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2001 Review

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PREFACE

The United Nations has been contributing towards the harmonization of financial accounting and reporting standards for about three decades. In order to address accounting and financial reporting issues on a continuous and inclusive basis, member States established the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) in 1982. Since then, the Group has held 18 sessions.

The eighteenth session was held in Geneva on 10-12 September 2001. The main agenda item for the session was accounting by small and medium-sized enterprises (SMEs). The experts had previously identified a number of obstacles that SMEs face in maintaining accounting records and generating meaningful financial information. They established an ad hoc consultative group of 23 experts to formulate proposals for resolving these obstacles. Intensive consultations were conducted and a report was presented to the eighteenth session.

This volume of the *Review of International Accounting and Reporting Issues* contains the proceedings of the eighteenth session of ISAR. The deliberations on accounting by small and medium-sized enterprises are presented in Part 1. It also contains essays by leading experts on the implementation of international accounting standards and the current state of the international standard-setting process; The essays are presented in Part 2.

UNCTAD would like to thank all the members of the ad hoc consultative group on accounting by SMEs for their valuable contributions: Ashok Chandak (The Institute of Chartered Accountants of India), India; ChenYugui, (Ministry of Finance) People's Republic of China; Colin Fleming, (Observer - International Accounting Standards Board), United Kingdom; Eric Delesalle (Institut National des Techniques Economiques et Comptables du Conservatoire National des Arts et Métiers), France; Aziz Dieye (PricewaterhouseCoopers), Senegal; Tihomir Domazet (Ministry of Finance), Croatia; Ndung'u Gathinji (Eastern Central and Southern African Federation of Accountants), Kenya; Lyle Handfield (Certified General Accountants Association of Canada), Canada; David Harvey (The Association of Chartered Accountants), United Kingdom; John Hegarty (World Bank), United States; Peter Johnston (International Federation of Accountants), United States; Owen N. Koimburi, Kenya; Mikael Lindroos (European Commission), Belgium; C. M. Lovatt (Deloitte and Touche), Malawi; Richard Martin (Association of Chartered Certified Accountants), United Kingdom; David Moore (Canadian Institute of Chartered Accountants), Canada; Mary Ncube, Zambia; Prawit Ninsuvannakul (Chulalongkorn University), Thailand; Ricardo Rodil, Brazil; Alfred Stéttler (University of Lausanne), Switzerland; Samiuela Tukuafu (Asian Development Bank), Philippines; John Vincent (Association of Accounting Technicians), United Kingdom, and Peter Walton (ESSEC Business School), France.

Last but not least, UNCTAD would like to thank David Cairns, Secretary General of the IASC (1985-1994), Dr. Patricia Sucher (Royal Holloway, University of London) and Professor Peter Walton (ESSEC Business School) for contributing essays to this volume of the *Review.* UNCTAD would also like to extend its appreciation to the Secretariat who made this publication possible; Yoseph Asmelash, Constantine Bartel, Chedra Bullock, Roselyne Carrier, Tatiana Krylova, Dezider Stefunko and Lorraine Ruffing.

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PART 1

ACCOUNTING BY SMALL AND MEDIUM-SIZED ENTERPRISES

SUMMARY

An UNCTAD resource person, introducing the item, recalled that the mandate given to the consultative group, whose report was contained in document TD/B/COM.2/ISAR/12, had been to decide on a categorization of SMEs and a user-friendly accounting and reporting framework for SMEs and identify implementation difficulties.

Any accounting system for SMEs should be simple, understandable, and user-friendly. It should contain management information, and this was a major departure from the usual financial accounting framework, which contained information for external rather than internal users. However, ISAR had decided that the needs of SME managers should be taken into account. The system should be reconcilable for tax purposes and should take into consideration the SME environment, particularly resource constraints. The framework proposed by the consultative group was based on several assumptions, including that different-sized enterprises required different accounting rules, that rules should be aligned with resources, and that rules should be consistent with the International Accounting Standards (IAS) and their conceptual framework.

Assuming that in any economy there were many different-sized businesses and that a single accounting framework would therefore ignore economic reality, a system should be created that was internally consistent and allowed enterprises to graduate from one level to another. The consultative group proposed that enterprises be divided into three categories

Level 1: entities that issue public securities and entities in which there is significant public interest, as well as banks and financial institutions
Level 2: larger SMEs that do not issue public securities and do not prepare financial reports for the general public.
Level 3: small businesses and new entrants.

Level 1 entities would apply full IAS. Level 2 entities would apply a core set of IAS. Level 3 small businesses would do simple accruals, while new entrants would be allowed to do cash accounting for a brief period. Each country would have to define "entities in which there is a significant public interest". However, this was generally thought to refer to enterprises with a "significant" number of employees, in-house accounting skills and the potential to expand to Level 1. The dividing line between Levels 2 and 3 would have to be determined by each country according to its economic structure.

The application of full IAS might be beyond the needs of Level 2 enterprises and the costs would outweigh their benefits. These enterprises would apply an "abridged IAS" that covered most of their transactions. The speaker referred to the 80/20 rule, which states that 20 per cent of the standards cover 80 per cent of SME transactions. However, if an SME were to encounter a transaction that the "core standards" did not address, it would be required to comply with full

IAS. Level 2 enterprises would always have the option of complying with full IAS.

The consultative group felt that a condensed set of rules for smaller businesses could be particularly useful in a developing-country environment and could serve as a stepping-stone to full IAS compliance. It could be a starting point for the development of a "technician" level of accounting expertise, specifically for SMEs.

Most importantly, the consultative group took the view that the "abridged IAS" should preserve the recognition and measurement base of the full IAS, but with limited disclosure requirements. The selection process would involve first identifying those standards thought unlikely to concern larger SMEs and then identifying disclosure requirements that would not be applicable to Level 2 SMEs or could be simplified. The "abridged IAS" could eventually be a single document that would bring together the relevant elements of the "core SME standards". The speaker explained which IAS had been included and which excluded. Criteria for inclusion included frequency of use and degree of complexity.

With respect to the smallest SMEs, the consultative group was of the view that these SMEs should follow a simple accruals system that would be consistent but not fully compliant with IAS. The accounting framework would principally aim at producing useful information for management, tax officials and creditors. The speaker introduced a set of sample financial statements (presented in annex 1 of the ad hoc consultative group's report) that would fulfil the external and internal reporting needs of SMEs. These included a model chart of accounts containing a list of headings that could be used to maintain a general ledger directly linked to the main financial statements. Such a chart would allow the creation of a database that tracked transactions and complied with accounting rules and could be handled by an accounting technician. The uniform approach imposed by the use of a chart of accounts would cut the cost of training and retraining at both the enterprise and the economy levels as people transferred from enterprise to enterprise or even from country to country.

In the discussion that followed, the group of experts reviewed and deliberated on the report prepared by the ad hoc consultative group. Although most experts agreed with the general approach to accounting by SMEs proposed by the consultative group, different views were expressed about specific aspects of the suggested accounting and reporting framework. Thus, for example, some experts questioned the usefulness of a uniform chart of accounts for Level 3 SMEs. In their opinion, model ledger accounts might lead to meaningless figures and did not reflect the individual nature of an enterprise. Others stressed that model ledger accounts were desirable in order to make financial statements more comprehensible for lenders. A harmonized system would also lower costs of training and provision of software. Some experts were of the opinion that a detailed chart of accounts tended to be too prescriptive. As a result, it did not allow for a thorough analysis of the essence of a transaction by the person entering it in the accounting system. Others felt that a model chart of accounts would be a useful guide, particularly for very small SMEs that did not have adequate expertise in-house. One expert cited economic integration efforts under way in his region and underlined the positive contribution that a uniform chart of accounts could make to harmonization efforts.

With respect to the suggested three-tiered accounting frameworks, it was generally felt that a uniform set of accounting rules would not suit the needs of all enterprises. Different-sized enterprises did require different accounting rules. A large number of experts supported the view of the consultative group that companies that issued public securities or enterprises in which there was significant public interest should comply fully with IAS. A number of experts

suggested that the proposed framework should comprise more than three levels, by breaking levels 2 and 3 down further. However, numerous experts strongly favoured the three-tiered approach suggested by the consultative group.

One expert felt that ISAR should not come up with a final solution for accounting by SMEs, since it was up to the International Accounting Standards Board (IASB) to develop financial accounting and reporting standards. He suggested that ISAR develop and publish a concise issues paper that would promote consensus on the issue of accounting by SMEs. Furthermore, it would help to focus the attention of the IASB on the importance and urgency of the issue of accounting by SMEs, especially but not exclusively in developing countries. Another expert said that, although the IASB had extensive experience in the area of financial reporting by multinational companies, he questioned its competence in the area of accounting by SMEs. He added that there were complementarities between ISAR and the IASB. He considered accounting by SMEs an important topic that needed to be addressed urgently, and therefore initial guidance by ISAR would be welcomed, particularly in developing countries. One expert stressed in this respect that developing countries could not wait any more. A number of experts concurred with this view, while stating that cooperation by IASB would be appreciated. Others felt that the IASB should take up the issue as a priority.

Concerning the suggested Level 2 enterprises, comprising significant commercial entities that issued neither public securities nor financial reports to the general public, it was by and large agreed that the exact definition should be left to each country to decide. Although it was largely felt that the suggested condensed set of IAS might be appropriate for larger SMEs, a number of experts commented on technical details of the proposed approach. In particular, many stated that it was difficult to establish a cut-off point between Level 2 and Level 3 enterprises. A number of experts also questioned the rationale for identifying some standards as “core” while suggesting that other standards be included in the minimum list of “abridged IAS”. In replying to questions, the resource person clarified that if an SME found that it had a transaction that was not covered by the “abridged IAS”, it would be required to refer to full IAS for appropriate guidance. Furthermore, a company that complied with “abridged IAS” would have to disclose in its accounting policy note that its financial statements were prepared in accordance with “abridged IAS” and not full IAS. If it did not comply with all elements of full IAS, an enterprise would be obliged to report compliance with “abridged IAS” only. The basic criterion used to determine whether a particular standard should be included in the minimum list of standards was whether a majority of larger SMEs were likely to perform a particular transaction addressed by an individual standard. Finally, he stressed that Level 2 enterprises would always have the option of complying with full IAS if they so wished.

Most experts supported the view expressed by the consultative group that a condensed set of standards should be based on IAS recognition and measurement criteria, but with limited disclosure requirements. Nevertheless, a number of experts drew attention to the potential complexity of some IAS and the fact that some standards were difficult to implement in an SME environment, especially in a number of developing countries. Another important issue was that the cost of meeting the requirements of some standards might outweigh the potential benefits.

One expert said that ISAR should develop a conceptual framework paper for accounting by SMEs. Numerous experts noted that the approach suggested by the consultative group was similar to the approach adopted by the United Kingdom. Nevertheless, one expert stated that other “differential reporting” approaches should also be considered when developing guidance

on accounting by SMEs.

A number of experts noted that the approach suggested by the consultative group for larger SMEs needed further refinement and considered that the consultative group should continue its work. Although the ad hoc consultative group that prepared the report consisted of 23 experts from a wide cross-section of countries, international organizations, accountancy bodies, standard-setters and academics, some experts favoured enlargement of the consultative group into a more widely based working party.

Numerous experts, especially from developing countries, stressed that interim guidance for smaller SMEs (Level 3) was highly desirable. By and large, they concurred with the opinion of the consultative group that voluntary technical aid for small owner-managed commercial entities should follow a simple accrual-accounting system, broadly consistent with IAS. They therefore urged further work to elaborate guidance for these SMEs so that an initial interim guideline could be developed and disseminated as soon as possible. It should provide information for such users as management, fiscal authorities and creditors.

There was general consensus that new entrants might be allowed to provide accounts on a cash basis for a limited transitional period of time. Nevertheless, some developing- country experts were of the view that micro-enterprises were an economic reality and therefore constituted a distinct category of SMEs. Most of their transactions were cash-based and small in amount. Additionally, the amount of fixed assets was insignificant. In this connection, they stressed that it was important to encourage the smallest SMEs to move into the formal sector by allowing them to use cash accounting on a temporary basis.

In response to comments regarding the mandate of the International Accounting Standards Board, the observer from the IASB stated that, though there was a general perception that the IASB was predominantly concerned with accounting and reporting issues for sophisticated capital markets, it was also mandated to take into consideration the needs of other users, such as private capital market participants.

A number of experts also commented in more detail on the “core set of standards” that the ad hoc consultative group proposed for Level 2 SMEs. An expert from a country with an economy in transition felt that IAS 36, Impairment of Assets, was particularly relevant in her region. The expert wondered why IAS 36 was not included in the core set of standards for Level 2. One expert was of the opinion that IAS 8, Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies was a basic standard and did not understand why the ad hoc consultative group suggested that the standard could be simplified further. He also felt that the 15 standards that made up the core standards were not sufficient to cover the needs of SMEs.

Several experts commented on the model financial statements and chart of accounts for Level 2 SMEs. Some experts felt that the model income statement and management report were trying to cater to too many needs of too many users. It had financial, managerial and tax components, all on A4 size paper. As a result, it was too complicated. A number of experts described practices in their countries and indicated that tax reporting was clearly differentiated from financial reporting. One expert commented that management accounting should be left to management. Other experts were of the opinion that the reporting system needed to provide information for managerial decision-making. With regard to SME management “buy-ins”, these would be easier if the system, in addition to basic financial reports, generated information that was useful for managers.

Many experts thought that global comparability on accounting and reporting by SMEs was not one of the intended outputs of the exercise that the group of experts was undertaking. Most were of the opinion that such comparability did not serve any particular purpose.

One expert commented that the approaches proposed by the ad hoc consultative group did not take into consideration the interpretations of IAS provided by the Standing Interpretations Committee (SIC). Some of the approaches of the ad hoc consultative group proposed reporting on a tax basis rather than providing a “true and fair view”. Such a deviation might lead to what was sometimes known as “IAS light”, and this might undermine the work of the IASB. The expert also stated that the proposed guideline would need updating. He was concerned that ISAR might not have the necessary resources to update it regularly.

Several experts noted that in many economies SMEs faced great difficulty in accessing financing, particularly when they were unable to provide collateral. Many experts agreed that there was an urgent need to provide SMEs with guidelines for preparing meaningful financial information so that they could gain better access to financing.

Following the extensive debate, the resource person reiterated that the proposal presented by the ad hoc consultative group was not a standard. The output of the work on accounting by SMEs would be used as a technical aid by member States on a voluntary basis. As a result, the enforcement of the approaches suggested or the global comparability of accounting reports by SMEs was not an issue that the group of experts needed to be concerned with. He also reminded participants about the development aspects of the work at hand.

The resource person said that accounting regulation was an evolving matter and that there would not be perfect accounting at any given time. The “true and fair view” was not something that could be objectively determined. It depended on the expectations of the user group for which the financial statements were prepared. In respect of the number of standards making up the “core set” for Level 2 SMEs, the reporting requirements placed on SMEs needed to be cost-effective. The selection of an accounting system represented a strategic decision for an enterprise. The availability of in-house resources was a consideration in determining the components of the “core set”. It was therefore not advisable to increase the number of standards in the “core set” beyond the 15 that were proposed by the ad hoc consultative group.

The resource person provided further clarifications on several issues:

- A model chart of accounts would be useful for software development as well as training purposes.

- The ad hoc consultative group had not taken as a criterion whether an enterprise was incorporated or not in determining the kind of financial reporting that SMEs needed to prepare.

- The rationale for further simplification of some IAS suggested by the ad hoc consultative group was that originally certain clauses had been added to standards even though it was clear that these clauses would not be generally applicable.

- Management information and tax reporting were desirable outputs of an accounting and reporting system to encourage SME owners and managers to implement accounting and reporting systems.

- A top-down approach was used in arriving at the reporting system for Level 2 and a bottom-up approach for Level 3 SMEs.

The accounting and reporting approach suggested for Level 3 SMEs was on an accrual basis. The temporary exemptions were suggested only in the case of new entrants to the formal economy. Like many other issues, the duration of the exemption period would depend on the economic reality of a given member State.

