practices (GAAPs in other countries) with suitable modifications and fine tuning considering the domestic conditions.

### Why Harmonize Accounting Standards after all?

Academicians, regulators and governments have been constantly striving to harmonize (i.e. to bring in line or match) the local/domestic Accounting Standards (AS), also referred to as Generally Accepted Accounting Principles (GAAP), with the International Accounting

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Standards (IAS) issued by the UK based International Accounting Standards Board (IASB) (formerly the International Accounting Standards Committee-IASC). The IASB has been trying to harmonize international accounting principles since 1973. Further, the IASB and the International Organization of Securities Commissions (IOSCO) have been jointly working on harmonization since July 1995, and in May 2000 the IOSCO finished its review of the IAS and recommended usage of certain IAS, supplemented with reconciliation, disclosure and interpretations.

### The Need for Harmonization

This harmonization is needed due to the globalization of businesses and services and increase in cross-border investments and borrowings. Some of the benefits of harmonization are as under:

- It ensures reliable and high quality financial reporting and disclosures.

- In certain cases, it can prove to be crucial to the economic and financial development of a country
- It enables a systematic review and evaluation of the performance of a multinational company having subsidiaries and associates in various countries wherein each country has its own set of GAAP
- It makes the comparison of the performance of a company against its domestic and international peers easier and more meaningful
- It adds to the international credibility of a company
- It is a precursor for accessing international capital markets which can, in turn, reduce the capital cost and consequently, improve the performance of a company
- It provides a level playing field where no country is advantaged or disadvantaged by its GAAP.

On these lines, Arthur Levitt, former chairman of the Securities & Exchange Commission (SEC) of USA, has stated that financial reporting standards that cross national borders are not merely an ideal for a better global marketplace –they are fundamental to its very existence.

### The Adoption of the Harmonization process across the Globe

In the USA, the SEC recognizes financial statements prepared using IAS, but, still requires listed companies to reconcile their accounts using US GAAP. The supporters of this reconciliation argue that IAS are less demanding, require less or fewer details and allow companies excess leverage in deciding what information to disclose. In contrast, IAS supporters argue that the IASB has considerably improved its standards over the years and now match US GAAP and that IAS are less expensive and less time consuming for companies to comply.

As IASB is a UK based organization, there is widespread support for IAS in Europe. The European Union (EU) has imbibed harmonization in its laws and as per the European Parliament's recent directive, listed companies are required to report under IAS by 2005.

In 1997, the Arab Society of Certified Accountants, repre-

sented by 22 Arab countries, entered into an agreement to support IAS as the national AS for the member countries.

Even in India, AS are being harmonized with the IAS, to the extent possible, in the light of the conditions and practices prevailing in India.

### Measurement of the Level of Harmonization

The level or degree of harmonization of the financial statements of different companies in the same industry can be compared by using any of the following methods:

- Comparability Index: By calculating the ratio between the income under the local GAAP and the foreign GAAP.
- Index of Conservatism: It is commonly known as the C-Index and can be calculated by using the formula shown hereunder:

$$C\text{-Index} = 1 - [(RA - RD) / RA]$$

Where RA = Adjusted earnings under the foreign GAAP  
RD = Disclosed earnings under local GAAP

If C-Index > 1: Local GAAP is less conservative than the foreign GAAP

C-Index = 1: Local GAAP and foreign GAAP give the same result; no difference

C-Index < 1: Local GAAP is more conservative than the foreign GAAP

For instance, let us consider the reported income of the following Indian companies operating primarily in the software industry (see are the Profits in Perfect Harmony?):

Are the Profits in Perfect Harmony?			
Particulars	Profit for the year ended March 31, 2002 (Rs.crores)		
	X Limited	Y Limited	Z Limited
Indian GAAP(a)	885.40	807.96	78.50
US GAAP(b)	833.00	785.82	126.35
Comparability Index (a)/(b)	1.0629	1.0282	0.6213
Conservatism Index	1.0592	1.0274	0.3905

From the above table, we observe the following:

- On reviewing the Comparability Index, we see that in the case of X Ltd. and Y Ltd. there isn't much difference in the reported profits under the Indian and US GAAP; while, in the case of Z Ltd., there is a significant difference in the reported profits under the Indian and US GAAP.
- Further, the C-Index of X Ltd. and Y Ltd. is more than 1 implying that applicable Indian GAAP is less conservative than US GAAP. While in the case of Z Ltd., The C-Index is less than 1 implying that applicable Indian GAAP is more conservative than US GAAP.

**Research Studies**

Interestingly, Christian Leuz, a Wharton accounting professor, conducted a research study using 1998 data on 80 firms listed in the "New Market", a segment of the Frankfurt Stock Exchange, to determine whether there is any difference in the bid-ask spread and turnover between firms reporting under IAS and US GAAP. He concluded in his paper titled "IAS versus US GAAP: A 'New Market' based Comparison" that there are no significant economic and statistical differences between the firms adopting IAS or US GAAP.

Thus, this would suggest that financial reporting under both the standards i.e. IAS and US GAAP are more or less equal, in quality and disclosures.

But, Leuz admits that more research is warranted in this area as his study of the New Market, which is considered to be similar to the NASDAQ of USA, where high-growth companies are listed, may not be comparable with other companies in more mature industries or old economy companies.

But, complete harmonization is difficult to achieve and there would always be certain differences to take into account the nature of business/services, economic and financial considerations prevalent in each country.

However, certain other studies have shown that for countries with low or poor quality financial reporting, mandating IAS might be the cure for bringing the accounting practices of such countries on par with international best practices.

