A Comparative Review and Analysis of the Movement Toward a Global Accounting Standard

Mohamad Sepehri
Jacksonville University

Robert Houmes
Jacksonville University

This study provides a comparative discussion of arguments for and against initiatives to implement a universal (or global) accounting system. We consider the potential influence of these initiatives on global markets in terms of their relative relevancy and reliability for providing comparable as well as equivalent financial reporting for decision making by both investors and corporations. The paper provides in depth review and analysis of the major differences between a rule-based and principles-based accounting system including the benefits and drawbacks of a move to a principles-based accounting system.

INTRODUCTION

The current movement towards implementation of accounting standards that may be uniformly interpreted and applied across countries is one of the most significant events in the history of financial reporting. Proponents of the movement assert that worldwide unification of standards will facilitate comparisons of firms by more informed investors. Opponents predict a reduction in comparability and decision usefulness.

A fundamental difference between U.S. standards and International Financial Reporting Standards (IFRS) is their respective emphases on rules and principles. Relative to IFRS, U.S. GAAP (General Accepted Accounting Principles) tend to be numerous, detailed and prescriptive. In contrast, IFRS are based on a more parsimonious set of principles that may be broadly applied. Using a rules versus principles-based comparative framework, we consider arguments for and against current and prospective initiatives toward implementation of a global accounting system.

Our discussion begins with a brief review of the current global environment, followed by a contrastive analysis of U.S. GAAP and IFRS. These sections are followed by a review of factors currently motivating the move towards global standards and a discussion of the benefits from and challenges to their implementation. The paper concludes with prospective remarks regarding the eventual outcome of the globalization movement.

THE CURRENT ACCOUNTING ENVIORNMENT

Significant impetus exists for the world wide convergence of accounting standards into one unified body. Currently, over one-hundred countries, including Turkey, Singapore, Australia, and all members of the European Union, require or permit IFRS reporting. The United States, Canada, and Russia, are also implementing plans to adopt and embrace IFRS. While the U.S. is not in full compliance yet, Canada and Russia expect to do so by 2011. In its November, 2008 proposed roadmap for public comments (File No. S7-7-08) the SEC approved early implementation of IFRS for 110 of the largest publicly held companies in the United States. Representing about 14% of the total market capitalization in the U.S., these companies can implement IFRS for their end of fiscal year 2010 filings. The SEC states that in 2011 it will make a final decision regarding conversion to IFRS by all U.S. companies. Seven milestones have been identified by the SEC that would shape their 2011 decision. These include (SEC Nos. 339109, 2010):

- *limited early use of IFRS,*
- *improvements in accounting standards,*
- *the accountability and funding of the International Accounting Standards Committee Foundation,*
- *improvement in the ability to use interactive data for IFRS reporting,*
- *education and training in the U.S. relating to IFRS,*
- *the anticipated timing of future rulemaking by the commission and,*
- *the potential implementation of the mandatory use of IFRS, including considerations relating to whether any mandatory use of IFRS should be staged or sequences among groups of companies based on their market capitalization.*

While there has been general acceptance of the convergence movement, U.S. momentum towards enactment has slowed recently as issues and concerns regarding actual implementation have been raised. A major concern cited by the SEC in their most recent comment on global standards is that under IFRS inherently ambiguous principles could make litigation and enforcement outcomes more difficult to predict (SEC Nos. 339109, 2010). The following provides an analytical discussion that contrasts rules-based and principles-based accounting standards.

DISTINCTION AND CONTRAST BETWEEN U.S. GAAP AND IFRS

The value of accounting information is a function of its quality and timeliness. As stated in FASB Concepts Statement No. 2, the presentation of accounting information that is relevant and reliable are important goals for standard setters (FASB, 1980). Relevancy pertains to the importance and impact of information on users' economic decisions. Reliability relates to its' consistency, verifiability and representative faithfulness. Both enable investors who are typically far removed from the firm's day to day operations to measure value and performance. Recent accounting scandals have prompted the SEC and other relevant U.S. regulatory agencies, along with the Financial Accounting Standards Board (FASB), to question whether GAAP in its present form is adequate to accomplish these goals. At the core of these discussions is which system - a rules-based or principles-based system – promotes more credible financial reporting.