Several experts suggested that the updated draft document be forwarded to member States in the form of an exposure draft for comment.

All experts agreed with the general approach to accounting by SMEs suggested by the consultative group. They requested the ad hoc consultative group to continue its work and to further elaborate the interim guidance for small owner-managed businesses and disseminate it as soon as possible. The results of its work were to be submitted to the nineteenth session of ISAR in 2002.

The group also requested the IASB to take up the issue of accounting by SMEs (Level 2) as a priority and expressed its readiness to cooperate with the IASB.

Agreed Conclusions of the Eighteenth Session of ISAR

A. Accounting by small and medium-sized enterprises

The Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) recalls that during its seventeenth session it agreed that improved accounting information would permit small and medium-sized enterprises to be better managed and to access financing more easily, and would permit a more accurate calculation of their taxes. With that in mind ISAR also agreed that SMEs needed a financial accounting and reporting framework which would:

- be simple, understandable and user-friendly;

- produce useful management information;

- be as standardized as possible;

- be flexible enough to accommodate the growth of business and increase the potential of some SMEs as they expand to use international accounting standards (IAS);
- be easily reconcilable for taxation purposes; and
- recognize the environment in which SMEs operate.

It also agreed that it was up to each country to define the term "small and medium-sized enterprise" in accordance with its national economic environment, as well as to define the different categories of SMEs in a manner appropriate to its needs, and that any proposed accounting framework put forth would be voluntary and would constitute optional guidance for member States.

At its eighteenth session, ISAR expressed appreciation for the excellent work of the ad hoc consultative group of experts, and at the conclusion of its deliberations based on the report of the ad hoc consultative group, it reconfirmed the urgent need for guidance on an accounting framework for SMEs which took into consideration the fact that one uniform set of accounting rules would not suit the needs of large, medium-sized and small enterprises. Any framework should cover all entities likely to prepare annual financial reports, in order to cover different definitions of SMEs. Furthermore, the objective of such a framework would be to allow enterprises to proceed logically from one level to another as they developed. Such a framework could have at least three levels or categories. The most sophisticated level would comprise a tier of entities that need to comply with all International Accounting Standards (Level 1), which include listed enterprises and enterprises in which there is significant public interest. Below this level the second tier (Level 2) would be larger SMEs, for which the full IAS might be beyond their needs since they are less likely to have transactions foreseen in the more complex standards and the costs could outweigh the benefits. It is preferable that these enterprises use a condensed set of standards, based on IASs, including recognition and measurement criteria, but with reduced disclosure requirements. The final level, Level 3, would be for smaller entities which have limited availability of and access to accounting expertise and so would be required to provide simplified accounts that comply broadly with the essential principles of accruals accounting. The accounting approach for Level 3 would aim at producing useful information for management, fiscal and other national authorities and other interested parties.

ISAR reaffirms that the actual definitions of each of the three tiers and even the eventual number of tiers must rest with the national regulators who might choose to adopt the proposed system.

It notes that the accounting framework for Level 1 enterprises is increasingly being set by the International Accounting Standards Board (IASB). The ad hoc consultative group elaborated its proposal for Levels 2 following an approach in which a separate standard for smaller entities would be produced as a subset of condensed standards. ISAR notes that the IASB has on its work programme a potential project on accounting by SMEs and in emerging markets. ISAR concurred with the consultative group's thinking that an abridged set of rules for smaller businesses could be particularly useful in developing countries. First, it could serve as a stepping stone on the way to full IAS compliance. Second, it could form the starting point for the development of a "technician" level of accounting expertise, specifically for SMEs. The

services of such an expert would be cheaper and better adapted to the needs of small enterprises.

At its eighteenth session, ISAR reviewed the report of the ad hoc consultative group of experts on accounting by SMEs (TD/B/COM.2/ISAR/12) and it agrees with the general approach to accounting by SMEs suggested by the consultative group. Based on its deliberations, ISAR also agrees that the report needs further refinement, and it requests the ad hoc consultative group to continue its work. In particular the ad hoc group should take into account the recommendations for revisions for which there is consensus. It is considered desirable to further elaborate the guidance for Level 3 entities so that interim voluntary technical aid is developed and disseminated as soon as possible; to further explain for Level 2 the rationale for the selection of the standards in the "minimum set of standards" and the rationale for excluding standards not in the "minimum set"; to further indicate the extent of disclosures and to finalize the draft pro-forma example of condensed standards for Level 2; and to demonstrate the consistency between the international conceptual framework and the proposed approach for accounting by SMEs.

ISAR also recommends that the ad hoc consultative group disseminate its revised report for comments to all members and observers of ISAR and submit the final draft to the nineteenth session of ISAR.

ISAR also agrees to initiate discussions on partnerships with professional bodies to consider how accounting technicians could be trained in the new approach.

In the meantime, ISAR would like to bring to the attention of International Accounting Standards Board and other relevant international bodies such as the International Monetary Fund, the Bank for International Settlements, and the World Bank the fact that accounting by SMEs is an urgent issue for economic and social development for developed and developing countries alike.

ISAR requests the IASB to take up this issue as a priority and on a timely basis. ISAR further indicates to the IASB that it has requested the ad hoc consultative group to continue its work and that ISAR is ready to cooperate with the IASB.

It further agrees that the results of the consultations be presented to the nineteenth session and that the main agenda items for consideration should be accounting by SMEs and corporate governance.

B. Further work to follow up on the fifteenth session

Environmental accounting and reporting

The work on environmental performance indicators is important in order to link environmental performance and financial performance. ISAR agrees to cooperate more closely with other initiatives, including the Global Reporting Initiative (GRI).

The environmental accounting and reporting project should be a two-stage process. The outputs that have been disseminated to over 25 countries and training activities should be followed up. More training is needed to enhance the capacity of accountants to deal with environmental issues in developing countries and countries with economies in transition.

There is a need to train experts to evaluate and measure environmental performance and to recognize positive and negative externalities, including training on the application of ISAR guidelines and other sustainability standards.

C. Further work to follow up on the sixteenth session

Assessment of professional qualification requirements

Taking into account the positive and recognized contribution that the guideline on national requirements for the qualification of professional accountants that ISAR adopted at its sixteenth session is making towards the goal of raising the level of professional qualifications, ISAR recommends that the UNCTAD secretariat continue to cooperate with international, regional and national organizations and professional bodies to strengthen accounting education and professional qualification.

D. Future work

ISAR encourages the secretariat to work with the members of the Group during the intersessional periods to identify future topics for discussion.

Accounting by Small and Medium-Sized Enterprises

Introduction

At its seventeenth session, ISAR recommended that ad hoc expert consultations be held with a view to formulating recommendations for a financial accounting and reporting framework appropriate for small and medium-sized enterprises (SMEs). To that end, an ad hoc consultative group consisting of 23 experts from a wide cross-section of countries and of organizations such as the International Accounting Standards Board, the International Federation of Accountants, the World Bank, the Asian Development Bank and the European Commission, as well as various professional accounting associations, government standard-setters, academics, practitioners and others, was formed. It had the following issues for its consideration;

- categorization of the target group to which the SME accounting and reporting framework to be suggested would apply
- identification of an accounting and reporting framework consistent with the characteristics set out in paragraph 3 of this report and suitable for the different types of SMEs
- identification of possible difficulties in implementation
- how the education needs of SMEs (owners, managers, accounting personnel, etc.) could be most appropriately met

The group held consultations through electronic means and a meeting in Geneva (from 10 to 11 May 2001). This report contains the outcome of those consultations.

The seventeenth session of ISAR specified that the financial accounting and reporting framework should:

- be simple, understandable and user-friendly;
- produce useful management information;
- be as standardized as possible;
- be flexible enough to accommodate the growth of business and increase the potential of some SMEs as they expand to use International Accounting Standards;
- be easily reconcilable for tax purposes; and
- recognize the environment in which SMEs operate.

The session also agreed that it was up to each country to define different categories of SMEs in a manner appropriate to its needs and that any model accounting framework put forth would be voluntary.[1]

In light of these requirements and of the background paper (TD/B/COM.2/ISAR/9) presented to the seventeenth session, the ad hoc consultative group decided that it was necessary to specify a framework that covered all entities likely to prepare annual financial reports. Furthermore, the aim was to place the SMEs within a coherent framework that would allow them to proceed logically from one level to another as they developed. Such a framework

[1] The possible future ISAR guideline on accounting by SMEs is intended to be a non-mandatory technical aid for regulators in developing countries and countries with economies in transition, as well as other countries that may choose to use it.

would inevitably have, at its most sophisticated level, a tier of entities that need to comply with all International Accounting Standards (IAS).[2]

Definitions and Categories of SMEs

The ad hoc consultative group decided that the approach which best recognized the wide variations in SMEs' natures and in their access to accounting expertise would involve a three-tiered accounting framework, including two tiers dedicated to SMEs. Level 1 would include listed companies and companies in which there is significant public interest. These are normally expected to fully meet IAS requirements. The second tier (Level 2) would include larger SMEs, for which many aspects of the full IAS may not be very useful since they are unlikely to encounter some of the transactions and situations foreseen in the more complex standards. It is preferable that these companies use a modified set of standards, based on IAS recognition and measurement criteria, but with limited disclosure requirements.

The final level (Level 3) would be for smaller entities. It would be assumed that these enterprises have limited access to accounting expertise, and they would be required to provide simplified accounts that comply broadly with the essential accruals accounting principles of IAS. The group recommended that the model include a chart of accounts for such entities and model financial statement formats. The group also acknowledged that, where a very small business was entering the formal economy for the first time, even these simple requirements might pose difficulties. It recommended, therefore, that the model allow further simplification for entrant businesses to use cash accounting in the initial phase, instead of accrual accounting, the rationale being that almost all their transactions are likely to be conducted on a cash basis.

The group recognized that the actual definition of each of the three proposed tiers must rest with the national regulators who might choose to adopt the proposed system. In particular, monetary and other thresholds would depend on a particular jurisdiction's structure and level of economic activity. In general, the agreed conclusions of the seventeenth session of ISAR recognized that “it is up to each country to define different categories of SMEs in a manner appropriate to its needs”. The group has therefore sought to provide generic definitions, intended above all to serve as a guide and to indicate its thinking. Member States wishing to adopt the proposed system would have to introduce more specific thresholds, such as turnover, number of employees and total assets, that are appropriate to their local economic environment. The three tiers proposed by the group are presented below.

> ***Level 1*** (full IAS compliance) covers all entities that issue public securities or in respect of which there is significant public interest, as well as banks and financial institutions. Significant public interest would include having enough employees to be in the top 10 percent of employers in the country by size. The group has therefore included an employment threshold as part of the Level 1 definition. The definition suggests that where an entity appeared in the top 10 percent of a list of employers ranked by number of employees, it would be required to comply with full IAS. However, there may be other ways of arriving at a definition that includes the largest employers in a country.

[2] The future standards issued by the International Accounting Standards Board (IASB) will be known as "international financial reporting standards" (IFRS). It is understood that the IASB expects that in the future companies and auditors will not distinguish between IAS and IFRS in accounting policy notes, but refer to the full set as international financial reporting standards. For the purposes of this report the term IAS is used.

Level 2 (abridged IAS) comprises significant commercial entities that do not issue public securities or financial reports to the general public. Such entities might have shareholders who are external to the management, would normally have in-house accounting expertise sufficient to track transactions and monitor credit; and would have more than a few employees.

Level 3 (simple accruals) includes small commercial entities that are owner-managed and have few employees. Newly formed businesses or new entrants into the formal economy might temporarily be allowed to provide accounts on a cash basis.

Level I SMEs — Accounting and Reporting Framework

While Level 1 is primarily meant to include commercial entities that issue securities on public markets, the ad hoc consultative group recognized that, in some countries, there may be entities that are either state-or privately owned and that play a significant role in the national economy. For the purpose of consistency with the objective of having an inclusive framework that covers all commercially active entities, the consultative group felt that it would be preferable for parastatals with commercial attributes to use private-sector accounting and reporting requirements (commercial accounting rules). It also felt that full IAS reporting should be required not only where an entity uses the public capital market, but also where the entity is large enough to have a significant role in the national economy, particularly in terms of employing many people. In fact, although the framework of the International Accounting Standards Committee (IASC) focuses on capital markets, it also recognizes the needs of other users, including employees, suppliers and customers.

Level II SMEs — Accounting and Reporting Framework

The ad hoc consultative group did not seek to define further the accounting framework for Level 1 financial reporting. This was assumed to be full IAS compliance, where this is applicable in the national accounting environment or the equivalent accounting requirements in force.

However, in defining rules for Level 2, the group sought to define what elements of IAS are likely to be most relevant to larger SMEs. During the consultations, the model to which the working party frequently referred to was the approach adopted in the United Kingdom, where a Financial Reporting Standard for Smaller Entities (FRSSE) has been produced as a subset of the standards that comprise United Kingdom Generally Accepted Accounting Principles. The FRSSE is considered to provide a single standard that covers all elements of the main standards that are likely to be encountered by smaller businesses. Although in the United Kingdom it has the status of a separate accounting standard, it is essentially a compilation of elements from the full set of standards. The entities that use it indicate in their accounting policy note that it is the FRSSE they are adopting, not full United Kingdom Generally accepted Accounting Principles (GAAP). When a smaller entity has a transaction or that situation which falls outside the FRSSE, it is required to comply with the relevant rules of the broader standards.

The group took the view that the collection of abridged IAS (which during the consultations of the group was frequently referred to as the International Accounting Standards for Small and Medium-Sized Enterprises (IASSME) would have a relationship to full IAS similar to the relationship of the FRSSE to United Kingdom GAAP. It would be expected that

in the vast majority of cases, SMEs that fall into the Level 2 category would find the accounting and reporting requirements for almost all of their activities covered by the abridged IAS. However, were an SME to find that it had a situation or a transaction not covered by the abridged IAS, it would be required to refer to full IAS for the appropriate guidance.

An enterprise complying with the abridged IAS would indicate in its accounting policy note that its accounts had been drawn up in accordance with the abridged IAS, not full IAS. If the enterprise also had to refer to an element of full IAS, it would still retain the reference to abridged IAS.

Notwithstanding, the group felt that Level 2 enterprises within this system would always have the option of complying with full IAS if they so wished. In such cases, it would be appropriate for the enterprises to refer to full IAS in their policy note.

The group felt that an abridged set of rules for smaller businesses could be particularly useful in a developing country framework. First, it could serve as a stepping-stone on the way to full IAS compliance. Second, it could form the starting point for the development of a "technician" level of accounting expertise, specifically for SMEs. The services of such an expert would be cheaper and better adapted to the needs of small enterprises. The report to the seventeenth session of ISAR noted that in many countries expert accounting services are too expensive for SMEs. This problem is more acute in developing countries. Thus, the existence of an abridged set of IAS would create a situation where technicians could be specifically trained to apply those standards.

The group took the view that the abridged IAS should preserve the recognition and measurement base of the full IAS, and so the selection process would involve first identifying those standards thought unlikely to concern SMEs, and then identifying disclosure requirements that would not be applicable to SMEs or could be simplified. While deciding to retain the IAS recognition and measurement base, the group took into consideration the views expressed by the outgoing Board of the IASC in its annual report for 2000 (Annual Review 2000, p. 12) that "the Board inclines to the view that a case can be made rarely, if at all, for differences in standards of recognition and measurement as between large and small businesses". A similar view was expressed at the inaugural meeting of the IASB in April 2001 (World Accounting Report, May 2001, p. 12).

The abridged IAS that the group has envisaged could eventually be a single document that would bring together the relevant elements of the "core SME standards" identified by the group. During its deliberations, the group identified "core standards" that are likely to affect most SMEs, bearing in mind that exceptions will always exist. Possible exceptions would also normally be caught by the requirement to refer to full IAS where the abridged IAS did not address a particular point. The group also had in mind that the core elements could well form the basis of training programmes, textbooks and software. The more complex the "core set of standards", the more costly their application would be, possibly outweighing the potential benefits. The education needed to implement such a system would also be more expensive. The aim was therefore to provide a set of "basic standards" that was as cost-effective as possible.