**International Precedent**

Let us consider a pertinent international case which highlights the importance of harmonization.

In 1993, Daimler Benz AG (now DaimlerChrysler), the German automaker well-known for its Mercedes cars, was the first company to seek listing on the New York Stock Exchange (NYSE) in USA. Under German GAAP, Daimler reported a net income of Deutsch Marks (DM) 615 million for the year 1992. However, for the purpose of listing its stock on the NYSE, Daimler had to reconcile its reported income under US GAAP and this resulted into a net loss of DM 1.839 million.

This just shows that there can be significant and material differences between the GAAP followed by each country which needs to be reconciled and disclosed to the investors.

**The Recent Corporate Debacles in USA**

The recent corporate debacles in USA which include global majors like Enron, WorldCom, Xerox *et all* has lead to widespread criticism of the US GAAP, which is considered to be one of the best GAAPs in the world. The very credibility and effectiveness of US GAAP was being scrutinized under a lens.

However, we need to realize that these cases involved incorrect accounting treatment and in few instances, even fraud due to which even their auditors are facing rough weather (see The Accounting Mirage).

The Accounting Mirage			
Enterprise	Modus Operandi	US\$ Billions	Relevant Year/period
Enron Corp.	Accounting Irregularities/Errors	14.00	2001
Mereck & Co.	Overstated Revenue	12.40	1999-2001
Xerox Corp.	Overstated Revenue	6.40	1997-2001
	Overstated Pre-tax Profits	1.41	
Adelphia Communications	Off Balance Sheet loans to founders	4.50	2001
	Overstated Revenue and Cash Flow	0.50	
WorldCom Inc.	Improper Capitalization of expenditure	3.80	2001-2002

Thus, in these cases, the US GAAP should not be blamed. Instead, as it should be, the management and others in connivance with them should be made accountable for adopting faulty accounting practices.

Thus, unless the accounting procedures and treatment are correctly followed, the credibility of any GAAP cannot be questioned. What is more important is the credibility of the management, the adherence to GAAP and independent certification of the financial statements by auditors.

## The Recent Convergence Agreement between the FASB and IASB

A crucial landmark was reached in October 2002, when the Financial Accounting Standards Board (FASB) of the USA and the IASB, the world's most influential accounting standards board signed The Norwalk Agreement i.e. Convergence Agreement to create a set of key international standards.

The two Boards have agreed on the following matters:

- To undertake a short-term project aimed at removing the various differences between US GAAP and International Financial Reporting Standards (IFRS) which include the IAS.
- To remove the other differences between the IFRS and US GAAP that will remain at January 1, 2005 through coordination of their future work programs.

The two Boards will now be working on drafting towards an agreed principle based approach including key standards on acquisitions, financial performance and revenue recognition. This is a very important development in area of harmonization of accounting standards and indicates a paradigm shift by the FASB moving away from its strict "rules based approach" of the US GAAP towards the European "principles based approach".

Both the Boards have also decided to use their best efforts to issue an Exposure Draft of the Proposed Changes to US GAAP or IFRS that reflect common solutions to some and perhaps all of the differences identified for inclusion in the short term project during the year 2003.

Some of the implications of this agreement are as under:

- Companies would be required to follow the spirit of the principle rather than the letter of the rule.
- Companies would have to comply with a single set of accounting principles in the USA and Europe.
- The former SEC Chairman, Harvey Pitt, has also indicated that if the convergence project turns out be successful then, the current requirement for foreign issuers in the USA to reconcile their accounts with US GAAP may be dropped.

## Going Ahead

The adoption and usage of IAS and harmonization of domestic GAAP with IAS will be useful and meaningful when the following aspects are dealt with:

1. The domestic GAAP and IAS need to be followed and strictly complied by the companies. However, if companies look for loopholes and start exploiting them, even reporting under the domestic laws would not give a true and fair picture and thus, the very objective of harmonization would be lost. For ensuring such compliance, it is necessary to establish and put into place an effective and independent legal framework for detecting and penalizing non-compliances, frauds and manipulations.
2. In this context, the recent introduction of the process of conducting peer reviews introduced by the Institute of Chartered Accountants of India (ICAI), in line with international norms, is a welcome step.
3. Domestic GAAP should be formulated by independent and private professional bodies or associations like in Australia, Canada, UK, USA and India, rather than the government bodies like in France, Germany and Japan.
4. Managerial compensation and auditor remuneration needs to be competitive and market-based to avoid the possibility of misreporting of financial statements. This is because in most cases, especially in advanced countries, remuneration, bonuses, stock options and other benefits are directly correlated to the success and more importantly, the financial performance of the company. Fixation of auditor's remuneration, Independent of performance and process of the enterprise will discourage "earnings management" and the adoption of strategies like income smoothing, dividend smoothing, round tripping, big bath, take the money and run and likewise.
5. With the ongoing globalization and the constant change in which businesses and services are conducted and provided, GAAP need to be updated by countries regularly and also harmonized.
6. The IASB and/or IOSCO needs to formulate a mechanism whereby the GAAP of a country are graded in terms of harmonization with IAS. Further, for those countries who have agreed on harmonization, a time-frame should be instituted to ensure that over a period of time, the prescribed level of harmonization is achieved.

## Conclusion

Harmonization of multiple and diverse national GAAP is a huge and daunting task by itself. But, it is the order of the day.

However, suitable and adequate safeguards and safety nets, as listed above, also need to be built into national accounting and financial systems to achieve the objectives of harmonization. ■