Enacted on July 30th, the Sarbanes-Oxley Act of 2002 (SOX) was the most significant financial reporting legislation since the SEC Acts of 1933 and 1934 and imposed numerous regulatory changes. Section 108 of SOX charged the SEC with conducting a study on the adaptation of a principles-based accounting system. In their July 25, 2003 responsive report to this mandate, the SEC concluded that the U.S. should move to a principles-based reporting system (SEC, 2010).

Proponents of a principles-based system assert that prescriptive rules-based standards reduce the quality of financial reports by implicitly sanctioning the structuring of transactions that promote superficial compliance with rules, but which in fact subvert the economic substance of the standard's intent. A particularly egregious example of "rules-based financial engineering" was Enron's infamous pre-bankruptcy use of special purpose entities (SPEs) to remove debt from their balance sheet.

Under FASB SFAS 125 and 140 (FASB, 2000) companies are not required to include the assets and liabilities of SPEs on their balance sheets as long as there is at least 3% ownership by an independent party and the party exercises control of the SPE. SPEs are separate legal entities created by a sponsoring firm with a limited purpose. For example, banks and finance companies enhance liquidity by selling receivables to SPEs. The SPE finances the purchase of the receivables by selling securities to outside investors. Their recent abuses notwithstanding, SPEs have long been a legitimate source of external financing.

A 2002 report by Enron's Special Investigative Committee of the Board of Directors states that for the period of years from 1997 to 1999, Enron used SPEs to remove $1.56 billion of debt off their balance sheets. The report goes on to state that *"During the late 1990s, Enron grew rapidly and moved into areas it believed fit its basic business plan……Much of this growth involved large initial capital investments that were not expected to generate significant earnings or cash flow in the short term. While Enron believed these investments would be beneficial over a period of time, they placed immediate pressure on Enron's balance sheet. Enron already had a substantial debt load. Funding the new investments by issuing additional debt was unattractive because cash flow in the early years would be insufficient to service that debt and would place pressure on Enron's credit ratings. Maintaining Enron's credit ratings at investment grade was vital to the conduct of its energy trading business. Alternatively, funding the investments by issuing additional equity was also unattractive because the earnings in the early years would be insufficient to avoid reducing earnings per share. One perceived solution to this finance problem was to find outside investors willing to enter into arrangements that would enable Enron to retain those risks it believed it could manage effectively, and the related rewards. These joint investments typically were structured as separate entities to which Enron and other investors contributed assets or other consideration" (*Powers, 2002, p. 42).

A more benign but frequent example of a rule's form over substance application is accounting for leases under SFAS 13 (FASB, 1976). Originally issued in 1976 and amended by subsequent pronouncements, SFAS 13 was originally intended to be a deterrent against firms using leases to avoid recognition of liabilities associated with the financing of capital asset purchases. Since classifying leases as capital increases reported liabilities, companies have incentives to structure leases to avoid capitalization. Indeed, the decision to classify a lease as operating can have a significant effect on a firm's reported financial position and in substance many operating leases are nothing more than "off balance sheet" financing arrangements. For example, a note disclosure in Southwest's Airlines' 2008 annual report states that "the majority the Company's terminal operations as well its 82 aircraft were under operating leases as of December 31, 2008", (Southwest Airlines, 2008, p.48). The note shows that during the 2009 to 2013 period total minimum lease payments for capital leases are $43 million and $2,032 million are for operating. In other words, 97% of Southwest's lease payments are classified as operating.

***TABLE 1**
EXCERPT OF NOTE DISCLOSURE FOR LEASE FROM SOUTHWEST AIRLINE 2008 ANNUAL REPORT TO SHAREHOLDERS

	Capital Lease	Operating Lease
	In millions	
2009	$16	$376
2010	$15	$324
2011	$12	$249
2012		$203
2013		$152
After 2013		$728
Total Minimum Lease Payments	$43	$2,032

Table I shows that the 2013 disclosed operating lease payment is \$152 million. Total operating lease payments after 2013 are \$728 million. Assuming future annual operating lease payments are similar to 2013 (Imhoff 1991), the estimated remaining lease term is approximately five years (\$728/ \$152). Adding this five year period to the 2009 to 2013 five year period results in an estimated lease term of 10 years. The relatively long estimated lengths of the lease terms suggest reclassifying these leases as capital.