The group recommended that the following standards form the abridged IAS:

IAS 1	*Presentation of Financial Statements*
IAS 2	*Inventories*
IAS 7	*Cash Flow Statements*
IAS 8	*Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*
IAS 10	*Events after Balance Sheet Date*
IAS 12	*Income Taxes*
IAS 16	*Property, Plant and Equipment*
IAS 17	*Leases*
IAS 18	*Revenue*
IAS 20	*Accounting for Government Grants and Disclosure of Government Assistance*
IAS 21	*The Effects of Changes in Foreign Exchange Rates*
IAS 23	*Borrowing Costs*
IAS 24	*Related-Party Disclosures*
IAS 37	*Provisions, Contingent Liabilities and Contingent Assets*
IAS 38	*Intangible Assets*

Analysis and discussion of the abridged IAS

The ad hoc consultative group felt that the proposed abridged IAS (IASSME) should focus on as small a core set as possible, so that it would be effective and useful and enable efficiencies to be achieved. The basic criterion applied was whether most small businesses were likely to have the particular kind of operation or transaction addressed by an individual standard. It was recognized that small entities in developed economies were more likely to have some of the more complex transactions than those in developing countries or economies in transition. It should be remembered that the proposed use of the abridged IAS would be within a context where there remains a requirement to comply with full IAS if an SME at Level 2 were to encounter a transaction that the "core standards" do not address.

The group debated each standard extensively and reached agreement on the above core set. Nevertheless, in the case of certain IAS (e.g.) leasing and employee benefits, it was not easy to decide whether these should be a part of the abridged IAS or not. Although IAS 17, *Leases*, has been included in the abridged IAS and IAS 19, *Employee Benefits,* has not, they may both apply to some SMEs.

In identifying the "core standards", the group retained the IAS recognition and measurement base. As a result, certain IAS that could be too burdensome for some SMEs have been included in the abridged IAS.

IAS 11, *Construction Contracts*, has been excluded from the abridged IAS but gave rise to much debate because, while it might be considered to be an industry-specific standard, it includes a fundamental revenue recognition principle applying to all entities that have unfinished contracts at the accounting date. The group finally decided to recommend that it be left outside the "core standards"; but, of course, compliance with it would be required if an enterprise had to record revenues earned on partially completed construction contracts.

The group took the view that enterprises with a group structure should not necessarily be excluded from the Level 2 definition. However, it believed that a group structure was found relatively infrequently in SMEs. It was therefore decided that IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries, and* IAS 28 *Accounting for Investments in Associates,* should not to be included in the core list. For consistency, the elements of IAS 21, *The Effects of Changes in Foreign Exchange Rates*, could be modified (for purposes of the abridged IAS) to exclude those parts that deal with the translation of the accounts of foreign subsidiaries. Similarly, a simplified form of IAS 8, *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*, would be desirable.

It was felt that IAS 29, *Financial Reporting in Hyperinflationary Economies*, might well apply in some countries to SMEs. However, it should be left open to national regulators to decide whether, in the interests of cost-effectiveness, to incorporate it into their minimum list.

Potential complexity of some IAS in an SME environment

While the ad hoc consultative group took the view that accounting requirements for Level 2 should maintain the IAS recognition and measurement base, it considered it necessary to point out that some IAS could be rather burdensome in an SME environment. Some examples are given below:

IAS 12, *Income Taxes:* The calculation of deferred taxes is relatively complicated and the information content as regards SMEs may not be particularly useful. The group felt that the cost of meeting the requirements of this standard might outweigh the potential benefits. Also, it noted that the United Kingdom FRSSE was currently being modified, and a simplified treatment of deferred tax being proposed.

IAS 17, *Leases:* Leasing is often a popular form of financing for SMEs, and the debt information is useful. The IAS provides for rental payments to be split between writing off the lease obligation and a charge for interest. The apportionment between loan repayment and interest charges should be done by treating the rental payment as an annuity. However, this could be simplified, as in the case of the United Kingdom FRSSE, to make application easier.

IAS 19, *Employee Benefits:* This was not included in the minimum list, but the ad hoc consultative group noted that it could well apply in a number of developing countries where employer-related pension schemes are being encouraged. The group felt that the cost of applying the standard could be high, given the need for actuarial estimates and the lack of a sufficient number of actuaries in many developing countries. It recognized the need for an alternative approach for SMEs.

IAS 36, *Impairment of Assets:* Although this standard was not included in the minimum list, the group noted that it could be applicable to SMEs in certain circumstances. It felt that the valuation process and its elements could be too complex to be applied confidently by SMEs.

IAS 39, *Financial Instruments Recognition and Measurement:* It was considered that few SMEs have financial instruments other than trade receivables and payables and bank finance. Some form of simplification could make the standard easier to apply and more useful for SMEs.

Preliminary discussion of the compilation of the simplified disclosure

While the ad hoc consultative group decided to retain the IAS recognition and measurement base, it considered the extent to which disclosure and other requirements might be reduced in the abridged version of IAS. After some discussion, it took the view that a number of disclosure requirements could be simplified in the "core standards", as in the case of the United Kingdom FRSSE, for example. The choice of disclosure items is necessarily subjective. Essentially the rationale is that, generally, there is not a sufficient public interest requirement for disclosure by SMEs, and in addition their activities are usually simple enough not to require further analysis. Additional disclosures therefore seem unnecessary for a proper understanding of their financial position. It also seemed that the costs associated with providing extensive disclosure would probably outweigh the potential benefits. The main external users of SMEs' financial statements are, to a large extent, banks and tax authorities, which can obtain the required information directly from the company. It is probably unnecessarily costly to require the SMEs at Level 2 to meet all disclosure requirements without regard to the real needs of their users. The consultative group therefore worked to simplify this burden as much as possible by identifying disclosure requirements that are typically important for present and potential users.

The group felt that, as a starting point, the reduced requirements should be based on the black-letter paragraphs of selected IAS, without significant changes to the text. It noted that there would be cases where elements of the explanatory grey-letter paragraphs might need to be added to make the abridged IAS a workable document. There could also be cases where material in the appendices to an IAS might be needed in whole or in part for the abridged IAS. The group noted that the practical examples in IAS 18 on revenue recognition and those in IAS 37 on provisions might be instances of this.

The group felt that there might also be cases where certain key recognition and measurement paragraphs of an IAS proved onerous for SMEs and created difficulties in the same way as certain complete standards. Falling into this category are paragraphs 45, 46 and 47 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, requiring measurement of provisions at the present discounted value of their future cash flows. Finally, the group was of the opinion that there might be a need to include some parts of the IASC framework and/or some parts of ISAR's Objectives and Concepts Underlying Financial Statements in the abridged IAS and, in particular some of the definitions of elements of financial statements.

Level III SMEs — Accounting and Reporting Framework

Level 3 comprises the smallest SMEs, those with the most difficulty in accessing bank and trade credit. These SMEs also have difficulty obtaining affordable accounting services of the kind they need. While a Level 2 SME might well have 50 or 100 employees, the typical Level 3 SME might be a one-person enterprise or a business with two or three people. Consequently, accounting requirements need to take into consideration the simplicity of the business transaction, the lack of resources and the limited in-house accounting expertise and infrastructure.

The ad hoc consultative group recommends that Level 3 SMEs follow a simple accruals accounting approach broadly consistent with IAS 1, although not necessarily aimed at users other than management, tax officials, creditors and investors. The rules proposed by the ad hoc consultative group would not involve compliance with IAS, but would be based on the

historical cost/accruals measurement approach, which is the basis of IAS. The reporting package recommended includes model financial statements and a model chart of accounts (see Annex I).

The basic measurement approach would consist of the following features:

- historical cost
- transactions accounted for when an economic event takes place (accruals)
- allocation of expenses to the accounting periods in which related income is recognized (matching)
- no offsetting of related items

This would imply a system capable of recognizing trade receivables and payables as they occur, as well as capitalization of fixed assets, use of depreciation and recognition of inventories.

Model financial statements and chart of accounts

Model financial statements are set out in Annex I. It should be noted that these are somewhat detailed. Privileged users (management, tax and finance) generally require a detailed analysis of the business. Assuming that there is no obligatory public disclosure, no purpose is served by proposing more aggregated statements (and typically the preparation of summaries takes place as a supplementary step after preparation of detailed statements).

The sample financial statements are intended to encourage managers to think analytically about their business. Their objective is therefore not simply regulatory in the traditional sense, but to help develop the business by providing useful information. In particular, the enterprise is encouraged to identify different product streams if relevant, and to analyze both income and expenses in light of these streams to help gauge profitability. Furthermore, there is a category for non-allocable expenses. Such a breakdown and analysis would provide useful information about the cost structure of the enterprise for internal decision-making.

The financial statements are necessarily linked to the maintenance of a general ledger. The system includes a chart of accounts for this ledger, which will facilitate the preparation of financial statements in line with the model. The chart is also set out in Annex I.

Suggested simplifications for new entrants

Although the ad hoc consultative group classified SMEs into three levels, it recognized that for a micro-enterprise that was a start-up or was moving from the informal to the formal economy, adoption of even the simplified accruals approach might pose too great an obstacle. National regulators might consider allowing new entrants to use cash accounting during a transitional phase or if their total revenue remains below a specified level. This cash accounting would involve tracking cash transactions and striking simple periodic balances, with no allocation of revenue and expenses to different accounting periods or recognition of fixed assets. In such businesses, most transactions are cash-based and small and the amount of fixed assets is insignificant. This alternative would minimize cost barrier for micro-enterprises wishing to enter the formal sector. It would also improve the availability of accounting data,

which could have positive impacts on the growth of such enterprises and the fiscal balance of the country in which they operate.

Conclusions

The ad hoc consultative group considered that the types of entities that may be found in an economy cover an enormous range, from subsistence-level, one-person businesses with virtually no records to transnational corporations. A voluntary framework for reporting is useful only if the range of types of entities is recognized and a differential reporting approach allowing for progressively simplified reporting by the less sophisticated entities is used. At the same time, a differential reporting system must be internally consistent, permitting a logical progression through different stages as a business grows.

The most sophisticated level within the system should be the standards prepared by the IASB for use in international capital markets. However, the group recommends that national regulators use an abridged version of the IAS dealing with the routine needs of most large SMEs, which technician-level preparers could apply.

For smaller SMEs at Level 3, the group recommends that regulators supplement the simple accruals system with a simple chart of accounts and standard financial statement formats. The uniform nature of this approach at the national level would facilitate the education of preparers and reduce accounting costs. It should lead to greater efficiency by providing management information for internal decision-making. National regulators may wish to allow micro-enterprises that are just entering the formal economy or are in a transitional phase to use cash accounting, since most of their transactions are likely to be conducted on a cash basis.

The framework that the ad hoc consultative group recommended is intended to provide a coherent system covering all commercial entities in an economy and enabling small businesses to advance to full IAS compliance as they grow. The system is therefore aligned with accruals accounting, which starts with a simple approach in Level 3, moving on to IAS-based recognition and measurement at Level 2 and then full IAS at Level 1.

The group considered on a preliminary basis the issue of possible reduced disclosure requirements for Level 2. This preliminary analysis is available in draft form, and ISAR may wish to comment on it immediately and/or assign it to the ad hoc group for further elaboration. Alternatively, national standard setters may wish to undertake the task of further elaboration so that the basic guidance is implementable within the context of their national economic environment.

The central task of the eighteenth session was to evaluate the report for each enterprise category. If it finds these approaches acceptable, it should discuss the ways and measures of producing a guideline for national standard setters for accounting by SMEs.

Annex I

Sample Level 3 Financial Statements

(previous years comparative figures omitted for simplicity)

Level 3 Management Report (Income Statement)

XYZ Ltd.
Income statement
For the year ended 31 December 20X1

	Total	Product A	Product B	Unallocated
Sales	**325,000**	**140,000**	**160,000**	**25,000**
Materials	74,500	32,600	41,900	-
Changes in inventories	1,200	2,100	(900)	-
Depreciation	12,300	3,400	2,800	6,100
Salaries	137,700	43,200	43,200	51,300
Telephone	1,800	-	-	1,800
Power, light and heat	10,800	5,400	5,400	-
Insurance	2,600	-	-	2,600
Rent/rates	28,600	-	-	28,600
Lease rentals	6,500	-	5,300	1,200
Provisions	1,000			1,000
Motor vehicle expenses	1,900		-	1,900
Total operating expenses	**278,900**	**86,700**	**97,700**	**94,500**
Profit before interest and tax	**46,100**	**53,300**	**62,300**	**(69,500)**
Interest	(6,200)			
Profit before tax	**39,900**			
Disallowed for tax				
Provisions	1,000			
Taxable profit	**40,900**			
Taxation	(10,275)			
Net profit for the year	**30,625**			

Movements on equity	
Balance at beginning of year	9,375
Profit for the year	30,625
Balance at end of year	40,000

Level 3 Balance Sheet

XYZ Ltd.

Balance sheet

As of 31 December 20X1

Assets			
Non-current assets			
Property	170,000		
Less: accumulated depreciation	40,000	130,000	
Equipment	85,000		
Less: accumulated depreciation	25,000	60,000	
Total non-current assets			190,000
Current assets			
Materials		18,200	
Inventory		34,000	
Trade receivables	28,500		
Less: provisions	2,500	26,000	
Bank accounts		5,600	
Cash		1,200	
Total current assets			85,000
Total assets			**275,000**
			========
Equity and liabilities			
Capital and reserves			
Capital		100,000	
Retained earnings		40,000	
Reserves		3,500	
Total capital and reserves			143,500
Non-current liabilities			
Notes payable	37,500		
Mortgage payable	68,000		
Total non-current liabilities		105,500	
Current liabilities			
Note payable (due in 6 months)	5,500		
Trade payables	20,500		
Total current liabilities		26,000	
Total liabilities			131,500
Total equity and liabilities			**275,000**
			========

Level 3 Cash Flow Statement

XYZ Ltd. **Cash flow statement** **For the year ended 31 December 20X1**			
Cash flows from operating activities:			
Cash receipts from customers	310,175		
Cash paid to suppliers and employees	(264,400)		
Cash generated from operations		45,775	
Interest paid	(6,200)		
Income taxes paid	(10,275)	(16,475)	
Net cash from operating activities:			29,300
Cash flows from investing activities:			
Purchase of equipment		(12,500)	
Proceeds from disposal of equipment		500	
Net cash used in investing activities			(12,000)
Cash flows from financing activities:			
Payment of notes payable		(5,500)	
Payment of mortgage (principal)		(10,000)	
Net cash used in financing activities			(15,500)
Net increase in cash and cash equivalents			1,800
Cash and cash equivalents on 1-1-20X1			5,000
Cash and cash equivalents on 31-12-20X1			**6,800**

LEVEL 3 Chart of Accounts

(ledger accounts relating to model statements)

Income statement items

Sales
- Product A
- Product B
- Sundry

Materials
- Product A
- Product B
- Sundry

Changes in inventory
Depreciation
Salaries
- Product A
- Product B
- General

Telephone
Power, light and heat
- Product A
- Product B
- General

Insurance
Rent
Lease rentals
Provisions
Motor vehicle expenses
Interest
Taxation

Balance sheet items
Property at cost
Property: accumulated depreciation
Equipment
Equipment: accumulated depreciation
Inventory: raw materials
Inventory: finished goods
Trade receivables
Provisions against receivables
Bank account
Cash

Capital
Reserves
Retained earnings
Proprietor's personal drawings

Notes payable
Bank loan
Trade payables
Sundry payables

Annex II

Members of the Ad Hoc Consultative Group on Accounting by SMEs[1]

Yugui Chen
Ministry of Finance
People's Republic of China

Mr. Ashok Chandak
The Institute of Chartered Accountants of India
India

Eric Delesalle
Institut National des Techniques Economiques et Comptables du Conservatoire National des Arts et Métiers
France

Aziz Dieye
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United Kingdom

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[1] Opinions expressed by the experts do not necessarily reflect those of the organizations that they are affiliated with.

