A standard argument

Myths and realities of harmonising accounting rules

The Australian Accounting Standards Board (AASB) believes strongly that accounting standards can no longer be developed in national isolation. For this reason, the AASB developed and issued its international harmonisation policy in 1996. The objective outlined in that policy is to move ultimately to the adoption of a globally accepted set of accounting standards. Ken Spencer explains that no such set of standards currently exists.

If we are to achieve a globally acceptable set of accounting standards in a reasonable time, it will probably be through the adoption of the International Accounting Standards Committee (IASC) standards, although some other route to the desired result cannot be ruled out. As an interim step towards its harmonisation objective, the Australian Accounting Standards Board (AASB) has made a commitment to contributing significantly to the work of the IASC.

The AASB's program aims to make Australian standards and IASC standards consistent, so that entities complying with Australian standards will automatically meet IASC requirements. Australia has in fact already done more than any other country with an established standard-setting regime to work towards harmonisation with the IASC. Despite this, some commentators believe that Australia should immediately discard Australian-developed standards (which, for the most part, are consistent with IASC standards) and adopt IASC standards without amendment.

This would be a mistake. In the interests of informed debate on the issue, this article exposes some of the myths which often accompany the calls to replace Australian-developed standards by adopting IASC standards without amendment.

Myth 1: IASC standards are, or are rapidly becoming, globally accepted

The argument that many countries and companies throughout the world are moving to adopt IASC standards has led to an inference that they now form, or are at least becoming, a globally accepted set of international standards.

In fact, only a few countries have adopted the substance of IASC standards, and none of them is significant in terms of world capital markets. A recent survey published in IASC’s Insight (October 1997) showed that eight countries – Croatia, Cyprus, Kuwait, Latvia, Malta, Oman, Pakistan, and Trinidad and Tobago – use IAS as national standards. It should be noted that even these countries add explanatory material to the standards.

Two countries, Malaysia and Papua New Guinea, also adopt IASC standards but also develop national standards for topics not covered by the international set. Fourteen countries, the most significant of which are Poland, Thailand and Zimbabwe, use IASC standards which have been “modified for local conditions or circumstances”. Five countries, including China, develop separate national accounting standards which are based on, and similar to, IASC standards. Twenty-four countries develop national standards based on or similar to IASC standards.
Table 1: Share of world market capitalisation

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage of world market capitalisation</th>
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<tbody>
<tr>
<td>Australia</td>
<td>1.25</td>
</tr>
<tr>
<td>France</td>
<td>3.21</td>
</tr>
<tr>
<td>Germany</td>
<td>3.86</td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>1.21</td>
</tr>
<tr>
<td>Indonesia</td>
<td>0.04</td>
</tr>
<tr>
<td>Japan</td>
<td>11.63</td>
</tr>
<tr>
<td>Malaysia</td>
<td>0.23</td>
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<tr>
<td>Singapore</td>
<td>0.18</td>
</tr>
<tr>
<td>Switzerland</td>
<td>3.04</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>10.90</td>
</tr>
<tr>
<td>United States</td>
<td>51.67</td>
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but the standards may provide more or less choice than those of the IASC. These countries include Australia, France, Hong Kong, India, Ireland, Netherlands, New Zealand, Singapore, South Africa, Sweden and Switzerland. Eleven countries, including Canada, Germany, Japan, Korea, Spain, the UK and the US, separately develop national standards.

Many of the countries said to be adopting IASC standards or developing standards based on them, such as Malaysia and China, have standards which differ in significant respects from the IASC models. For example, Malaysia adopts some IASs without significant amendment and some with significant amendment. Others it ignores altogether.

Other countries, such as Hong Kong, have standards which differ in some significant respects from their IASC counterparts and do not have standards for many topics covered by IASC standards. Financial reporting practice in these countries cannot be described as being consistent with IASC standards.

It is clear that many countries have not adopted IASC standards without amendment. Further, Table 1, which shows countries’ share of world market capitalisation, suggests that IASC standards would need to be accepted for domestic reporting purposes in countries such as the US, UK and Japan if they are to be considered globally accepted.

In this context, it is important for Australia, which has a small but well-developed capital market, not to place its reputation at risk by committing to IASC standards before it is clear that they will become truly global standards.

Whether IASC standards will become globally accepted by virtue of being adopted in the world’s major capital markets depends on a number of factors, including their quality. In addition, much depends on the relationship that the IASC develops with key national standard-setters. If key national standard-setters remain informal participants in the IASC process, rather than becoming voting members of the IASC, it is possible that the standards of another standard-setter (or group of standard-setters) may become the preferred set.

