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## **A professional goal - international harmony in accounting standards**

### **Notes to the International Congress of Accountants**

Thank you for inviting me to Mexico, a great country enduring difficult times. For a lawyer like myself, it is an awesome privilege to stand before the international leaders of a sister profession. I have been invited to venture a few remarks about the international aspects of accounting, in terms which might promote some discussion among you during the next few days.

Business and finance are today international in scope. And where a businessman or banker goes, so goes his accountant. Thus the range of accounting activity has grown rapidly to international proportions. An increased number of accounting systems is needed to gather sufficient data to meet the requirements of all the jurisdictions in which business operates. Moreover, there has been an awakening of the requirement for public financial reporting by multinational enterprises (MNE's) particularly in lesser developed countries. Many financial and non-financial reporting requirements have broadened the field for international accounting.

All of this has raised many questions which must be answered by an international group of accountants such as your Federation.

The first, and most important, question to be approached is a definitional one - what concept of international accounting should the world's accountants be addressing? In my view, and that, I believe, of most of you, it is the idea of a universally applicable system of accounting principles. This subject now warrants your urgent attention.

The advantages that international harmonization of accounting practices would bring are unquestioned. They have been reviewed in such detail by your profession, that I will just touch on them briefly.

The greatest benefit which would flow from harmonization would be the *comparability* of international financial information. Such comparability would eliminate the current misunderstandings about the reliability of 'foreign' financial statements, and would remove one of the most important impediments to the free flow of international investment.

Commercial lenders or investors could have confidence in such harmonious reporting and accounting. This would result in improved risk analysis of both foreign enterprises and governments - and better risk analysis means lower risk premiums and consequently lower interest rates, - and this would ease the free flow of international capital. Investors and financial analysts would be able to obtain reliable and understandable reports on which to base their international investment decisions. Government revenue authorities would then find it much less difficult in dealing with the tax problems of MNE's. All these users have a legitimate and very strong interest in ensuring that financial information assembled in various countries is reliable, compatible and comparable, or at least that the nature and the magnitude of any differences are disclosed.

A second advantage of harmonization would be the significant *reduction of the time and cost* of having to consolidate divergent financial information, where more than one set of reports is required to comply with different national laws or practice.

As pointed out by John L. Kirkpatrick, the Regional Chairman of Klynveld Main Goerdeler:

'the companies of the wealthy countries are placing their money abroad; they become multinational; they have to report to their proprietors; they have to receive reports of overseas stewardship; they have to account to the public nationally and internationally. How can the future credibility of their financial statements be maintained if a multitude of standards continues to exist?'<sup>1</sup>

A third improvement from harmonization would be the tendency for accounting standards throughout the world to be raised to the *highest possible level* consistent with local economic, legal and social conditions. As the World Bank has stressed in its reports, harmonization requires at least a minimal level of adequate reporting - and the education to go with it. In order to obtain true harmonization, the level of accounting practice in many countries will have to be raised substantially. The accounting information provided by the firms and governments of many developing nations has been criticized as 'deficient, irrelevant, unreliable, and often lacking credibility.'<sup>2</sup> The World Bank has recognized this deficiency by offering to assist in providing accounting education programs in countries which receive financing from it. This is, of course, a monumental task which will demand a great deal of effort from your profession as a whole. In addition, achieving this minimum international level of standards would assist international economic development because, for many developing countries, accounting information that can be depended on is needed desperately by governments, developing capital markets and businesses.

There has been an increasing recognition, particularly by the World Bank,

that there is a very strong relationship between the poor economic performance of a particular country, and its lack of accounting capability. Governments require adequate, timely and reliable financial information for implementing policies and influencing economic cycles. Business, which is fundamental to the development of any economy, requires such information for all management functions. And finally, international lenders and agencies would feel more comfortable about providing economic infrastructure if they were confident of a minimum level of accountability.

There seems little question that international harmonization is a laudable goal. That being accepted as an ideal or utopian target, it still poses some practical questions and difficulties.

I will deal with the *difficulties* first, and I wish to emphasize - particularly in light of the great spirit of cooperation that I see before me - that they should not be underestimated.