John Hegarty
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Peter Johnston
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Certified Public Accountants
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PART 2

INTERNATIONAL ACCOUNTING AND REPORTING ISSUES

SUMMARY

As more and more enterprises move towards reporting on the basis of International Accounting Standards (IAS), a number of issues concerning their implementation are emerging. More recently, important developments have occurred in the international accounting standard-setting process. The UNCTAD secretariat invited experts on these issues to contribute the following essays to this volume.

Compliance with International Accounting Standards; Current Practice, Future Prospects

David Cairns[1]

Introduction

International Accounting Standards (IAS) now deal with all the topics that are important in the financial statements of companies. Furthermore, the application of IAS should result in financial statements that contain high-quality, transparent and comparable information that helps participants in capital markets and elsewhere make economic decisions.[2]

The quality of IAS and IAS financial statements has been recognized in the ever-strengthening links of the International Accounting Standards Committee (IASC) with national standard-setting bodies and three recent developments:

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[1] The author was secretary-general of the International Accounting Standards Committee (IASC) from 1985 to 1994. He now advises companies, accounting firms and other institutions on the application of IAS. He is a consultant to the Institute of Chartered Accountants in England and Wales on global education and a senior visiting fellow at the London School of Economics and Political Science. He is the author of several books and surveys on IAS and other international financial reporting issues.

[2] The text of IAS is contained in IASB, *International Accounting Standards*, IASB Publications, London, 2002. The practical application of IAS is dealt with in detail in David Cairns, *Applying International Accounting Standards*, 3rd edition, Butterworths, London, 2002.

- the endorsement[3] by the International Organization of Securities Commission (IOSCO) of the use of IAS in financial statements used in cross-border offerings and listing;
- the concept release[4] issued by the US Securities and Exchange Commission (SEC) which considers, and seeks opinions on, whether foreign companies should be *allowed* to use IAS financial statements without modification or reconciliation to raise capital and list their securities in the United States;[5] and
- the European Commission's proposal[6] that EU listed companies be *required* to publish IAS consolidated financial statements by 2005.

The links with national standard-setting bodies have recently been further enhanced as a result of the restructuring of the IASC which has led to the creation of the International Accounting Standards Board (IASB).[7] This restructuring will, in turn, lead to further improvements in IAS (to be renamed International Financial Reporting Standards or IFRS) and even greater recognition from other national and international organizations.

While the IASC has done, and the IASB is now doing, much to ensure that IAS are high-quality standards, the use of these standards will result in high-quality financial statements only when companies comply fully with them. Indeed, the IASC's achievements and hard-won recognition, along with support for the new IASB, could be undermined by poor levels of IAS compliance in what are purportedly IAS financial statements. Poor audit opinions (or the lack of audit opinions) on those financial statements could add to the problems.

The *International Accounting Standards Survey 2000*[8] addresses the issues. It is the second such survey.[9] Both surveys have examined the use of IAS in different countries and by different institutions as well as the practices adopted by companies that use IAS.

Country survey – Do listed companies use IAS?

The *International Accounting Standards Survey 2000* looks first at whether the largest listed companies in four regions used IAS in their 1999 financial statements:[10]

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[3] International Organization of Securities Commissions (IOSCO), *International Accounting Standards*, Report of Technical Committee, IOSCO, Montreal, May 2000.

[4] Securities and Exchange Commission (SEC), International Accounting Standards, International Series Release 1215, SEC, February 2000.

[5] The SEC is the US member of IOSCO and a major player in IOSCO's deliberations. A representative of the SEC chaired the IOSCO working party that evaluated IAS and produced the report on IAS.

[6] European Commission, EU Financial Reporting Strategy: The Way Forward, Communication from the Commission COM(2000) 359, European Commission, 2000.

[7] A discussion of the restructuring of the IASC and a comparison of the old and new structures are included in Chapter 1 of David Cairns, *International Accounting Standards Survey 2000.*

[8] David Cairns, *International Accounting Standards Survey 2000*, David Cairns, Henley-on-Thames, United Kingdom, 2001.

[9] The first survey was David Cairns, *(The Financial Times) International Accounting Standards Survey 1999*, Financial Times/Informa, London, 1999.

[10] Most of the annual reports examined covered the year to 31 December 1999 but the full sample encompassed all periods ending from June 1999 to May 2000.

- **the Americas** companies listed in Canada, Mexico, the United States and (in summary) 15 other countries;
- **Europe** companies included in the FTSE Eurotop 300 and FT 500, companies listed on EASDAQ, and other large listed companies in 34 countries, with the main emphasis on EU member States and Switzerland;
- **Asia-Pacific** companies listed in Australia, China, Hong Kong (China), Japan, New Zealand and (in summary) 21 other countries; and
- **Africa** companies listed in South Africa, Zimbabwe, and (in summary) nine other countries.

It is impossible, within the confines of a short article, to deal with all the countries covered by the *Survey*. However, the results for Europe (as a region) and some key countries are summarised below.

Europe

The *Survey* confirms that the use of IAS is growing rapidly in Europe but that there is much to be done before the European Union's 2005 deadline for IAS consolidated financial statements. Approximately 20 per cent of FTSE Eurotop 300 companies referred to the use of IAS. Put another way, almost 250 of Europe's largest companies will have to change their financial reporting within the next five years. That challenge is all the greater for the fact that many of the 20 per cent of FTSE Eurotop companies that used IAS did not comply fully with IAS.

EASDAQ companies are required to present either IAS financial statements or a reconciliation to IAS (or, if first traded on NASDAQ, they may use or reconcile to US GAAP). Of the 45 European EASDAQ companies examined by the *Survey*:

- Nine published IAS financial statements;
- Three published reconciliations from domestic standards to IAS;
- Two stated that the differences between their domestic standards and IAS were immaterial; and
- Over half reported in accordance with, or reconciled to, US GAAP.

Turning to individual European countries, the *Survey* confirms a number of trends:

- Austrian, German and Swiss companies are increasingly reporting in accordance with IAS. For the substantial majority of companies, this means full compliance with IAS.
- The use of IAS has been declining in France and the Nordic countries, although the decline has subsequently been reversed in Denmark.
- Many Italian companies use IAS, but only as residual standards in the absence of equivalent Italian law and standards.
- Very few companies in the Netherlands and the United Kingdom use IAS.

Germany

The adoption of IAS by German companies is one of the most dramatic changes in financial reporting in the last 10 years. As recently as 1993, German officials argued that compliance with the EU Directives was all that was needed to raise capital on international capital markets.[11] **Daimler Benz's** decision to reconcile its 1993 German GAAP financial statements to US GAAP in order to list on the New York Stock Exchange changed everything.

Bayer, **Heidelberger Zement** and **Schering** adopted IAS in their 1994 financial statements, and the floodgates opened with the result that by 1999, almost 100 major German companies published IAS financial statements. Furthermore, the German law has been changed to allow listed companies to use IAS (or US GAAP) in place of German GAAP provided that the financial statements continue to comply with the EU Fourth and Seventh Directives. Of the German FTSE Eurotop companies dealt with in the *Survey*, only **BMW**, **Gehe**, **Linde**, **Mannesman**, **Metro**, **Siemens**, **Sodexho** and **Volkswagen** had not adopted IAS or US GAAP by the end of 1999 and some, notable **Siemens** and **Volkswagen**, subsequently changed over.

France

In contrast to developments in Germany, a significant number of French companies have dropped the use of IAS in recent years. **CANAL+**, **Cap Gemini**, **Eridania Béghin-Say, IMS, Lafarge, LVMH, Saint-Gobain** and **Usinor** referred to compliance with IAS in their 1998 financial statements but not in their 1999 financial statements. One reason for the change was their dislike of new IAS on such issues as goodwill and the presentation of financial statements. Another was the burden created by compliance with new French requirements that came into force in 1999. A third reason was the apparent desire of French companies to be able to make full use of all available transitional provisions when they are required to comply with IAS from 2005.

Among French companies, the *Survey* identified only **Essilor**, **Moulinex**, **Norbert Dentressangle** and **Technip** as claiming full IAS compliance in their 1999 financial statements. **Renault** and **Valeo** retained their references to their use of IAS but reduced their level of compliance. Whereas **Renault** prepared its 1998 financial statements in accordance with French law and IAS (except for IAS 9), it applied IAS in its 1999 financial statements only insofar as IAS were compatible with French accounting principles and accounting practices generally adopted by the worldwide automobile industry. **Valeo** prepared its 1998 financial statements in accordance with French GAAP and "the international accounting principles formulated by the IASC" (with the exception of IAS 9 and certain aspects of IAS 22) but in its 1999 financial statements it complies with only the valuation and accounting principles of seven IAS in its 1999 financial statements.

Italy

In 1982, the Italian securities commission (CONSOB) decreed that listed companies should consider IAS for issues not covered by Italian principles. In 1982, however, there

[11] See, for example, Biener's comments at the 1993 conference of the Fédération des Experts Comptables Européens (FEE) included in W. Schuetz, H. Biener, and D. Cairns, "The Politics of Mutual Recognition", *The European Accounting Review*, 1994, pp. 329 to 352.

were few Italian principles and IAS were both few in number and flexible in their requirements. Therefore, compliance with CONSOB's decree was relatively easy. It also improved Italian financial reporting. In subsequent years, Italian requirements have increased significantly, most notably through the adoption of the EU Fourth and Seventh Directives and the development of national standards by the Italian accountancy profession. During the same period, IAS have been extended and have become much less flexible. Compliance with CONSOB's decree is still possible, but its value is questionable.

The *Survey* identified 11 companies that use IAS in this way. For example, **Benetton** discloses that its accounting policies "have been adopted in observance of article 2426 of the Italian Civil Code, also taking account of accounting principles prepared by the Italian Accounting Profession, and in the absence thereof, those issued by the IASC."

The problem now is that some current Italian requirements may be materially different from those required by current IAS. For example, some Italian companies comply with CONSOB's decree but adopt the following policies that may not comply with current IAS:

- Some revalue property, plant and equipment irregularly and according to monetary revaluation laws rather than to fair value.
- Many use tax depreciation rates for property, plant and equipment.
- Some measure securities at the lower of cost and market value determined on a LIFO basis.
- Some include negative goodwill in equity.
- Virtually all report an extensive number of extraordinary items, none of which meets the IAS 8 definition of such items.
- Many do not account for post-employment benefits in accordance with IAS 19.
- Some banks make additional provisions for general banking risks in a manner that is inconsistent with IAS 30.

Among Italian *Survey* companies only **Recordati** claims, full IAS compliance (although it discloses in the footnotes that it does not provide for all deferred taxes). **Compart** and **Montedison** adopt accounting policies that complies with IAS, but both specify exceptions from full compliance. These companies do not account for development costs in accordance with IAS 9, and **Compart** does not consolidate its insurance subsidiaries.

<u>The Netherlands and the United Kingdom</u>

The *Survey* identifies three British and two Dutch companies that currently refer to IAS. Four of the five companies are among the EASDAQ companies that reconciled their domestic GAAP financial statements to IAS or stated that their domestic GAAP financial statements did not differ from IAS. The fifth company is **Gucci Group,** which, while perhaps perceived as an Italian company, is in fact registered in the Netherlands. It published full IAS financial statements.

Canada

Only two Canadian companies (**BCT.TELUS** and **Enbridge**) referred to compliance with IAS in their 1999 financial statements. Both stated that their financial statements complied with Canadian GAAP and IAS. During the mid-1980s, the IASC made considerable efforts to persuade companies in several countries to disclose dual compliance in this way. The IASC's biggest success was in Canada where, thanks to the efforts of the Canadian accountancy profession and the Toronto Stock Exchange, over 100 listed companies were referring to dual compliance by 1987.[12]

As with the Italian residual standards approach, the dual compliance disclosure worked in the 1980s because IAS and national standards were more flexible and less detailed. The improvements made in the 1990s led to new differences between IAS and national standards; for example, the IASC banned (in IAS financial statements) the Canadian practice of deferring and amortizing gains and losses on long-term foreign currency debt.

By 1999 all Canadian companies except **BCT.TELUS** and **Enbridge** had dropped the reference to dual compliance. **BCT.TELUS** and **Enbridge** should also have dropped the reference and, in fact, did so in their 2000 financial statements. In its 1999 financial statements, which did claim dual compliance, **BCT.TELUS** accounted for merger costs as a charge to equity in accordance with Canadian GAAP but contrary to the 1993 changes to IAS 22. Similarly, **Enbridge** used special Canadian GAAP accounting for regulated industries in its 1999 financial statements, but this accounting conflicted with IAS on inventories, deferred taxes and retirement benefit costs.

United States

In the 1980s, the IASC achieved limited success in persuading US companies to disclose compliance with IAS in addition to US GAAP. For several years, such companies as **Exxon**, **FMC, General Electric** and **Johnson and Johnson** disclosed dual compliance, but the IAS references have gradually disappeared. **FMC** was the last to claim dual compliance in its 1998 financial statements.

Japan

No Japanese companies complied with IAS in their March 2000 financial statements, but **NDK** announced that it would comply fully effective March 2001. Several Japanese companies (for example, **Fujitsu**, **Kobe Steel**, **Sakura Bank** and **Sanwa Bank**) disclosed the nature of the differences between their Japanese GAAP accounting polices and IAS, while **Kajima** disclosed the nature of some differences and quantified one difference. **Fujitsu** also reconciled its Japanese GAAP net profit and shareholders' equity to IAS.

[12] IASC, *Survey of the Use and Application of International Accounting Standards – 1988*, IASC, London, 1988.

Company survey: Approach to IAS and domestic GAAP

The *International Accounting Standards Survey 2000* examines in more detail the 1999 annual reports of 165 listed companies that referred to the use of IAS. It begins by identifying four approaches to IAS and domestic GAAP (Table 1). The four approaches are a useful starting point because they may affect the level of compliance with IAS. For example:

- Companies that follow approaches 1, 2 and 3 should comply fully with IAS or make clear any exceptions to full compliance with IAS.
- Companies that follow approach 3 appear more vulnerable to cases of "undisclosed IAS lite" (see below).
- Only companies that follow approach 3 can be classified in compliance categories 7 to 11 (see below).

Table 1: Approaches to IAS and domestic GAAP

	Companies
Use IAS as primary reporting standards; no reference to compliance with domestic GAAP	88
Use IAS as primary reporting standards; also refer to compliance with domestic GAAP	1
Use domestic GAAP as primary reporting standards; also refer to compliance with IAS	57
Use domestic GAAP and IAS jointly as primary reporting standards	19
Total	**165**

Czech Telecom is a good example of approach 1. It stated that its financial statements are prepared "in accordance with and comply with IAS." **Nokia** is the only *Survey* company that is classified as following approach 2. It prepared its financial statements 'in accordance with IAS' but the notes to the financial statements "also conform with Finnish accounting legislation."

As was explained above, the IASC made considerable efforts in the early 1980s to encourage companies to refer to compliance with IAS as well as national GAAP. This is approach 3. For example, **BHP** disclosed that its financial statements complied with the requirements of the Corporations Law, Australian accounting standards and Urgent Issues Group consensus views and were "consistent, in all material respects, with IAS."

Companies that follow approach 4 include **Danisco,** which states that its consolidated accounts are "drawn up in accordance with the Danish Company Accounts Act, IAS and the requirements of the Copenhagen Stock Exchange." **Technip** discloses that its financial statements are "prepared in accordance with the French law on consolidation, and its implementing decree, and with the statements of IAS, as set forth in the pronouncements of the IASC."

Company survey: Compliance with IAS

The four approaches to IAS and domestic GAAP tell only part of the story. The *International Accounting Standards Survey 2000* also looks closely at how companies that use IAS actually comply with IAS. Do they comply fully? Do they disclose exceptions from full compliance? Do they use only selected IAS? The *Survey* finds 11 categories of compliance with IAS (Table 2), not all of which result in what should be described as IAS financial statements.