**MYTH 2: IMMEDIATELY ADOPTING IASC STANDARDS WOULD BENEFIT AUSTRALIA**

Proponents of the view that Australian standards without amendment argue that it would benefit Australia by:

- reducing reporting costs for Australian-based multinational companies;
- increasing the comparability of financial reports for investors;
- increasing the attractiveness to foreign companies of an Australian Stock Exchange (ASX) listing; and
- helping the ASX to retain its current listings.

**Benefits to Australian companies**

If Australian standards are harmonised with IASC standards, and if IASC standards are accepted for cross-border purposes in capital markets such as the US, then Australian entities seeking a foreign listing would derive some cost savings from being able to prepare just one set of financial reports for both domestic and overseas purposes. However, medium and smaller Australian entities who raise their capital domestically could not benefit directly from adopting IASC standards. In fact, they may incur additional costs, including those relating to staff retraining and redesign of accounting systems.

**Benefits to the ASX**

Under the listing rules of the ASX, non-domestic entities which satisfy certain criteria can meet their reporting obligations by lodging financial reports prepared in accordance with IASC standards, rather than preparing additional reports which comply with Australian standards.

Because existing ASX financial reporting rules do not impede listings by non-domestic entities of significant size, adoption of IASC standards is unlikely to cause an influx of non-domestic entities seeking to list on the ASX.

Further, it is highly unlikely that Australian entities will be driven offshore if Australia does not adopt IASC standards without amendment. Major capital markets around the world require locally domiciled companies to prepare financial reports in accordance with local (national) accounting standards. For example, an Australian company changing its domicile to the UK would need to prepare financial reports in accordance with UK standards.

**Benefits to investors**

Adopting IASC standards without amendment would not improve the comparability of Australian entities’ financial reports with those of overseas entities, since very few of the latter use IASC standards. Moreover, the options available under IASC standards mitigate against their positive impact on the international comparability of financial reporting (see Myth 3).

**MYTH 3: IASC STANDARDS ARE MORE RIGOROUS THAN, OR AT LEAST AS RIGOROUS AS, AUSTRALIAN STANDARDS**

It has been claimed that, with few
exceptions, IASC standards are at least as rigorous as Australian standards.

Alan Cameron, chairman of the Australian Securities Commission (ASC), observed in November 1997 about the relative rigour of IASC and Australian standards: “IASC standards are generally more permissive and less comprehensive than are domestic standards in Australia and in other major economies. Work being done by the IASC towards improving the quality of its standards is useful and should be encouraged. But, ultimately, IASC standards will always be the result of a complex compromise between numerous jurisdictions, and may never be aimed specifically at Australian needs and circumstances.”

The rigour of IASC standards, compared with Australian standards, falls on two major fronts: the alternative accounting policies which they allow, and their suitability to the Australian environment.

Alternative accounting policies

Standards in most major jurisdictions allow choices between alternative accounting policies. Despite an IASC program to limit the available choices, its standards continue to allow alternative policies in a wider range of circumstances than those of major national standard-setters such as the US, the UK and Australia.

The number of IASC standards which permit alternative accounting policies for like transactions or events is a significant hindrance to the international comparability of financial reports. Two companies could report the same transactions and events in different ways, and consequently report significantly different results and financial positions, and yet both could claim that their financial reports comply with IASC standards.

Even today, the IASC continues to issue standards which allow choices between significantly different accounting policies. For example, a standard on employee benefits approved by the IASC in January 1998 allows, at the discretion of the preparer, actuarial gains and losses relating to retirement benefits to be recognised either immediately or in any systematic manner over a period up to the average remaining service lives of employees. The difficulties posed by alternative accounting policies are widely acknowledged. Brigid Curran, a partner at Coopers & Lybrand and former technical director of the IASC, pointed out in the September 1996 issue of her firm’s publication Emerging Issues:

“Application of the various alternatives [in IASC standards] may result in significantly different financial information and can have a material impact on comparability.”

Suitability to the Australian environment

The format of IASC standards reflects the fact that they are generic, are not designed to be legally binding in their own right, and have not been developed to be applied or enforced in the context of the specific legal framework and business environment existing in each country. Because IASC standards are not designed to be implemented as “black-letter” law, applying them would be particularly difficult in a country such as Australia, where accounting standards have legal status.

For example, many IASC standards contain substantive requirements in commentary paragraphs. This means that the paragraphs which establish the requirements of a standard (often referred to in Australia as “black-letter” paragraphs) do not contain sufficient detail to adequately prescribe the accounting policies or disclosures.

Further, in some instances the commentary in IASC standards is inconsistent with the black-letter paragraphs, effectively watering down the black-letter requirements or creating uncertainty about the required treatment. In contrast, Australian standards distinguish carefully between black-letter and commentary paragraphs, as the former comprise the enforceable part of a standard under the Corporations Law. Commentary paragraphs in Australian standards cannot modify or add to the requirements set out in black-letter paragraphs.

Shortcomings of Australian standards

Australian standards, compared with the IASC’s, are not without shortcomings. Some have not been improved for a number of years.