Moody's end of 2008 bond rating for Southwest was Baa. Using a rate of 7% - the average daily interest rate for Baa ten year bonds in 2008 – to discount the remaining lease payments would result in an estimated present value of \$1,544 million. Hence reclassifying the leases from operating to capital would increase the firm's assets and liabilities by \$1,544 million. Using Southwest's 2008 balance sheet, Table II shows the effects of this adjustment on short term and long term financial risk ratios. Liquidity ratios decrease respectively for cash to current liability and current assets to current liability from .49 to .43 and from 1.03 to .92. Long term financial risk ratios show similar results as the long term debt to total asset and long term debt to total stockholder's equity ratios increase.

TABLE 2
SHORT AND LONG TERM FINANCIAL RISK RATIOS BEFORE AND AFTER ANALYTICAL ADJUSTMENTS FROM OPERATING TO CAPITAL LEASE

Financial Risk Ratios	Before Adjustment	After Adjustment
Cash / Current Liability	.49	.43
Current Asset / Current Liability	1.03	.92
Long Term Debt / Total Asset	.24	.32
Long Term Debt to Total Stockholder's Equity	.71	1.01

Southwest's treatment of leases is similar to other airlines. A review of the note disclosures for other airlines under Southwest's SIC code 4512 (air transportation scheduled) confirms that these firms generally classify a substantial portion of their leases as operating. In other words, for the 2008 fiscal year end period, airlines avoid balance sheet recognition of capital assets by classifying the vast majority of their leases as operating.

Hence it may be argues that an unintended consequence of SFAS 13 is that managers perceive adherence to "bright line" lease classification criteria as an implicit justification to structure leases to effect off balance sheet financing of long-lived asets. Nelson et al. (2002) provide evidence that managers are more likely to attempt earnings management through structured transactions and auditors are less likely to adjust these earnings management attempts when standards are more precise. Lease financing has increased over the years and has become the primary source of plant and equipment financing for certain industries, e.g. airlines, transportation and retail. Lindsey (2006) documents that rental commitments by U.S. firms from off-balance sheet operating leases is 1.05 trillion. Additional examples of rules-based standards that have inspired similar alternative accounting treatments include SFAS 133: Accounting for Derivative and Hedging Activities (FASB, 1998), SFAS 140: Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities (FASB 2000), etc.

Relative to a rules-based approach the overall goal of principles-based accounting is to create a less complicated and more economically substantive framework of general principles that accountants and managers can use to audit and prepare financial statements. Rather than complying with specific "bright lines" managers are required to report financial transactions according to their economic substance (Shortridge, 2004). Proponents of IFRS assert that the ability of preparers to manage financial reports with form over substance transactions will be impaired under a principles-based system. Although the

U.S. is among the majority of countries currently utilizing a rule-based accounting system, from a global perspective a shift to a more principal-based - international standards based system is gaining momentum.

WHAT IS CAUSING THE SHIFT TO IFRS?

Although the current movement towards global standards is formidable, it has been only recently that the goal of worldwide standardization has been perceived as achievable. At present, around 100 countries follow IFRS. The European Council of Ministers gave the growing IFRS movement a boost in 2002 when they passed regulation requiring all European Union corporations listed on a market to prepare reports in accordance with IFRS beginning January, 2005 (Deloitte, 2003).

In conjunction with the integration of world economies, the increasing fluidity of international markets provides a significant impetus for the movement towards global accounting standards. Motivated by the potential for a single worldwide set of high-quality principles bred from the best ideas from each set of standards and the hope for a dramatic improvement in the efficiency of global capital markets, the SEC and European Commission have increasingly embraced the ideas of convergence and harmonization. Indeed, many countries are in the process of replacing their own national GAAP with IFRS. According to a joint pledge from the IASB and the FASB, the widespread use of global accounting standards will become a reality within the next few years (Gill, 2007). Securities regulators state that, in light of the growth and internationalization of economies, global standards are inevitable (Iwata, 2008).