Table 2: 11 categories of compliance with IAS

	Companies
1. Full IAS compliance	102
2. Full compliance with national standards that comply with IAS	4
3. Full IAS compliance, with exceptions specified in the accounting policies	10
4. Full IAS compliance, with exceptions specified in the notes to the financial statements but outside the accounting policies	3
5. Accounting policies comply with IAS or are based on IAS or the principles in IAS	4
6. Accounting policies comply with IAS or are based on IAS or the principles in IAS, but with specified exceptions from full compliance	4
7. IAS used only when there are no equivalent domestic standards	12
8. IAS used only for selected items or when permitted by domestic requirements	13
9. Reconciliation from domestic GAAP to IAS	6*+
10. Summary IAS financial statements	4*
11. Unquantified description of differences from IAS treatments	5+
Total	**165**

* Includes one company that published both a reconciliation and summary IAS financial statements.

+ Includes one company that published a reconciliation for some items and unquantified differences for other items.

Category 1 is the only category that should be acceptable to regulators and governments requiring or allowing companies to comply with IAS. It should be the only approach acceptable to IOSCO members when they implement their endorsement of IAS for cross-border offerings and other foreign listings. Category 1 should also be the only

approach that is acceptable when the European Union requires listed companies to publish IAS consolidated financial statements.

Following are examples of Category 1 companies:

- **Pliva** "The consolidated financial statements ... have been prepared in accordance with IAS and with accounting and reporting requirements issued by the IASC".
- **Stora Enso** "The financial statements of Stora Enso Group ... are prepared in accordance and in compliance with IAS.
- **Gucci Group** "The Group's financial statements and the financial information discussed below have been prepared in accordance with IAS."

Category 2 consists of companies that comply with national standards which, according to the companies, comply with IAS. For example, **DMC** stated that its "consolidated financial statements have been prepared in conformity with the accounting rules and principles applicable in France. ... As applied by the group, these principles comply in all material respects with those of the IASC." This is not the same as saying that the financial statements comply with IAS.

Category 3 consists of companies that disclose compliance with IAS, but with certain exceptions specified in their accounting policies. IAS 1 *Presentation of Financial Statements* does not permit a company to describe its financial statements as complying with IAS with specified exceptions.[13] However, irrespective of the requirements of IAS 1, this approach continues to be used. For example, **Wienerberger** prepared its consolidated accounts "in accordance with the principles set forth in IAS and interpretations issued by the SIC" but also explained: "In contrast to IAS, goodwill arising from the acquisition of companies up to December 31, 1996 was charged to reserves in keeping with the Seventh EU Directive."

Category 4 is the same as Category 3, except that exceptions to full IAS compliance are disclosed in the notes rather than in the accounting policies. For example, both **Erste Bank** and **SanoChemia** disclosed that they do not present all the segment information required by IAS 14, and **Recordati** disclosed that it does not provide for all deferred taxation.

Some companies state that their accounting policies comply with IAS or are 'based on' IAS or comply with the 'accounting principles' set out in IAS. IAS 1 warns that these approaches are 'misleading' and 'detract from the reliability and under-standability of the financial statements'. They imply that the companies are not complying with the disclosure and accounting requirements of all IAS. Again, in spite of IAS 1, these approaches are followed by such companies as **Edcon**, **Investec** and **Richemont**. Furthermore, **Renault**, **Compart**, **Montedison** and **Delta Corporation** go a step further: they all disclosed that their accounting policies complied with IAS, but with specified exceptions.

Category 7 IAS used as residual standards is the approach used by Italian companies that is described above. **ING** is included in category 8 but could easily have been classified as category 7; it used IAS "where possible", an assertion that is omitted from the financial statements it filed with the US SEC. Some companies in Category 8 present only a IAS 7 cash flow statement (perhaps in response to the IOSCO endorsement of IAS 7). Others

[13] *IASC Insight*, June 1998, p. 2.

probably used IAS to fill gaps in national standards for example, **Tractebel** with its use of IAS 19 and **Cimpor** with IAS 12 and IAS 25.

Examples of companies that reconciled their domestic GAAP financial statements to IAS include **Bergesen**, **Fujitsu**, **Bank Pekao** and **Antisoma**. **Bank Pekao** also published summary IAS financial statements — others that published summaries are **Ceské Radiokomunikace**, **Hellenic Petroleum** and **Hellenic Telecom**. **Partek**, **Kobe Steel** and **Atlas Copco** are among those who described, but did not quantify, differences between domestic GAAP and IAS.

Company survey: "IAS Lite"

The *International Accounting Standards Survey 2000* identifies three types of what it refers to as "IAS lite":

- *Disclosed IAS lite* that is, companies that disclose exceptions from full IAS compliance;
- *Implied IAS lite* that is, companies that refer to the use of, rather than compliance with, IAS, and therefore imply that they are not complying fully with IAS; and
- *Undisclosed IAS lite* that is companies that claim compliance with some or all IAS but fail to comply fully with those IAS.

17 of the Survey companies that are examples of *disclosed IAS lite*. Table 3 shows the issues that are the subject of the exceptions. There are some recurring themes.

Table 3: Disclosed IAS lite exceptions from full IAS compliance (by IAS)

IAS and topic	Companies
IAS 9 – development costs expensed	Metra, Renault, Montedison, Compart, Micronas
IAS 12 – non-recognition of some deferred tax liabilities	Recordati, Delta Corporation
IAS 14 – disclosures omitted	Erste Bank, SanoChemia, Micronas
IAS 19 – non-recognition of pension costs	Kemira, Metra, TEGE
IAS 22 – goodwill written off to equity	Wienerberger, Disetronic
IAS 24 – related party transactions not disclosed	Merck
IAS 27 – some subsidiaries not consolidated	OTP Bank, Compart
IAS 29 – no restatement for hyperinflation	PKN ORLEN, Delta Corporation
SIC 8 – prior periods not restated on initial adoption of IAS	Schindler
SIC 16 – treasury shares	Renault

48 Survey companies are examples of *implied IAS lite*. These companies are included in compliance categories 5 to 11. Any reader of their financial statements should be put on warning by the nature of the references to the use of IAS.

By far the most worrying form of "IAS lite" is *undisclosed IAS lite*. Approximately 20 Survey companies adopt accounting treatments that appear to conflict with those IAS that they purport to comply with or omit disclosures that are required by those IAS. Furthermore, some of these companies compound the problem by appearing to use their US GAAP information to correct their IAS information.

The *Survey* highlights a number of troublesome issues in the income statement. It points out various exclusions from operating profit, questionable classifications of goodwill amortization, and the plethora of extraordinary and quasi-extraordinary items. Possible examples of *undisclosed IAS lite* include:

- **Moulinex** deducted certain unabsorbed fixed costs and productivity losses as unusual items before arriving at profit on ordinary activities;
- **AMB** deducted amortization of goodwill from result of ordinary operations; and
- **Nestlé** excluded profits and losses on disposal of fixed assets and impairment of fixed assets and goodwill from operating profit.

Examples of possible *undisclosed IAS lite* in cash flow statements include:

- **Moulinex** and **Delta Corporation** reported changes in net debt rather than changes in cash and cash equivalents;
- **Norbert Dentressangle** included unit trust funds in cash equivalents;
- **Preussag** included shares in specialized funds in cash equivalents;
- **Rieter** included investments in ‘prime chemical, insurance, industrial and banking stocks’ in cash equivalents;
- **Gucci** deducted short-term loans when determining cash equivalents; and
- **TZI** deducted the current portion of long-term loans when determining cash equivalents.

In addition, several *Survey* companies did not disclose tax and interest payments in their cash flow statements.

The way in which **Swisscom** accounted for gains and losses and the related foreign-currency translation adjustments on its discontinuing operations may not comply with IAS 21 and IAS 35 and may, therefore, be a case of *undisclosed IAS lite*. This is also an example of US GAAP reconciliation appearing to be used to correct the IAS accounting.

Several major business combinations involving *Survey* companies have been accounted for using the pooling of interests method. Two may be cases of *undisclosed IAS lite:*

- **HypoVereinsbank** was created by the merger of Bayerische Vereinsbank and HYPO-BANK, but at the merger date, Vereinsbank already held a 44.2 per cent

interest in HYPO-BANK which seems to indicate that it was probably the acquirer and should have applied the purchase method and

- **Panafon** accounts for the cash "acquisition" of Panavox in a manner similar to the pooling of interests method and explains that this is "in accordance with IAS".

Two instances of the use of the pooling of interests method – **Novartis** and **Stora Enso** – have been changed to acquisitions in the US GAAP reconciliations notwithstanding the US SEC's 1994 concession to allow foreign issuers to use IAS 22, rather than US GAAP, to determine the appropriate accounting. These could be cases of *undisclosed IAS lite*. More likely, they are examples of the SEC's tough stance on the interpretation of IAS 22.

Fiat has not consolidated Case; which it acquired on 12 November 1999, in its 31 December 1999 financial statements "as it would not have been practicable to obtain the necessary information on a timely basis without disproportionate expense". **Fiat** has consolidated Case in its US GAAP reconciliation, a practice that is required by IAS 27. **Olivetti** and **Tecnost** have consolidated Telecom Italia from 1 January 1999, whereas goodwill was determined as at 30 June 1999 "being the closest to the acquisition date. This suggests non-compliance with one of IAS 22 or IAS 27 or both".

Another consolidation problem is the disposal and acquisition of subsidiaries. **Richemont** has retrospectively de-consolidated its interest in Rothman's International with effect from 15 months prior to its loss of control over that subsidiary. That does not comply with IAS 27 nor, for that matter, with IAS 35 *Discontinuing Operations*.

Dyckerhoff and **VIAG** used LIFO for some inventories and FIFO for other similar inventories and may not, therefore, comply with SIC 1, although in both cases the effect may not be material. **Enbridge's** use of "approved prices", rather than cost, for inventories is an example of its use of regulatory accounting that may not comply with IAS (in this case IAS 2).

The policies of **BHP**, **Metra**, **Kemira** and **TZI** for the revaluation of property, plant and equipment may not comply with the 1993 requirements of IAS 16 and may, therefore, be cases of *undisclosed IAS lite*. The depreciation policies of **Schering**, **Jardine Matheson**, **Mandarin Oriental** and **SIG** may not comply with IAS 16 and may also be cases of *undisclosed IAS lite*.

There is an understandable confusion between temporary and timing differences in the context of the recently revised IAS 12, with the result that **BHP**, **Stora Enso**, **DMC**, **Moulinex** and **Autonomy** may not comply with IAS 12. All use a timing, rather than temporary, differences approach. There is also considerable variety in the criteria applied to recognize the expected benefits from tax loss carry-forwards as assets. It is likely that some companies are not applying IAS 12 on tax loss carry-forwards as intended by the IASC. Some may be recognizing assets too early, others too late.

Both **BHP** and **Nokia** treat their retirement benefit plans as defined contribution plans under IAS 19 but as defined benefit plans under the similar (but more detailed) US GAAP. **Enbridge** recognizes retirement benefit expenses on a contribution basis for IAS purposes but on an accruals basis under US GAAP. **Panafon** has not carried out an actuarial valuation (but the effect may be immaterial). All these may be further cases of *undisclosed IAS lite*. The range of assumptions used in IAS 19 actuarial valuations among companies in the same

countries is surprising, particularly the assumption about the discount rate which should be the interest rate on long-term, high quality corporate bonds. It seems likely that companies are applying the requirements of IAS 19 in very different ways and, therefore, that some may be examples of *undisclosed IAS lite*.

Auditors and IAS financial statements

How do auditors deal with the various approaches to IAS compliance adopted by *Survey* companies? The *Survey* identifies 10 combinations of auditing standards and accounting frameworks. It finds five approaches to the audit opinion. Only a little over half the audits have been carried out in accordance with International Standards of Auditing (ISA). Furthermore, the financial statements of two *Survey* companies did not include an audit report.

Given that the *Survey* focuses on companies that use IAS, it is worrying that the auditors of over a third of *Survey* companies do *not* express an opinion on compliance with IAS. Of even greater concern is the fact that 11 *Survey* companies claim full compliance with IAS, but without an audit opinion on IAS compliance. The 11 companies are **BHP**, **BCT.TELUS**, **Enbridge**, **Essilor**, **Moulinex**, **Norbert Dentressangle**, **Technip**, **Pharming, AECI, Harmony** and **Iscor**. Several of these companies appear to be clear practisers of *undisclosed IAS lite,* and it is tempting to conclude that the audit firms have opted to give no audit opinion rather than the qualified opinion required by ISA 700.

The *Survey* pays particular attention to whether auditors qualify their opinions in cases of *disclosed IAS lite* that is, when the company itself discloses exceptions to full IAS compliance. The *International Accounting Standards Survey 1999* identified three instances of unqualified IAS, audit opinions on *disclosed IAS lite* – **Roche**, **Saint-Gobain** and **Valeo** – and expressed concern that **PricewaterhouseCoopers** was auditor or joint auditor in each case. The *2000 Survey* identifies two different cases – **Erste Bank** and **SanoChemia** – with different auditors. **Roche** now complies fully with IAS while **Saint-Gobain** has dropped its reference to IAS and **Valeo** has significantly reduced its level of compliance.

The *Survey* also reveals that there are auditors who condone, in purportedly IAS-compliant financial statements, accounting policies and disclosures that clearly do not comply with IAS. For example, some auditors imply that they think that IAS 22 requires the use of the pooling of interests method for business combinations that are cash acquisitions. There are auditors who allow irregular revaluations of property, plant and equipment and allow revaluations to amounts other than fair value. There are auditors who allow companies to correct their IAS financial statements in SEC filings.

Conclusions

The major concern of the *International Accounting Standards Survey 2000* is that poor compliance and poor audit opinions are undermining the IASC's achievements. This concern leads to four recommendations that set out what should be some very obvious basic rules of compliance (Table 4).

Table 4: Recommendations

Recommendation 1

Companies that refer to the use of IAS in their financial statements should preferably comply fully with all IAS. Both the companies and their auditors should redouble their efforts to ensure the elimination of *undisclosed IAS lite* for such companies. Full compliance should mean full compliance in all material respects.

Recommendation 2

Companies that comply only partially with IAS should state clearly and unambiguously what they have done and how their financial statements fall short of full IAS compliance. Such statements should be made in one place at the beginning of the statement of accounting policies.

Recommendation 3

When a company refers to the use of IAS, its auditors should also express an opinion on compliance with IAS. Regulators and the accounting firms should take steps to ensure that all IAS information is audited. Pending such steps, auditors should, at the very least, state clearly in their audit reports on compliance with domestic GAAP that they do not express an opinion on compliance with IAS.

Recommendation 4

Audit reports on IAS financial statements should comply with the relevant ISA. The International Auditing Practices Committee (IAPC) should seek greater consistency in the wording of audit reports. When a company specifies an exception from full IAS compliance and that exception is material, the company's auditors should express a *qualified opinion* or *adverse opinion* on compliance with IAS.

The task for companies is simple: full compliance or clear and unambiguous disclosure of partial compliance.

The task for auditors is equally simple: to issue audit opinions on IAS compliance when a company claims such compliance and audit opinions that comply with ISA 700. Audit firms must also recognize that the increased use of IAS, including the European Union's 2005 deadline, is a commitment to financial statements that contain high-quality, transparent and comparable information that helps participants in capital markets and elsewhere make economic decisions. That commitment carries responsibilities for the firms. It is not simply a marketing opportunity leading to glossy brochures, high-profile seminars and similar gimmicks.

Implementation of International Accounting Standards in Economies in Transition

Pat Sucher*

Introduction

In many economies in transition, the largest and publicly traded companies prepare financial statements according to international accounting standards (IAS). According to the web site of the International Accounting Standards Board, 21 companies in transitional economies prepare IAS financial statements (IFS) as at January 2002. It is likely that this figure substantially understates the number of financial statements.[1] As many stock exchanges in transitional economies move to obligatory preparation of IFS for publicly traded companies, and many transitional economies move to provide for the preparation of IFS by all large enterprises, it would seem appropriate to ask what issues arise when large enterprises in transitional economies prepare IFS. Are there any particular problems for preparers and auditors of these financial statements?