The most serious practical barrier to harmonization is the widespread '*cultural*' differences that exist internationally: differences in language; differences in law; differences in government priorities; and differences in societal concepts.

The most basic cultural disparity which must be overcome is *language*. Language is not only a reflection of a culture; but it also reflects that culture's degree of technical sophistication. The languages of lesser developed countries do not easily assimilate words or concepts that denote new technical or business developments. Even among developed countries that speak the same language there are fairly substantial distinctions. Thus, accountants in the United States, the United Kingdom and Canada have tried to simplify the language of accounting by publishing a uniform glossary of accounting terms.<sup>3</sup> A suggestion has been made for a common international accounting language with translations based on common uniform concepts rather than on words. The International Accounting Standards Committee (IASC) has recognized this problem by setting international accounting standards that attempt to define carefully the technical terms they contain so as to avoid different meanings being attached to them in different parts of the world.

*Nobes & Parker* in their comprehensive treatment of this subject, point out, however, that:

'Language barriers are by no means the only obstacles to the goal of international harmonization... considerable differences in theory, legislation, policies and practice exist among the various English speaking countries, and language differences are only a minor factor in the gap that exists between (for example) British, German, French and Dutch reporting practices. There are good reasons for the differences, and unless

the reasons are properly understood . . . there is little chance of being successful in the process of harmonization.<sup>4</sup>

Many countries, particularly the developing nations, have differing interpretations of the concepts of 'timeliness', 'adequacy' and 'reliability'. Of course, for financial statements and accounting reports to be useful, they must be timely, disclose an adequate amount of information, and above all, be reliable. In addition, the concept of 'proprietaryship' is the basis for much of accounting for property ownership in the West. Property ownership is given much less importance in other countries and in communist nations it officially does not exist at all.

When attempting to reconcile these variations, as *Nobes & Parker* carefully point out, one must distinguish between divergences in accounting methods which are justified by differences in the cultural environment, and those which are merely accidents of history. The latter will be much easier to deal with. With regard to the cultural forces that have shaped accounting differences in the Western countries:

'The factors that have been important in shaping the principles and practice of accounting in various countries include the nature of the legal system, the prevalent types of business organization and ownership, the influence of taxation, and the strength of the accounting profession.'<sup>5</sup>

For example, if most enterprises in a country are small family businesses, as in France, the necessity for a strong accountancy profession and detailed comparable published accounts is less. If most of the shares of public companies are owned or controlled by banks, as in West Germany, again the requirement for 'true and fair' comparative information for private use is reduced. If, on the other hand, there are many publicly listed companies whose ownership is widely spread, as in the United Kingdom, the United States, Canada or Australia, then, published accounting statements that have been prepared and audited for shareholders become useful and necessary.

*Nobes & Parker* differentiate between the Anglo-American class of accounting, which focuses on a 'shareholder fair view' presentation, and the Franco/German class, which focuses on a 'creditor/tax/conservative' presentation. (The remaining class of accounting is the 'communistic' class, which will, of course, have to be considered for any true international harmonization). These authors conclude that the dichotomy between the first and second classes, 'is a sufficiently difficult obstacle that it cannot be overcome without major changes in attitudes and law'. This conclusion is reached without even considering the very significant differences within one of the classes itself, for example, between British, American and Canadian standards.

Aside from a country's legal and cultural differences, its *current economic environment* can also strongly influence its choice of accounting methods: 'Consider, for example, the situation of a country that wants to encourage

capital investment. Such a country might wish to 'improve' the income statements of its industries by permitting certain deferred charges that in other countries would be recorded as an expense immediately. A country experiencing a period of rapid inflation might wish to encourage a form of current value accounting. A country that liberalizes certain taxes to encourage investment might object to a requirement to provide deferred taxes . . . Governments may prescribe financial reporting requirements to achieve national goals. For example, following a major devaluation in its currency, the government may require that exchange losses be capitalized and recognition deferred to future periods rather than expensed currently.<sup>6</sup>

A further difficulty is *nationalism*. This may reveal itself in an unwillingness to accept compromises which involve changing accounting practices in favour of those of other countries. Changing any part of a country's system to adapt to another system may be viewed as 'accounting imperialism' and may be resisted for that reason. However, as has been demonstrated in the European Economic Community, nationalism is not an insurmountable barrier. Within the EEC, where a remarkable degree of harmonization in some major areas has already been achieved, all of the major countries have had their own solutions challenged and have had to accept compromises of both a technical and political nature.