BENEIFTS OF A GLOBAL ACCOUNTING STANDARD

Supporters of IFRS cite numerous benefits of a unified global financial reporting system. As stated above, global standards enhance comparability. Under the current system of various standards, "One of the obstacles that investors have to overcome in making investment decisions is the different ways that this information can be reported" (Cox, 2007). As the world becomes more globalized, the difficulty in analyzing and comparing companies across their national boarders also increases. As more and more businesses turn global, companies that adopt one global accounting standard "will be able to compare their financial reporting to that of their international competitors" (KMPG, 2008).

Another important benefit of principles-based accounting is its' inherent flexibility. Since rules-based systems tend to be more situation specific, they may be poorly equipped to deal with the dynamic and ever changing reporting environment that characterize today's modern economies. In contrast, a principles-based system could provide more robust guidance for companies in both traditional and dynamic new industries.

Relative to rules-based standards, principles-based statements are also more parsimonious less complex and, therefore, easier to use. If the overriding principle is understood, it can be applied. In contrast, discovering understanding and applying appropriate specific GAAP pronouncements which pertain to complex accounting issues can consume scarce resources which might otherwise be used to generate value. Ray Groves, the retired chairman of Ernst and Young LLP, estimated that during the 1972 to 1994 period the number of pages of footnotes increased at a compound rate of 7.5 percent per year (Hewett, 1995). He asserts that the increase in note disclosures has produced a more opaque financial reporting environment. For example, to account for lease transactions, including various interpretations and pronouncements, the IASB has seven documents referencing leases, compared to seventy-eight under US GAAP (Shortridge, 2004).

Increased market efficiency from the enhanced world- wide comparability of financial reports based on one set of standards is another compelling argument for principles-based guidance. Indeed, proponents of principles-based standards assert that investors from the EU and elsewhere will be more inclined to invest across borders if they can more easily make educated inter-nation comparisons. The ability of better informed U.S. investors to diversify with international portfolios should also improve. Further, financial reporting costs associated with takeovers and mergers between international firms should decline (Katz, 2007). In addition, global accounting standards might reduce costs associated with new and secondary equity issues, since firms would no longer have to incur the cost of preparing financial statements using different sets of accounting standards" (Cox, 2007). Multinational entities could also "streamline reporting and reduce related costs by developing common reporting systems" (KMPG, 2008). Non-value adding internal reporting costs incurred to convert different accounting reports to those that are more readable and comparable could instead be invested into value adding projects.

Global accounting standards might also enhance international investment. That is, greater reporting comparability and the associated decrease in costs to do business internationally, may increase incentives for companies to invest resources into international endeavors. Cox (2007) asserts that "global accounting standards would improve investor confidence in the market, so long as the standards are high-quality, comprehensive and rigorously applied." From an international perspective, since one set of high-quality IFRS would simplify the reporting process and increase understandability, more companies with better information could have greater confidence to invest into franchises, ventures, acquisitions and perhaps even create new industries in foreign countries (KPMG, 2008). Consequently, overall investor confidence should improve with more uniform international standards (Gill, 2007). Finally, a global standard could attract foreign investors to U.S. markets since there would no longer be the need to adjust GAAP based financial statements.

Although the benefits of one international set of reporting standards are numerous and the current movement towards their creation, use and implementation are widely supported, others remain skeptical. While the SEC continues to reiterate its' support for IFRS, the Commission has also recently expressed reservations regarding its' feasibility. The following section considers arguments against and challenges to implementation of global accounting standards.

CHALLENGES TO IMPLEMENTATIION OF GLOBAL ACCOUNTING STANDARDS

While proponents of IFRS argue that global standards will enhance comparability, opponents assert that comparability will be reduced. Schipper (2003) contends that detailed implementation guidance enhances the comparability between financial reports. Hence, a greater emphasis on ambiguous principles rather than prescriptive and precise rules would reduce comparability. In addition, more precise standards could enhance verifiability. It may be conjectured that due to concerns about the potential for litigation from their exercise of judgment in the absence of concise rules auditors prefer rules-based standards. In a comment letter responding to FASB's proposed principles-based approach to standard setting, the accounting firm BDO Seidman LLP (2002) predicts that since principles-based standards are inherently ambiguous, the incidence of litigation against auditors and companies will increase. In light of the comparatively higher incidence of litigation in the U.S. this could be especially relevant for domestic accounts.