Drawing on the research currently being conducted as part of an Institute of Chartered Accountants in England and Wales (ICAEW) project,[2] this paper discusses preliminary observations on issues that have arisen in preparing IAS financial statements in two economies in transition: the Czech republic (CR) and Russia. These observations are based on an analysis of the IFS for a sample of Russian and Czech companies in 1999 and on interviews with preparers, auditors, users and regulators of financial statements. Particular attention is given to concerns about issues of ownership, auditor independence, interpretation of complex IAS standards, and aspects of particular IAS that may need more development. Other issues (e.g. the nature of the audit report on IFS) have ahead been covered elsewhere (Cairns 2001).

The report is organized as follows: background discussion of the economic context in the CR and Russia and a note of those companies preparing IFS are followed by an examination of issues of who prepares the IFS and auditor independence. The fourth section looks at particular areas of concern in preparing IFS that were discussed in interviews. The fifth and final section suggests areas for particular consideration by the IASB and other international bodies.

The Economic context in the Czech Republic and Russia

The Czech Republic

With the Velvet Revolution of 1989, the CR (then Czechoslovakia) started the process of transition from a command economy to a market economy. At first the CR seemed to be very far ahead in the process of transition with privatization of companies

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[1] For example, none is listed for Poland.

[2] International Accounting Standards: Issues of Country, Sector and Audit Firm Compliance

through a high profile voucher scheme as well as large and small-scale direct sales (e.g. Hingorani et al., 1997; Mejstrik, 1997); liberalizing of price and wage controls; setting up of a stock exchange and restructuring the banking system (EBRD 2000). However, by the mid-1990s, there had not been any large-scale restructuring to focus on the demands of a market economy, and it became clear that there were major structural problems that had not been addressed (Earle et al., 1997; Filacek et al., 1998). A substantial number of companies were being kept afloat through non-payment of creditors. There were problems with corruption among politicians and company management, exacerbated by a lack of transparency in much of the sell-off and subsequent management of companies (Lizal and Kocenda, 2000). The practice of "tunneling" symbolized some of the practices in this era. Tunneling involved the siphoning off of profits by company management from a profitable privatized company to a related company, where the profits disappeared.

By mid-2001, the CR was into its second round of industrial restructuring and legislative change. Over 80 per cent of the economy was in private hands (EBRD 2000). A new bankruptcy law had been enacted in May 2000 and new laws on investment funds in June 1998. Several large industrial conglomerates had been declared bankrupt (e.g. Skoda Pilsen, the heavy machinery conglomerate and the lorry producer Tatra Koprivnice), and several large Czech companies had been sold off to foreign investors (e.g. the remaining 30 per cent state share in Skoda Auto was sold to Volkswagen). However, enforcement of the new bankruptcy and investment fund laws was still a problem, and "It was estimated that more than 10,000 companies were technically bankrupt and about one third of Czech companies had overdue debts" (EBRD 2000: 154).

The operations of the Prague Stock Exchange (PSE) have also improved over recent years, after the scandals of the mid-1990s (Sucher and Zelenkas, 1998). After the political crisis in 1997, which resulted in a change of government, the establishment of an independent securities commission began to be discussed both in the parliament and in the government.[3] The Commission was established in April 1998. New regulations enacted in 2001 strengthened its position and bought local regulations into line with EU regulations (e.g. the one requiring that companies listed on the main market must produce accounts in accordance with IAS. However, as was written at the time, "Market liquidity is still associated with only a handful of stocks and the local capital market does not serve as a source of capital for enterprises. There has not been a single initial public offering since the Prague Stock Exchange was re-established in the early 1990s" (EBRD 2000: 155).

The only major company stocks traded on the Prague Stock Exchange are Czech Telecom, CEZ, Ceske Radiokomunikace and Unipetrol. Only the latter does not produce publicly available IAS accounts.

[3] Prior to the establishment of this independent body regulation was carried out directly by the Ministry of Finance. A capital market supervision division established in 1995 was in charge of granting licenses to brokers and investment companies. It was also responsible for monitoring compliance with the listing requirements on the Prague Stock Exchange.

Russian economic context

Since the economic and political changes of the early 1990s, there has been a general move towards a market economy in Russia. However, as monitored by the European bank for Reconstruction and Development (EBRD) over the period 1996 to1999, this development has been associated with much political, legal and economic disruption.

As privatisation has taken hold, enterprises have been restructured and sold off. However, often there has not been much transparency in this process. In Russia this trend reached its apogee with the "loans for shares" deal of mid-1995 (Freeland 2000) experiences.[4]

Many individual privatized enterprises have continuing problems with establishing new markets for enterprise products. High inflation has not helped. Over the period 1995-1999, consumer price inflation varied between 197.7 per cent (1995) and 14.7 per cent (1997), with a renewed upswing to 86.1 per cent by 1999 (EBRD 2000). The development of new, strong intermediary financial institutions such as banks is still an issue. The "inexperience in lending and inadequacies in banking supervision " (EBRD 1996: 3) has led to several banking crises. There has been a strong restriction on the local availability of investment finance at suitable rates (EBRD 1996). In Russia, in particular, finance for most enterprises has not been provided through the stock market, but rather at high interest rates, for short periods, from local banks. The financial shock of August 1998 with its associated devaluation of the rouble compounded economic problems for enterprises as markets for Russian products dried up. Many enterprises have taken to financing themselves through arrears to state authorities (i.e. by not paying taxes). In August 1998 it was already estimated that total overdue arrears of the enterprise sector amounted to 43 per cent of GDP (EBRD 1998).

Other issues that have reduced the transparency of enterprise activities and trading have been barter, siphoning off of enterprise profits, insider trading and bribery. It has been reckoned that 60 per cent of the economy is conducted through barter (EBRD 1998). Siphoning off of enterprise profits through friendly related parties has also been a major problem. Particularly after 1998, asset-stripping became widespread. "Mechanisms included transfer prices, share dilution, manipulation of debt-offsets, and diversion of cash flow and assets to related companies" (EBRD 1999: 259).

Given this context, Russia has more problems than most countries in attracting external investment. For example, in 1999, it attracted $746 million of investment, whereas the CR attracted $4,912 million (EBRD 2000). These conditions in the CR and Russia are likely to affect the issues that arise in the preparation of IAS financial statements.

The Preparation of IFS

In the following sections the findings are based on the author's analysis of the IFS and on interviews with preparers, auditors, users and regulators. The 1999 IFS are shown in Table 1:

[4] Here a group of Russian "oligarchs" agreed to buy an equity stake in various large Russian enterprises in exchange for loaning money to the Government of Russia. In effect, they obtained controlling stakes in the relevant enterprises at costs below the enterprises' market value.

Table 1 IAS Financial Statements Reviewed

Company	Auditor
Czech Telecom	PricewaterhouseCoopers
CEZ	Arthur Andersen
Ceske Radiokomunikace	Deloitte and Touche
CSA (Airlines)	Ernst and Young
Artelecom	Arthur Andersen
Aeroflot	Arthur Andersen
Gazprom	PricewaterhouseCoopers
Khantymansiyskokrtelecom	Audit Ajour
Primorsk Shipping	Moore Stephens
Red October	PricewaterhouseCoopers
Rostelecom	PricewaterhouseCoopers
Severstal	KPMG
Syyazinform	Arthur Andersen
UES	PricewaterhouseCoopers
Uralsvyazinform	PricewaterhouseCoopers

Who prepares the IFS and how it is done

In interviews (see tables 2 and 3 at the end of this paper for general description of the organizations and positions of the persons interviewed), the preparers and auditors were asked how the IFS were prepared. In the CR and Russia the IFS generally appear to be prepared by the company's auditors, at least initially. Except to the largest Russian and Czech companies, a few companies prepare their own IFS. This is owing to the lack of IAS capability among accountants working in Russian and Czech companies. In the future, company management may take on the preparation of more of the IFS. However, even in the most advanced and largest Czech companies, the auditors seem to be heavily involved in the preparation of IFS.

In the CR, in all cases interviewees said that the basic numbers (balance sheet and income statement) for IFS were prepared using Excel. The underlying account books were kept according to Czech accounting regulations. The trial balance from the Czech accounting system was input into an Excel spreadsheet, and then adjustments were made to convert the Czech trial balance into one suitable for IFS. Generally there were two parts to this conversion: (1) reclassifications (e.g. regarding foreign exchange differences), and (2) changes to Czech accounting information (e.g. leasing, deferred tax, government grants). Subsequently there was consolidation, and a full set of IAS notes was then prepared. The auditors were involved in the preparation of the final IFS, their degree of involvement varied. At one company, though the interviewees claimed that they were preparing the IFS “more or less on their own”, it became clear in interviews that they had not been heavily involved in preparing the detailed notes to the accounts, as any queries on the authors’ part had to be referred to the auditors with the comment “We did not discuss the notes to the financial statements. These were more or less done with the help of the auditors.”

When this was discussed with the auditors, while the choice of words varied, the message was that only the very large Czech companies could prepare IAS accounts without the help of auditors (and these were the companies interviewed by the author). This has implications for the sense of ownership by companies of their IFS and possibly for auditor independence, as is evident from some of the comments in interviews. Comments from the Big five firm interviewees and one large auditing firm in the CR and Russia were as follows:

"Assistance here is quite broad – far beyond the role of auditor. (We) never take a decision over the accounts. It is an advisory role and the client has to take the decision."

"In most cases [the auditors] have to do most areas; clients do not have the capacity."

"They don't have much expertise in IAS and we have to try and get them to understand the adjustments. They have to keep ownership. [But they say], "You're the auditors, you do the finance report, you know the rules."

"We do audit our own work, but there is also a professional standards group [which] reviews our work."

"The issue of auditing our own work was an issue, [but] now the educational process had reached the point where checking disclosure points."

"It is pure accounts preparation of information provided. They have to take responsibility for it all, but they don't. That is the issue for me. It is a big issue for me because they don't take responsibility in my overall opinion, they really don't. We hide behind it, the fact that they [state that it is the company's responsibility]."

(Referring to auditing of one's own work) "We are aware that there is no other way. In this sense there is a conflict. We are considered as normal. We can live with it. That's the reality. We ask other partners when critical issues [arise]."

"As you know, we do not prepare accounts for our clients – it is an independence issue…. However, we do provide a degree of assistance….. Some accountants in enterprises crunch the numbers (for IAS) and others say, 'Look, guys, we pay you to do it. It is a fairy tale'" (Russian Big Five firm interviewee)

The relevant international Code of Ethics (IFAC), section on auditor independence states:

"In all cases in which a professional accountant in public practice is concerned in the preparation of accounting records for a client, the following requirements should be observed:

(a) The professional accountant in public practice should not have any relationship or combination of relationships with the client or any conflict of interest which would impair integrity or independence.
(b) The client should accept responsibility for the statements.
(c) The professional accountant in public practice should not assume the role of employee or of management conducting the operations of an enterprise.
(d) *Staff assigned to the preparation of accounting records ideally should not participate in the examination of such records*. The fact that the professional accountant in

public practice has processed or maintained certain records does not eliminate the need to make sufficient audit tests." (IFAC 2000 author's italics added)

If the client prepares the revised trial balance, there is the issue of whether the preparation of all the disclosure notes and financial statements for IFS for the client counts as "preparation of accounting records." Even if it does not, one would expect that there would be separate audit and IAS preparation teams. However, because of considerations cost, this did not seem to be the case in all audit firms. Clear international guidelines are needed here, given the move of many large companies to IFS, the complexity of many of the IAS, and therefore the likelihood that audit firms will prepare even more IFS for their clients. It is quite possible that this is a reason why some errors or omissions may arise in IFS.

There is also the issue of ownership of the IFS. This may be a larger issue in transitional economies, where there is no market economy tradition of providing financial statements to interested groups of users. Companies are not yet taking the needs of users very seriously. Some of the auditors interviewed said that companies did not perceive IFS as their responsibility. If this is the case, the same companies are unlikely to take them seriously, and proper reform (with an emphasis on substance over form) may be slow to come.

Particular areas of concern in the preparation of IFS

This section reviews some of the areas of concern that may arise in the preparation of IFS. Some of these areas are identifiable from actual financial statements; others were elicited in interviews.

Of the numerous aspects of IAS that could cause problems for Czech and Russian companies, most flow from the different treatment of items in Czech, Russian and international accounting standards (e.g. finance leases and the treatment of exchange differences in Czech accounts). However, in many cases adjustments could be made (e.g. leases, depreciation, bad debts), more fundamental problems related to the ability to obtain relevant information. Specific areas included group accounts, related parties, fair values, deferred tax and segmental information. In Russia, hyper inflation and barter were particular problems. IAS 37 on provisions and IAS 39 on financial instruments were also considered likely to pose problems, particularly by interviewees in the companies; however, these were outside the focus of the research.[5] One of the biggest areas to consider was that of substance over form.

Group accounts and related parties

The main problem for auditors of group accounts was obtaining the information. One audit partner in the CR commented that "to determine first of all what is a group is the biggest problem, and then getting sufficient information to enable us to do a proper examination, and then sometimes we have to use the get-out under IAS.[6]……Either the client is not very helpful, or they don't see why they should do it." Another comment was: "Educating clients is an issue. We are reliant on the client to tell us."

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[5] IAS extant in 1999.

[6] Difficulty in obtaining information is not a "get-out" under the relevant IAS.

In the sample of Russian IFS, in two cases the accounts provided were not consolidated. In one case this led to an "except for" opinion; in the other there was no comment.

In one case, some subsidiaries were not consolidated because "of the present economic difficulties and the lack of accurate financial information" (Primorsk), and in another case, with no explanation, a bank had not been consolidated (Uralsvyazinform). These are not sufficient conditions for exclusion from group accounts according to IAS 22 and 27, unless the unconsolidated subsidiaries are "not material" in the context of the group.

The issue of related parties was closely related to that of the preparation of group accounts. As noted by two different audit partners,

"In this part of the world there have evolved very circular complex ownership structures. Groups are often not organized on straight divisional lines, which means that ensuring all related parties in the group [are accounted for] is a problem. A mix of taxation and a lack of transparency as to who exercise control makes for complex group structures."

" Determining who is in control of groups is an issue. [Related parties] is a link because sometimes you decide you haven't control [here] and then [you] hang onto this individual. Are they employed or are they related in any way? Of course they are not related and they [have] no influence so can this party really influence this group? The trouble here [the Czech republic] is that the connected person you can really take to the extreme."

In Russia, this area has been even more of a concern, and reference was made to it in interviews with auditors; one auditor labelled it "unrelated related parties". The most high-profile example of this is the "unrelated relationship" between Gazprom and Itera, "whose owners are unknown, (and which) has benefited from gas transport deals and production licences received from Gazprom" (*Accountancy Age* 2001).

"Gazprom has never convincingly explained why it gives so much preferential business to Itera, an American-based outfit that started as a trading company in 1993 and has now become the seventh-largest hydrocarbons company, by revenues, in the world," (*Economist* 2001a)

Within the relationship-based business culture in Russia, which has been called an "economy of favours" (Ledeneva 1998), there may be relationships between enterprises that do not fall within the definition of "related parties" in IAS 24.[7] Such relationships may have a substantial impact on enterprise performance: for example, as with Gazprom, there may be a substantial siphoning off of profits to another enterprise through transfer pricing; yet this even will not be represented in the IFS. The preparation of IFS audited by a Big Five auditor may be no guard against such misappropriation of assets: "Under the noses of its Western auditors, billions of dollars of assets and cash leaked to companies whose ownership was at best murky" (*Economist* 2001b with reference to PWC and Gazprom).

[7] "Parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operational decisions" (IAS 24, para5).

IAS 24, on related party disclosures, deals with only five types of related-party relationships of control-through company intermediaries, company associates, individual shareholders and their families; key management personnel and their families and enterprises in which the latter two groups exercise significant influence. However, many related-party relationships in the CR and Russia are based around friendships, not family relationships. As one audit partner suggested, the IAS might have intentionally not included friendship as one of the relationships, as it is so difficult to audit. Another audit partner suggested that the problem was one of applying substance over form, but one was dependent on management for the information.