Another problem is that international accounting standards will necessarily be *compromises*. This should not disturb us. The international accounting standards that have already been developed by the IASC, are generally regarded as being very effective and substantive solutions to attempts to bridge the diversity of current national practices. The really controversial standards, for example, inflation accounting rules, are unsatisfactory primarily because no completely satisfactory solution has yet been found anywhere in the world. Also it must be remembered that any human standard, be it legal or practical, is always a compromise between competing interests.

A final practical concern is the issue of *legal enforcement*. It is disappointing that relatively little attention has been paid by the international business community to the International Accounting Standards that have already been issued by the IASC. To remedy this, the Committee has begun a program to encourage multinational enterprises whose annual reports receive international distribution to refer to adherence to International Accounting Standards in those reports. For example, the Canadian Advisory Group to the IASC has sent a letter to the CEO's of all Canadian based multinational enterprises urging each of them to support the International Accounting Standards Committee by referring to IAS's in their annual reports. A similar letter has been sent to the senior partners of all the accounting firms that audit these companies.

This approach, even if widely followed elsewhere, would depend on the



existence of a strong national professional accountancy body. Unfortunately, most countries lack strong professional bodies; many countries lack any such body at all. This means that any attempt to operate through the accountancy profession itself will not be effective in many countries. Therefore, as has been pointed out by several commentators, the success of member accountancy bodies' 'best endeavours' to promote the work of the IASC varies to a very large degree.

Notwithstanding that the difficulties that I have raised warrant very serious consideration, it seems patently clear to me that *any* degree of harmonization will be of great use to the international financial community. Given this conclusion, there are a number of *questions* which your Federation should address. It is to be hoped that this meeting will provide an important beginning. These questions are:

a. What should the nature of an international accounting rulemaking body be, and who should participate in it?

(Should this body be primarily made up of private sector or public sector representatives? Should there be some nations designated as vital to the operations of international accounting? If so, which ones? How then is the interest and involvement of those nations not declared to be vital to be maintained? Is the UN formula of direct and equal involvement of developing nations a workable approach? Should a country's delegates include non-accounting representatives, e.g. business, labour and government interests?)

b. What is the level of subject matter that should be dealt with by an international rule-making body?

(Should it deal with the same technical subjects as national bodies, or should it concern itself more with wider and more general topics?)

c. What should the nature of the pronouncements flowing from this body be? (How should the enforceability question be dealt with?)

(In the national context standards are generally supported by a government agency with enforcement power. On the international scene this is not the case. The key question is how to gain the acceptance of whatever rules are promulgated. What mechanism should be used to achieve the required level of acceptance?)

Let me first deal with what the nature of the international accounting rule-making body should be, and with how its pronouncements should be treated.

There is no question that without the force of international law behind it, any international rule-making body will experience a great deal of frustration.

Sir Henry Benson, the father of the IASC, was very straightforward on

this point. 'Let us all be clear . . . on one issue' he stated. 'The IASC will fail unless the founder and associate bodies ensure that the standards are complied with by their members.'<sup>7</sup> This can only be done through the force of international law, legislated domestically by individual governments. Without the weight of law, any standards will be of only very limited usefulness.

The necessity for an enforcement mechanism will be a fundamental consideration in the development of a unified international standard-setting body.

With regard to the question of who should participate in the formulation of international accounting standards it is clear that the international profession as a whole must now develop an effective structure for co-operating with the many agencies interested in the accountability of multinational enterprises. Before this can be done the profession itself must unite behind one authoritative entity. This cannot be accomplished without a clear definition of the role of the 'international accountant' - i.e. should the profession play an active or just advisory role in the entrenchment of international standards in international law, or will international accountants merely be responsible for policing international standards through their auditing arm?