Also, the adoption of principles-based standards requires additional interpretation of the standards' application which could potentially lead to intra-country reporting inconsistencies. Indeed, for countries with new and diverse industries, principles-based standards may actually be a deterrent against taking part in the globalization effort.

The European Commission, the executive branch of the European Union, launched a public consultation on the endorsement of IFRS. Eumedion, the corporate governance forum for institutional investors expressed concern with regards to a transition to a principled-based system. Eumedion advised that they cannot completely endorse IFRS. They expressed a potential general increase in financial statements' inherent risk since early on managers might be more reluctant to disclose negative information to board members. The forum has also sighted the lack of objectivity, loss of comparability, loss of risk and reward override, loss of geographic information and finally inconsistent measurement criteria (Madziar, 2007).

From a cost-benefit perspective, implementation will impose costs that include the standardization of training programs to educate and train certified public accountants to practice not only across state, but also international borders. In addition implementation of IT system changes along with the requisite knowledge to operate under IFRS must be effected (PWC, 2008). Nevertheless, proponents assert numerous benefits of IFRS and stress that in spite of the additional costs of young and evolving international standards, the cost of having two sets of standards is not sustainable.

CONCLUSION

Using a rules versus principles-based contrastive framework, this study considers the merits and shortcomings of initiatives towards global accounting standards. It is interesting to note that although U.S. standards are generally characterized as rules-based , GAAP are in fact based on *principles* articulated in its' underlying conceptual statements. It may be argued that despite GAAP's well conceived body of principles the evolution of numerous "bright line" standards may have been a necessary outcome of the inability of principles alone to provide sufficient guidance in an increasingly diverse and complex economic environment.

In addition to the issues mentioned above, geo-political factors may also impact the pervasiveness (or lack thereof) of a convergent set of FASB-IASB standards. Indeed, it may be argued that the long standing, well established regulatory and legal infra-structure that U.S. GAAP has evolved from is both politically and economically well entrenched. In addition, although uniform standards that generally enhance reporting quality across borders is a widely espoused regulatory goal, certain specific financial reporting objectives may differ between U.S. and other countries. For example, Black and White (2004) document that financing tends to be more equity driven in the U.S. and more creditor or bank driven in European countries. Hence the acceptability of standards that tend to increase reporting quality for one statement (e.g. the LIFO income statement) at the expense of another (e.g. the LIFO balance sheet) may prove to be but yet another impediment to convergence. IFRS prohibits LIFO accounting. As of this writing much remains unresolved. Yet both FASB and IASB resources remain committed to a converged set of international standards.

REFERENCES

American Institute of Certified Public Accountants (AICPA). (2008). SEC Unanimously Approves Exposing Proposed IFRS Roadmap for Public Comment. Retrieved October 1, 2008 from: IFRS Resources Web site: http://www.ifrs.com/updates/sec/SEC_approves.html.

Alexander, D. and Jermakowica, E. (2006). A True and Fair View of the Principles-Rules Debate. *Abacu*s, June, 132-164.

BDO Seidman, LLP. (2002). Comment Letter to Financial Accouting Standards Board of Proposal, Principles-Based Approach to U. S. Standars Setting. *Financial Reproting Newsletter* (December).

Black, E. L. and White, J. J. (2003). An international Comparison of Income Statement and Balance Sheet Information: Germany, Japan and the US. *European Accounting Review* 12 (1): 29–46.

Cox, C. (2007). Speech by SEC Chairman: Chairman's Address to the SEC Roundtable on International Financial Reporting Standards. U.S. Securities and Exchange Commission. Retrieved March, 27, 2008 from: http://www.sec.gov/news/speech/2007/spch030607cc.htm.

Deloitte and Touche. (2003). Deloitte: Global Insurance Industry Outlook. Retrieved September 27, 2008 from: www.hoeft-wessel.com/de/aktie/GB2003/HWS03E.pdf.