Fair values and barter

Czech and Russian auditors considered fair values an issue in the preparation of IFS. Some of the comments from audit partners in the CR were as follows:

"I struggle a little bit with the concept of fair value and I think conceptually we don't do a good job on it…You are trying to come up with words that make sense [in the accounts, but] the guidance is so poor as to what we are supposed to put in there [that it is] always very difficult to interpret."

"Lots of clients have unique fixed assets. Fixed assets were acquired from the State at some figure… Market values are very difficult. [We] have to use them. [There is] no instant solution. It is very difficult here because it is a small country, there is no ready market for clients' property."

"Fair values of fixed assets is an issue. People are still hooked on historic cost less depreciation."

Fair value is also closely linked with the issue of barter in Russia. Barter has been a large feature of inter-company trade in Russia given the problems of liquidity. Under the relevant standard, IAS 18 revenue recognition, when goods or services are sold in exchange for dissimilar goods and services, "the revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents transferred. When the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents given up" (section 12).

It is important to note the use of "fair value" in the above requirement. Fair value "is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction" (section 7).

This definition of fair value is a term used in several IAS. However, it can cause problems when applied to certain assets and liabilities in Russia and the CR. For example, promissory notes are a common method of payment between enterprises in Russia. As one interviewee suggested, "Promissory notes may be offered at a 20 to 25 per cent discount. How does this affect sales if a client wants to pay in discounted promissory notes? [Sometimes] they pledge promissory notes against loans. However, there is no market for this [fixed-rate] loan. Nobody wants it. How do you do a fair value [of the loan and promissory note]?"

With barter, as one interviewee suggested, "Barter prices are often inflated for the benefit of lowering tax."

Barter is an area the IASC had on its "emerging economies committee" agenda. As this chapter noted in comments on the economic situation, many Russian companies are involved in barter because of liquidity problems in the country. The amounts involved vary between sectors, and the percentage of trade involved has probably varied year to year, but as it can have a major impact on the amount of receivables and payables shown in the balance sheet and profitability, one might expect to see a reasonable amount of detail about it. In the sample of Russian IFS for 1999, there was often little comment on barter (though the IFS of Gazprom were an exception). IAS 1, Presentation of Financial Statements, states that "the appropriate application of International Accounting Standards, *with additional disclosure where necessary."* (IAS 1 (10) – author's italics) should ensure a fair presentation. It would seem that more information on barter would result in a fairer presentation in the Russian IFS for 1999.[8]

Deferred tax

Deferred tax is an area in which Czech, Russian and IAS practice differ greatly. For example, there is little provision for deferred tax in Czech accounting practice. Accountants in those companies preparing IFS seemed to see it merely as a technical issue to be dealt with. This seemed to be an area where the Big Five auditors were heavily involved, as their comments indicate:

"I reckon that 90 per cent of [UK] accountants do not understand it. It is so subjective. The client is not interested. 'You sort it out and tell us what it could be.' We present three numbers. It is very time-consuming and nobody wants it."

"20 per cent of our time is spent on deferred tax. It is the most complex area."

A comment from a Czech credit analyst indicates that some users understand some of the scope for creativity here: "Deferred taxation is where [you] can manipulate [the] figures."

In Russia one of the Big Five auditors commented that the interaction between the accounting for hyperinflation and deferred tax led to "crazy figures". Others commented that clients had problems understanding it.

Segmental information

In the review of the Czech and Russian IFS, the one area where there was obvious non-compliance with IAS was with IAS 14 on segmental information. Either there was not full segmental information, as with many of the Russian companies,[9] or there were gaps in the provision of segmental information. This was considered an issue by some preparers in companies and also by various auditors in the CR. Comments from audit partners were as follows:

" In general segmental data is not available and it is hard to audit."

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[8] Unless the amount involved was immaterial.

[9] Table 4 (at the end of this paper) shows the presentation of segmental information in Russian IFS.

"Cash flow we have struggled a bit [to obtain it for segmental analysis]."

"[It is] complicated to get segmental information. [You] can't do it yourself and [it] really depends on information available in the company. Sometimes this information is not from the accounts and [does] not agree and then [we have to] apply creativity. [It is] very hard to get information on segments because companies are not run that way."

In a transitional economy where company management is only just beginning to grapple with new management structures, this area is likely to pose problems. The company with the best segmental information, CEZ, was also the company where IAS accounts had been prepared for the longest amount of time. However, this would also seem to be an area where auditors are more heavily involved in the preparation.

Hyperinflation: IAS 29

In 1999, the Russian economy had all the four characteristics that in IAS 29 gives as indicators of a hyperinflationary economy.

IAS 29 proposes that in this situation, financial statements expressed in the currency of a hyperinflationary economy (in this case the Russian rouble) be restated in a current measuring unit by using a "general price index that reflects changes in general purchasing power. It is preferable that all enterprises that report in the currency of the same economy use the same index" (IAS 29: 37). SIC 19 attempts to provide a clarification about when general price indexes should be used and when it may be possible, instead, to translate the financial statements of a company operating in a hyperinflationary economy into another currency. (Japanese yen is used as an example in the SIC.) As has been noted elsewhere, the requirements are not clear (Alexander 2001). Some Russian IFS used the general price index approach; some restated the IFS into US dollars. This did not facilitate comparison of the IFS.

In the interviews in Russia, accountants involved in preparing IFS at the larger accountancy firms, responded to the question "what problems arise in preparing IAS accounts" by saying that IAS 29 was a particular problem.

"Our client does not understand hyperinflation and how it makes a profitable company under IAS loss making. It is more useful for users if [we do] not apply IAS 29." (interviewee in large Russian audit firm where the IAS accounts produced did not include IAS 29)

"Analysts complain as they want to use dollar accounts; all stock exchange trading is in dollars and for convenience bankers want [accounts in] dollars to compare. Clients might push you towards it." (one Russian Big Five firm interviewee)

"Is [the hyperinflation in Russia what was] thought about by the IAS? [Or] with the move up or down [of exchange rates] and collapse of purchasing power and [the] national currency more something else? IAS 29 (was) not really developed with Russia in mind." (interviewee at Russia's Ministry of Finance)

The particular technical issues of IAS 29 and Russian companies are not considered here in detail (Alexander 2001). However, in Russia the debate is over whether, under IAS

29, Russian companies should use the US dollar as a functional currency on the basis that Russia is effectively a dollar economy (as might be consistent with the guidance provided in SIC 19) or should use a general price index to restate all the accounts. The two approaches give very different results. (Alexander 2001 has an example.) An underlying theme in the interviews with the Big Five firms and large Russian audit firms was that their clients preferred to assume the dollar was the functional currency and implement IAS 29 in that light (i.e. with no use of general inflation indices to restate accounts). The concern was that Russian financial statements prepared under IAS 29, using general price indices, were not informative for users. Some Big Five firms agreed with this assessment; some did not. Interviewees drew support for their varying positions from different aspects of IAS 29 and SIC 19, or from personal feedback from individuals at the [then] IASC.

The Big Five firms and some of the large Russian audit firms had met on the subject in April 2001 (some of the interviewees had been at this meeting) and had agreed that in future all IAS accounts produced by Russian companies should use general price indices to implement IAS 29. It was evident that there was still disagreement among the interviewees about whether this was a "good" decision, and also whether it would be upheld.

Substance over form

In many interviews with non-native auditors, the problem of emphasizing form over substance was regarded as a key issue in the preparation of IFS.

"The transfer from prescriptive Czech accounts to substance over form (in IAS) is very difficult….. It is a way of thinking." (Big Five auditor)

"The cultural thing that legal form prevails is the biggest problem." (Big Five auditor)

Further probing and requests for examples led to the identification of three particular aspects of this key difference between Czech accountants: materiality, legalism and the desire to flatter the numbers.

One Big Five firm interviewee conceded that materiality was more of an issue, than substance over form, as Czech accountants tried to provide exactly correct figures rather than estimates. Czech accountants also took an excessively legalistic approach to accounts. However, this might often be linked to a desire to present a flattering picture of the company at the year's end: "My personal feeling on these issues is that it is all to protect a picture they wish to portray."

With regard to the concentration on legalism, as there is no body of case law or precedent, one partner commented that the attitude was sometimes "the law doesn't say this, so I can do it."

Summary and conclusions

1. The issue of substance over form is about whether the financial statements present the substance of what has happened in the company. This might arise from issues about what is the group and related parties in particular, but it is also a more general issue. An IAS on substance over form may be needed in order to give more audit partners persuasive power in

their negotiations with clients. The standard on related parties probably needs to be reconsidered, and its definitions of related parties need to be broadened. Is the difficulty of auditing related parties sufficient argument for limiting the related-party relationships noted in the standard, assuming this had been an issue in the original discussion of the standard?

2. There are various areas where individual companies do not comply with particular aspects of IAS (e.g. IAS 14) and the auditors do not comment on the lack of compliance (e.g. non-consolidation of either all or various subsidiaries). The auditors have taken different stances on this, from no audit qualification to an "except for qualification" to a "no comment" on the non-consolidation of particular subsidiaries. There may be issues of feasibility in the preparation of consolidated accounts; however, this could be made more explicit. Very few Russian companies prepare segmental reporting under IAS 14. It is possible that IAS 14 does not apply, but this seems unlikely. It is often difficult to obtain segmental information, and this probably accounts for what may be quite poor compliance with IAS 14. This situation is probably not unusual and should improve over time.

3. There is the issue of complexity and interpretation. Interviews with some of the audit partners indicated that fair value aspects of IAS 16 on property, plant and equipment and coverage of deferred tax in IAS 12 caused some problems of understanding. This was before considering IAS 39.[10] If audit partners had problems with these issues, how difficult were they likely to be for company accountants? The IASB needs to give more unambiguous guidance on how IAS 29 should be applied, to consider the needs of the investors who may rely on the IAS accounts and to involve more representatives from emerging economies who may have more specific issues that affect how IAS financial statements are prepared.

The particular issue of IAS 29 demonstrates the influence on IAS statements of client demands for an attractive and understandable presentation of their business; the influence of the Big Five audit firms over the preparation of these accounts; the problems of implementing a complex standard when there is a lack of local IAS capability outside the Big Fives and the practical problems of applying an international standard, drafted for all conditions of hyperinflation, to a particular country with specific conditions of hyperinflation.

Given their power over both the production and audit of IAS accounts, the Big Five firms play a very large role in interpreting and implementing IAS standards in a particular country. This raises issues of power and responsibility with respect to compliance with IAS that need to be addressed clearly by the IASB.

4. Given the importance of barter in the Russian economy in 1999, it would have been helpful for users to have more information on the subject (e.g. the amounts involved and details on how it is measured). Similarly, in various cases more information on related parties would have helped; there is surprisingly little information in many of the accounts. One may suspect that IAS 1 (10) is not being properly followed.

5. More detailed consideration needs to be given to the independence issues that arise when Big Five firms both prepare and audit IAS financial statements.

[10] Though, to be fair, IAS 39 would not be applicable to many Czech companies

6. The preparation of IAS financial statements needs to be done by enterprises so that there is a sense of ownership of such statements. This needs to be supported by a programme of training in IAS that takes a fundamental approach to the understanding of IAS, as well as the detailed bookkeeping requirements.

Table 2: Interviews in Russia, May 2001

Organization	Interviewee
Russian company – prepare of IAS accounts	Director
Russian company – subsidiary of overseas company	Finance manager
Russian company producing IAS/US GAAP accounts	Chief accountant
Russian company producing IAS/US GAAP accounts	Head of financial analysis department
Russian company producing IAS/US GAAP accounts	Financial controller
Russian company producing IAS/US GAAP accounts	Deputy director of corporate finance
Russian investment analysts	Head of research
Russian investment analysts	Equity analyst
Big Five audit firm	Director
Big Five audit firm	Partner
Big Five audit firm	Senior manager
Big Five audit firm	Tax partner
Large Russian audit firm	President
Large Russian audit firm	IAS manager
European Bank for Reconstruction and Development	Director
European Bank for Reconstruction and Development	Principal banker
World Bank	Senior financial management specialist
Russian Ministry of Finance	Deputy to the Deputy Minister
International Center for Accounting Reform (ICAR)	Director
Russian university	Professor of accounting

Table 3: Interviews in the Czech Republic, September 2001

Organisation	**Interviewee**
Czech company producing IAS accounts	Economics director
Czech company producing IAS accounts	Head of accounting
Czech company producing IAS accounts	Head of audit and taxes
Czech company producing IAS accounts	Chief accountant
Czech company producing IAS accounts	Director of accounting
Czech company producing IAS accounts	Head of IAS accounting
Czech company producing IAS accounts	Head of accounting and tax
Investment analyst	Managing director, research
Investment analyst	Research manager
Société Générale	Credit analyst
Prague Stock Exchange	Director of trading
Big Five audit firm	Partner
Big Five audit firm	Senior manager
Big Five audit firm	Director
Big Five audit firm	Partner
Big Five audit firm	Partner
Big Five audit firm	Partner
Audit firm part of international partnership	Partner

Table 4: IAS 14: segmental analysis in Russian IFS

Company	Segmental analysis	Further information
Artelecom	Revenue	Comprise one industry and geographical segment; a broad split between different revenue groups
Aeroflot	Yes	Only for revenues by type and region
Gazprom	Yes	Full information on revenue; profits and assets
Khantymansiyskokrtelecom	None	No comment, but they are not consolidated accounts
Primorsk Shipping	None	Single main activity
Red October	None	Comprise one industry and geographical segment
Rostelecom	Yes	Revenue analysis by type and region. Company does not have the information for profits and assets
Severstal	Yes	Sales, but not profits or assets. No policy note
Syyazinform	(not available)	
UES	Yes	Analysis by sales; profits and assets
Uralsvyazinform	Revenue	Operate as one group and in one geographical region; only a broad split between different revenue groups

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International Accounting Standards: The New Regime

Peter Walton*

Introduction

The year 2001 saw the inauguration of the new machinery for setting International Accounting Standards (IAS). The international regulator has moved from being a part-time, voluntary organization run by the accountancy profession to being an independent NGO with full-time standard-setters whose standards will soon be compulsory for at least 7,000 listed European companies and are the model for many sets of national rules.

The old International Accounting Standards Committee (IASC) started work in June 1973 under the auspices of the professional accounting bodies from nine countries. The original initiative came from the United Kingdom, spearheaded by Lord Benson (a scion of the Cooper family) and Sir Douglas Morpeth (a partner in Touche Ross), which is why it was based in London. Its official objectives were to provide some common accounting rules for international operations, although some commentators also note that the British profession was looking for a counterweight to the accounting harmonization initiatives of the European Commission.

The IASC became one of the main engines of accounting harmonization, but, although its standards were widely cited and were increasingly used as a model by national standard-setters, they were not applied by a significant number of large companies. In the late 1980s, however, the IASC entered a new phase, when the then Secretary General, David Cairns, forged an alliance with the International Organization of Securities Commissions (IOSCO). The stock exchange regulators were looking for a set of accounting rules that could be part of a standard international listing agreement to be applied by all national regulators for listings by foreign companies.

The relationship with IOSCO was pivotal to the evolution of IASC, even if, over the years, it was also a source of many frustrations. IOSCO finally gave its endorsement to IASC's core set of accounting standards at its Sydney meeting in 2000. While this did not lead to the blanket acceptance of IAS by the US Securities and Exchange Commission, which was the prize hoped for, it was, nonetheless, an anointment of IASC as the world's international standard-setter. It was followed by an announcement by the European Commission of an intention to make the use of IAS compulsory for all European listed companies by 2005. These two events were a clear signal to the rest of the world in general, and to possible alternative suppliers of accounting rules for international use (such as the United States Financial Accounting Standards Board and G4+1 standard-setters) in particular, that the IASC had won political acceptance and should now be considered the unchallenged global regulator of financial reporting.