As to the professional input into this process, there is a strong argument that the IASC and the IFAC should unify as the one international voice of the profession. As your president Gordon Cowperthwaite puts it: 'the IASC has been recognized as a worldwide accounting standard-setting body since its formation in 1973 and has since maintained a close relationship with (the IFAC) . . . but many of our members . . . now feel that, to be formally recognized as a unified accounting profession world wide, our two organizations should be integrated.'<sup>8</sup>

There is no question that only the profession has the expertise and commitment to research and establish international standards. But it does not have the authority to compel the observance of such standards. Only international law, such as it is, can provide any real degree of enforceability. Through intergovernmental agreement under the auspices of the U.N., the nations of the world can commit themselves to take legislative and other action to make IAS's mandatory.

Harvey Kapnick, the Senior Partner of Arthur Andersen & Co., has commented on this subject frequently. 'Without meaning to be facetious', he stated to his firm's annual meeting in 1973,<sup>9</sup> 'I would say that developing sound accounting standards for use by world business is too important to leave solely to accountants.' He later concluded that: 'the only way that international accounting standards can be developed and enforced is through a co-operative effort of governments and the accounting profession.'

It is important to recognize that Government support through the force of law for standard-setting, does not necessarily mean that an individual government need set those standards. In Canada, the Federal Government looks to the Canadian Institute of Chartered Accountants (CICA) to develop standards, (by defining 'generally accepted accounting principles') which are then given the force of law by statute. It is only very rarely that the Government has second-guessed the expertise of the Canadian profession. I see this type of relationship as a practical solution to the enforcement issue.

The most frequent criticism of U.N. involvement is that it is governed by political considerations. Let us recognize, however, that standard-setting in general, and international standard-setting in particular, has gone beyond simply being a choice of the best system of measurement. It has now become essentially a political choice where the interests of one group are given priority over the interests of another or where both are reconciled.

Basically, particularly with regard to developing nations, the U.N. will have to take the lead, and with the assistance of the profession, enact new standards. And, as has already been indicated, it is very important that any new unified accounting organization which your profession agrees on should be directly supported by the most influential accountancy bodies in each country. This is particularly so with regard to the FASB, which is probably the most influential accounting standard-setting body in the world, and which is not now a direct participant in the IASC.

Also, it is very important that this new body work in close conjunction with the EEC's standard setters. This is so because the EEC is the only organization that has had a high degree of success in reconciling international differences and achieving trans-national harmonization. This success must not be ignored because, as concluded by observers, standardization will only move ahead effectively if six 'vital' countries support it.<sup>10</sup> These countries are: the U.S., the United Kingdom, France, West Germany, the Netherlands and Japan, and we must look to the EEC for harmonization concerning four of these six.

Another area which your profession must concentrate on is the encouragement of more involvement by the international 'user' community in standard-formulation, by convincing your clientele, particularly international business, that uniform standards are desirable from their point of view. If the international business community does not demonstrate its support for international standard setting, then questions about its validity will become more numerous and searching. The business community must be prepared to support such efforts if they are to succeed.

A reference to International Accounting Standards in the annual reports



of multi-national corporations that report in the international environment will constitute concrete evidence of such support.

With regard to the *level of subject matter* to be dealt with by the international profession, the stated objectives of the IASC are to publish and promote the acceptance of *basic* standards on a 'World-wide basis'.

With regard to how basic international accounting standards should be, I think that the IASC has adopted the most useful approach by selectively identifying the problem areas most in need of harmonizing and then dealing with them on as technical a level as reasonably possible.

As to attempting to harmonize standards on a world-wide basis, this objective might be thought to be too ambitious. As *Nobes & Parker* have pointed out: 'to attempt world-wide standardization seems a hopeless and unnecessary target. The greatest benefits will come from standardization among countries where there are companies which publish financial statements and which have foreign investors, auditors, parents or subsidiaries.'<sup>11</sup> The context therefore, of success for the IASC might more sensibly be seen as the developed western world and those developing countries with which it has significant economic links.