As part of the AASB’s international harmonisation program, these shortcomings are being addressed and existing Australian standards are being improved. This will result in a better quality of financial reporting.

MYTH 4: WHOLESALE ADOPTION OF
IASC STANDARDS IS WIDELY
SUPPORTED BY THE AUSTRALIAN
BUSINESS COMMUNITY

Despite arguments favouring the immediate adoption of IASC standards, most groups in the Australian business community support the AASB’s strategy of pursuing harmonisation as a first step towards a globally accepted set of standards. In an ASX survey of listed companies in 1996 to determine whether they supported immediate adoption of IASC standards or harmonising Australian standards with them, a clear majority (250 of 287, or 87%) chose harmonisation over immediate adoption. Only 37 (13%) supported immediate adoption.
Other groups such as the Australian Investment Managers Association, the Securities Institute of Australia, the Group of 100 and the Australian Shareholders Association have recently supported the current harmonisation process, rather than the immediate adoption of IASC standards. Many of the AASB’s constituents have put this view strongly when commenting on Australian exposure drafts, stating that Australia should reserve the right to amend IASC standards where they are inappropriate for the Australian environment.

MYTH 5: NATIONAL SECURITIES REGULATORS WILL SOON ENDORSE IASC STANDARDS FOR CROSS-BORDER LISTING PURPOSES

The International Organisation of Securities Commissions (IOSCO) has agreed that it will consider endorsing IASC standards for use in cross-border listings following completion of the IASC’s present work program. Evaluation of the standards by IOSCO, through an as-yet unstated process, will take some time. If IOSCO endorses the core standards, they will then be referred to individual national securities commissions for endorsement.

It is likely to be some time before the US Securities and Exchange Commission (SEC) is in a position to endorse the standards. The SEC is required to undertake a public consultative process, which could involve congressional hearings, before it can alter the rules for registration of foreign companies.

SEC chairman Arthur Levitt, in an address in Detroit on 19 May 1997, said: “Commission acceptance of international standards is not a foregone conclusion. It bears repeating that while harmonisation is a desirable goal for the US, our standards are already accepted in capital markets throughout the world, and their quality is unmatched. We can only accept a framework that will enhance, rather than diminish, the strength and stability of the US capital markets.”

CONCLUSION

The overall quality of IASC standards has improved significantly, to the point where there appears to be a realistic prospect of their being adopted in the world’s major capital markets. However, this has yet to occur because, as a set of standards designed to ensure high-quality financial reporting, IASC standards still generally lack the rigour of those developed by major national standard-setters, including Australia.

Accordingly, it would be premature for Australia to adopt IASC standards without retaining the right to amend them where appropriate. Rather, Australia’s interests would be best served by continuing to participate in IASC activities and carrying forward the harmonisation program. This will ensure that Australia is well placed to adopt IASC standards if and when they become globally accepted, without compromising the quality of its financial reporting or the reputation of its capital market.

Harmony — to whose tune?

The debate in Australia on international harmonisation of accounting standards has ebbed and flowed for decades. Interestingly, one of the strongest themes voiced by academics and practitioners has been their call to resist simply falling into line with some global consensus. Rather, say critics of the follow-the-leader camp, Australia needs to protect what is in many ways a superior set of standards. Australia could be the leader.

Much space has been given to the controversy in Australian Accounting Review, an academically-focused journal published by the Australian Society of CPAs with the support of the Accounting Foundation at the University of Sydney. The exposure of multiple viewpoints has given emphasis to the importance of the question for Australia’s securities industry.

An issue of AAR in late 1997 included an assessment by Richard Humphry, managing director of the Australian Stock Exchange, who contended that harmonisation would improve the competitiveness of our finance sector and benefit companies operating overseas. A companion article argued that the harmonisation program would have more credibility if time were taken to examine the conceptual issues properly, rather than looking for a “quick fix”.

In the most recent issue of AAR, the managing editor, Linda English, comments in an editorial that the harmonisation debate now occupies centre-stage in the accounting standards arena.

Introducing another series of articles on the controversy, English reminds readers that the call for harmonisation goes back to 1960, although with the advent of the government’s Corporate Law Economic Reform Program (CLERP) it has become more strident and urgent. "The benefits seem compelling to many commentators but the argument so far has conveniently skirted some serious questions," she writes.

"Why do we observe the differences in the first place? Do not differences in accounting standards reflect underlying legal, socio-economic and political differences? And can they be brushed aside in the name of comparability of financial statements?"

"What will happen to Australia's intellectual capital base in accounting if the standard-setting action shifts offshore? Is there really a first mover advantage? Or, rather than committing ourselves publicly to the wholesale adoption of international accounting standards (as canvassed in the CLERP paper), would it be better to keep our powder dry?"