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The accelerated completion of the IASC's core standards under Secretary General Sir Bryan Carsberg had been accompanied by extensive consultation as to what structure would best enable the IASC to perform its future role. While the involvement of the profession had been unexceptional in 1973, when the profession dominated standard setting in the English-speaking world. In fact that period also marked the start of a move towards standard-setting by dedicated full-time bodies, with the creation of the FASB. By the year 2000, the old IASC structure had become an anachronism, with few formal links to national standard-setters. The IASC was also faced with the question of whether its composition should be geographically representative in any way, given its international ambit. In effect, the IASC had to find a structure that would enable it to maintain close contact with as many national standard-setters as possible, while still having a rule-making body small enough to be efficient and decisive. The solution was to create a small standard-setting unit, the International Accounting Standards Board (IASB), with formal links to eight national standard-setters, and a much larger Standards Advisory Committee (SAC). Both have regular meetings with the IASB. Figure 1 shows the structure of the IASB.

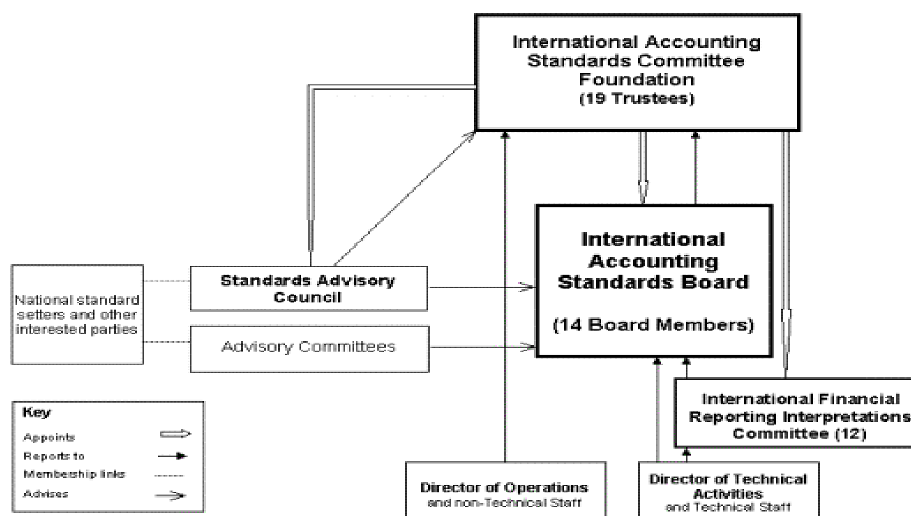

Figure 1

Source: IASB web site. www.iasb.org.uk

Formally, the overall structure is constituted as the IASC Foundation. The Foundation is a not-for-profit company formed in Delaware, USA, but based in London, that is presided over by the Trustees. The Trustees are responsible for oversight of the IASB and the SAC and appointment of their members, as well as for raising operating funds necessary for their operations. The chairman of the Trustees, Paul Volcker, has an office in New York and frequently represents the organization in a political context, notably in Washington. The

Foundation is estimated to need about $15 million a year in revenue, and the Trustees have succeeded in obtaining sufficient undertakings from donors to cover the first three years. The Big Five audit firms have each pledged to contribute $1million a year.

The IASB itself consists of 12 full-time members and two part-time ones (see Figure 1). The Board meets once a month, generally for three days and in public. It has four meetings a year with what are known as the "liaison standard-setters". These are the standard-setters from the United States, Canada, Japan, Germany, France, the United Kingdom and Australia/New Zealand. Seven members of the IASB have a mandate to maintain continuing contact with the national standard-setter, and all these bodies are involved in joint regulatory projects with the IASB.

Members of the IASB at inception

Sir David Tweedie (chairman)
Thomas E Jones (vice chairman)
Mary E Barth (part-time)
Hans-Georg Bruns (liaison to German standard-setter)
Anthony T Cope
Robert P Garnett
Gilbert Gélard (liaison to French standard-setter)
Robert H Herz (part-time)
James Leisenring (liaison to US standard-setter)
Warren McGregor (liaison to Australian and New Zealand standard-setters)
Patricia O'Malley (liaison to Canadian standard-setter)
Harry K Schmid
Geoffrey Whittington (liaison to UK standard-setter)
Tatsumi Yamada (liaison to Japanese standard-setter)

The SAC consists of 50 individuals nominated for their ability to make a contribution to the standard-setting process. While they are frequently part of significant organizations, it is the individual and not the organization that is a member. SAC members are drawn from a very wide spectrum and come from all parts of the world. The SAC meets three times a year with the IASB to receive a progress report and provide feedback.

The IASC created its Standards Interpretations Committee (SIC) in 1997 to provide answers to questions of how to apply IAS or to deal with areas on which a standard is silent. The SIC remains in existence under the new structure, but it will be known as the International Financial Reporting Interpretations Committee (IFRIC). The way in which it operates has also been modified, given that there is now a full- time Board. In future the IFRIC will be chaired by someone from the IASB, initially its Director of Operations, Kevin Stevenson, and will work more closely with the Board.

The way in which standards are set has also been changed, with emphasis switching from the old steering committees towards the work of the permanent secretariat. Steering committees are being replaced by Advisory Committees. These will work on individual standards or areas, commenting on drafts prepared by the secretariat. Standards advance through a series of iterations first between the advisory committee and the secretariat and then between the Board and the secretariat. The IASB "due process" will involve, first, preparation of a discussion document, that reviews the issues and advances the preferred

solution. This will be followed, after exposure, by a formal exposure draft and then the final standard.

Convergence

The principal objective of the IASC had been harmonization of accounting. In a sense this remains the objective of the IASB, but the vocabulary has changed. The new Preface to International Financial Reporting Standards (IFRS), as the IASB's output will be known, states that a major objective is "convergence" and the identification of high-quality solutions. IASB members talk about "best of breed". This marks a subtle shift of approach: where the old IASC was, in theory, free to come up with solutions it thought good, without necessarily making reference to existing national standards, IASB has an explicit objective of considering existing rules and selecting a solution in line with existing best practice. It is not limited to existing solutions, but it needs to justify any standard that it issues which does not converge with existing rules.

Critics suggest that convergence in effect means that IFRS will be heavily biased towards US rules. Europeans are particularly vociferous on this issue, but Sir David Tweedie reportedly indicated to the French national standard-setter (in a speech in December 2001) that Europe would not let the IASB issue standards any more demanding than US ones, while the US would not countenance standards that were less exacting than US ones. Consequently it would not be too surprising if the IASB came up with rules not far removed from the US model.

At the end of 2001, the IASB was indeed looking at a major convergence with the US in the area of group accounting. The decision in June 2001 by the FASB to ban the use of the pooling of interests method of consolidation but to allow goodwill to be treated as a non-depreciating asset (subject to impairment tests) set off a ripple of adjustments by other standard-setters. In particular, the IASB immediately set out to revise its own consolidation standard, broadly in line with the new FASB approach.

However, in reality, while the issue of what the United States is doing on a particular subject figures prominently in the debate at IASB meetings, the IASB is not content with merely emulating the United States. A notable project taken on by the IASB during 2001 was a decision to prepare a standard dealing with the issue of accounting for payments made in shares. As was made clear by the Financial Executives International at a SAC meeting, this issue is hotly opposed by US corporations, since it affects the accounting treatment of stock options granted to management. The FASB famously suffered a major reverse in the early 1990s when it tried to issue a tough standard and was forced to back down. The IASB has taken up the cudgel, and sees the issue as potentially crucial for the credibility of the international standard-setter. No national standard-setter wants to be the first to address this problem, and yet all are agreed that it remains a major gap in the literature. It is therefore a natural issue for the IASB to take up and provides the opportunity for a demonstration of global leadership.

Current programme

The IASB is also continuing to pursue the issue of an accounting standard for the insurance industry and is revising its standard for financial institutions. Although the new Board showed a good deal of reluctance in its early days to take on either of these subjects, it

seems to have been persuaded that its international leadership role requires that it address questions of accounting in the area of banking and insurance, the only alternative being to see the industry set up its own standard-setter. The insurance project is relatively well advanced, having been put in hand some time ago by the IASC. In its present form, the insurance project promises to be ground-breaking in its desire to measure annual performance in terms of changes in the value of the underlying assets and liabilities of individual insurance contracts.

At the same time, the IASB decided to make a number of immediate revisions to existing IAS to remove anomalies or correct practice difficulties. It has targeted IAS 39 (Measurement of financial instruments) as being particularly obscure and riven with inconsistencies in approach. The Implementation Guidance Committee (IGC), which was created to respond to preparer queries on the standard, has been working on revisions with the objective of making the standard more internally consistent and easier to work with, as well as enhancing the degree of convergence with the US standard. While many people thought IAS 39 would have a very short life, having been forced through as a temporary compromise under pressure from meeting the IASC's commitment to IOSCO, it seems likely now that there is not enough acceptance of fair value to encourage moving to a more radical standard. National standard-setters are beginning to align themselves with IAS 39, and the IASB has apparently decided that it is more appropriate to devote resources to cleaning up that standard than to looking ahead to its successor.

A number of other existing standards are also being addressed in an improvements project that should be finalized by the end of 2002. This project aims to remove choices from existing standards and sometimes, bring them up to date. IAS 21 on foreign currency is to have the 'functional currency' notion brought in from the US standard, while long term leases of buildings under IAS 17 will qualify as finance, leases and not operating leases. An attempt was made to remove the 'true and fair' override from IAS 1, but this was voted down, albeit by only 8 votes to 6.

Another high priority is the preparation of a standard dealing with first time adoption of IFRS, which is being done with help from the French regulator, the Conseil National de la Comptabilité. While the proposed standard is intended to address all first-time adopters (and supersedes SIC 8 on the subject), the introduction of IFRS for listed companies in Europe in 2005 gives it an added edge. The standard will probably require IFRS comparatives for at least one previous year, but some grandfathering of past business combinations will probably be allowed. EU companies will have to have IFRS figures for 2004, and should recognize in their opening comparative balance sheet (1 January 2004) all assets and liabilities that are recognized by IFRS. Where it is difficult to calculate costs, these should appear at fair value.

A longer-term project is the development of a performance reporting statement. In principle the IASB is committed to mandating a format for the profit and loss account that incorporates both realized and unrealized gains in measuring annual performance. The United Kingdom already has a system that puts revaluations and other value changes into a Statement of Total Recognized Gains and Losses, and the United States calls for a note disclosure of 'comprehensive income'. The G4+1 standard-setters issued a discussion paper on the subject, but the IASB project, which is being done in conjunction with the UK Accounting Standards Board, seems unlikely to adopt the model proposed by G4+1. The project is at an early stage and will probably fuel a long debate about exactly how information should be broken down for presentation in the comprehensive statement.

At the time of writing, the IASB has no project concerning accounting for small and medium-sized business. In 2001 the Board debated putting the issue on the agenda but decided against making it a priority item. However, in 2002 it suggested to its liaison standard-setters that there was pressure from organisations such as the World Bank to do something in this area, and a fear that if the IASB did not move, other organizations would take the initiative. It seems probable, therefore, that the matter will come on to the agenda, with preference being given to some condensed version of IFRS being produced as an SME standard.

Underlying issues

Although the debate within the IASB is inevitably concerned with technical matters, there are conceptual issues and approaches that, if not necessarily shared by all the Board members, nonetheless inform the debate and in some cases shape final decisions. The most important of these is reliance on the *Framework for the Preparation and Presentation of Financial Statements*, the IASB's conceptual framework.

It is clear that some members require any technical argument to be expressed in terms of how it meets the requirements of the conceptual framework. However, preference is given to what is known as the "asset/liability" approach. That is to say that the conceptual framework defines assets and liabilities as the key recognition and measurement building blocks. Equity is simply a residual number representing the difference between these two, and the income statement shows changes in net assets. Any accounting transaction is recognized only if it meets asset and liability definitions that is, if there is a triggering event, if this will lead to a future cash flow (if it is a positive flow, whether this is under the control of the entity), and if it can be measured reliably.

At the same time, conceptual framework arguments refering to user needs (as defined by the *Framework)*, or to cost/benefit considerations are much less often invoked, even if in general the IASB does have capital market users well in mind. Equally, issues of relevance or reliability rarely figure in the debate.

Linked to the asset/liability approach is a dislike of 'smoothing'. Some balance sheet items that are currently classed as assets and liabilities such as deferred charges or deferred income, do not meet the *Framework* asset or liability criteria and appear in the balance sheet merely as an allocational device linked to the matching principle. A number of Board members appear to think that such aspects of traditional accounting are counterproductive because they hide real economic changes from the user. These Board members do not feel that the income statement should be protected from fluctuations by the use of smoothing devices that spread value changes over a number of years.

The use of a conceptual asset/liability approach also leads to a debate about the measurement approach. How are assets and liabilities to be measured ? While the existing standards are largely grounded in historical cost, the later IAS have made wide use of fair value. IAS 39, 40 and 41 all rely on fair value, and IAS 36 uses entity-specific cash flows as a measure of impairment. There is therefore an underlying debate about the concept of value appropriate to financial reporting. Fair value has some supporters within the IASB, but other members feel that entity-specific value is more relevant. Put another way, if one prefers a current value system to a historical value system (and not all Board members do), there

remains the question of whether the current value measurement should reflect the open market value of an asset or liability, or the value to the entity of the cash flows related to the asset or liability. In many cases they might be the same, but not in all cases. The entity might have knowledge or opportunities that are not available to everyone in the market.

Aside from the fact that there are competing measurement paradigms, there is the related issue of whether there should only be one measurement base, or whether in practice, the present model where several methods co-exist (the so-called 'mixed attribute' model) provides better reporting because it is practically not possible to find a single measurement base that is relevant in all circumstances. There remains an unresolved debate about notions of value, although fair value is currently fashionable in the United States, and the IASB "hawks" make constant reference to it, even if supposed abuses of fair value at Enron may give pause for thought.

The question of consistency is one that is continually raised during debate within the IASB. Board members confront the issue in relation to a number of objectives. If convergence is to be respected, then new rules should be consistent with best practice in other countries. At the same time they should also be consistent with the IASB's conceptual framework. Thereafter, the standard-setters also consider consistency within the range of standards: one standard should ideally be consistent with another, and each standard should be internally consistent as well. In practice it is not possible to achieve consistency on all these points, and the Board members find themselves having to choose between inconsistencies.

Conclusions

It is clear that the IASB will perform quite differently from the IASC, and that it intends to thoroughly revise and make more rigorous the standards it has inherited. Equally clearly, the new structure has been heavily influenced by the US model, and this raises some questions.

While concepts-based approach is presumably intended to provide rigorous and consistent standards, not everyone would agree that this necessarily leads to good or relevant financial reporting. Many jurisdictions, notably those in mainland Europe, do not agree with the conceptual framework approach. They argue that accounting rules are built up as pragmatic answers to the measurement of specific economic circumstances. If an intellectually rigorous approach does not provide a useful answer, that is not good financial reporting. If the resulting rules are inconsistent, that has to be accepted as a price of reflecting an inconsistent economic reality. This contrasts with the US approach as articulated by Jim Leisenring, who said at one Board meeting that you apply the principles to the transaction and if the result looks ugly, that is too bad. There is a risk that professional standard-setters will become so locked into the dialectic of standard setting that they produce financial reports that are not relevant in the marketplace.

The second problem arising from use of the US model is the possible lack of efficiency. While the demise of the FASB has been predicted regularly since its creation in 1973, and no doubt it will survive the Enron crisis, as it has survived others. However, the Enron scandal does raise the question of whether the FASB due process and iterative methods of drafting standards are actually able to deal in a timely and effective manner with the problems needing to be addressed. The IASB has an enormous work programme and is

making slow progress. It is to be hoped that the initially slow pace of advance can be explained by the hiatus caused by the reorganization of the IASC and then the need to re-evaluate the existing standards or "literature" as standard-setters now call it. It could be that the IASB has adopted a model that works too slowly and can no longer cope with the volume of work.