Ernst and Young. (2008). IFRS: A Strategic Opportunity. Retrieved September 16, 2008 from: Ernst & Young Web site: www.ey.com.

Financial Accounting Standards Board (FASB). (1976). *Accounting for Leases SFAS No.13*, Stanford, CT: FASB.

Financial Accounting Standards Board (FASB). (1998). *Accounting for Derivative Instrument and Hedging Activities No. 133*, Stanford, CT: FASB.

Financial Accounting Standards Board (FASB). (2000). *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities No. 140,* Stanford, CT: FASB.

FASB Response to SEC Study on the Adoption of a Principles-Based Accounting System. Retrieved July 7, 2004, from FASB.org: http://www.fasb.org/response_sec_study_july2004.pdf.

Financial Accounting Standards Board (FASB). (1980). *Statement of Financial Accounting Concepts No. 2: Qualitative Characteristics of Accounting Information*, Stanford, CT: FASB.

Gill, L. (2007). IFRS: Coming to America. What CPAs Need to Know About the New Global GAAP? (June) *Journal of Accountancy* June, 27-35.

Hewett, G. (1995). Calling Directors to Account, May, *South China Morning Post*.

IASB and the IASC Foundation (2008). Who We Are and What We Do. Retrieved June 6, 2009 from: www.iasb.org.

Imhoff, E. A. and Thomas, J. K. (1991). Economic Consequences of Accounting Standards. *Journal of Accounting and Economics* 10, 277-310.

Iwata, E. (2008). SEC OKs Plan That Could Lead to Global Accounting Rules. (8/28/2008). *USA Today*, p. Money, 05b.

Katz, David M. (2007). IFRS or GAAP? Take your pick. Retrieved September 16, 2008, from: www.cfo.com

KPMG. (2008). IFRS in the U.S.: Benefits and Challenges of the Coming Change. Retrieved March 10, 2009 from: www.kpmg.com.

Lindsey, B. R. (2006). A Value Relevance Examination of the Current Leasing Standard, dissertation proposal. The University of North Carolina at Chapel Hill.

Madziar, Piotr. (2007). Eumedion Response to the European Commission's Public Consultation on the Endorsement of IFRS Operating Segments. Retrieved September 28, 2008, from: http://ec.europa.eu/internal_market/accounting/ias/index_en.htm.

Nelson, M. W., Elliot, J. A. and Tarpley, R. L. (2002) Evidence from Auditors about Managers' and Auditors' Earnings Management Decisions. *The Accounting Review*, 77, Supplement, 175-202.

PWC. (2007). International Financial Reporting Standards (IFRS). Retrieved September 18, 2008, from PricewaterhouseCoopers Web site: www.pwc.com.

Pounder, Bruce. (2009). Convergence Guidebook, for Corporate Financial Reporting. John Wiley & sons, Inc. Hoboken, New Jersey.

Powers, William C., Troubh, R. R. and Winokur, H. S. (2002). p. 42. Retrieved January 18, 2010 from: http://i.cnn.net/cnn/2002/LAW/02/02/enron.report/powers.report.pdf

Schipper, K. (2003). Principles-Based Accounting Standards. *Accounting Horizons*, 17(8), 61-72.

Securities and Exchange Commission (SEC). (2010). Commission Statement In Support Of Convergence and Global Accounting Standards Release Nos. 33-9109; 34-61578. Retrieved March 10, 2010 from: http://www.sec.gov/rules/other/2010/33-9109.pdf.

Securities and Exchange Commission (SEC). (2008). Roadmap For The Potential Use Of Financial Statements Prepared In Accordance With International Financial Reporting Standards By U. S. Users; Release NOS. 33-8892; 34-58960; File No. S7-27-08. Retrieved April, 2010 from: www.sec.gov/rules/proposed/2008/33-8982.pdf.

Shortridge, R., and Myring, M. (2004). Defining Principles-Based Accounting Standards. *CPA Journal*, *74*(8), 34-37.

Southwest Airlines (20008) Form *10-K Southwest Airlines Inc. for the fiscal year ended December 27, 2008*. (Filed: February 25). Retrieved March 10, 2010 from: http://www.southwest.com/html/cs/investor_relations/annual_reports.html#ar.