It also seems to me that the definition of what is to be reported in international statements should be given priority over the consideration of harmonization of actual measurement policies. Once international reporting standards have been established, then selected harmonization of certain accounting principles would be made much easier. i.e. the method for valuation of a certain item is irrelevant if it need not be reported. Professor Edward Stamp, in a recent paper, stated that: 'Since it is a matter of public interest that corporations *should* provide adequate disclosure in financial reports, it is perfectly legitimate for government authorities to introduce requirements in this area.'<sup>12</sup> Such disclosure rules should precede measurement rules. It will then of course be for the profession as a whole to provide the expertise necessary to develop the required measurement rules which necessarily follow from the establishment of disclosure rules.

Perhaps the most appealing suggestion that has been raised with regard to how harmonization could best be achieved is that the use of two different sets of standards should be considered, at least on a temporary basis. When discussing the difficulties in reconciling the fundamental differences in accounting philosophy in the western world, *Nobes & Parker* have come to the interesting conclusion that:

'indeed it is not clear that (these differences) should be overcome. If the predominant purposes of accounting vary by country, then it seems reasonable that the accounting should vary. However, standardization is concerned with similar users who receive information from companies in different countries. It may be that the relevant companies should be

required to produce two sets of financial statements: one for domestic and another for international consumption.’<sup>13</sup>

The best method for the implementation of this proposal would be that companies would prepare a set of primary financial statements, obeying the standards most suitable for users in their own country, and a second set should be prepared using other accounting standards most appropriate for the international community. This would be the set of standards produced by the IASC which would be used in all countries when preparing secondary accounts for foreign users. In practice, such a system of multiple reports already exists. For example, foreign companies who wish to obtain capital on the New York or London markets already produce financial statements which have been translated and adjusted in various ways. To a large extent, in the case of these two most important capital markets, it is the standards of the IASC which are adopted because these largely coincide with American and British practice. Clearly, a formalization of this dual reporting procedure, while it would be more expensive in many cases, would be much easier to implement than wholesale standardization, and clear advantages would flow from having the most suitable financial statements for domestic and, separately, for international comparative purposes.

A final point which I would like to raise, as a lawyer, is that one of the aspects most in need of international harmonization is the question of the legal responsibility of accountants for the information they produce. This question is becoming of key importance under the Anglo-American legal systems, and is causing a great deal of apprehension for accountants, particularly while auditing. This apprehension must be much greater when dealing with an international situation with the possibility of owing a duty to potential users in many different countries. Under the Anglo-American common law, an auditor's exposure to liability has increased dramatically, particularly in the U.S. This, of course, has a direct impact on the nature and extent of accounting procedures and quality control systems. Contrast this legal exposure with the situation under a European civil code, as for example in West Germany, where the extent of an auditor's liability is strictly limited by law.

Again, however, this situation basically calls for a harmonization in legal philosophy, which will not easily be achieved.

I have tried to muster these thoughts in an attempt to advance what I believe to be a most important goal for your profession: international harmony in accounting standards. Thank you for listening with such patience and courtesy.

### Notes

- 1 World Accounting Report, *July 1981*, p. 3
- 2 G. M. Scott, *Accounting and Developing Nations International Business Series No. 9 Studies in Accounting (University of Washington: 1970)*
- 3 Accountants International Study Group, *Comparative Glossary of Accounting Terms in Canada, the United Kingdom and the United States, (AISC: 1975)*
- 4 *Comparative International Accounting*, C. W. Nobes & R. H. Parker, eds. (Oxford: 1981) pp. xv-xvi
- 5 Nobes & Parker, p. 3
- 6 R. L. May 'The Harmonization of International Auditing Standards' in *The Internationalization of the Accounting Profession*, W. J. Brennan, ed., (CICA: 1979) p. 62
- 7 Sir Henry Benson 'A Story of International Accounting Standards' in *Accountancy July 1976*, p. 47
- 8 C A Magazine, *July 1980*, p. 17
- 9 H. Kapnick, 'Proposal for a Council for World Accounting', In *the Public Interest*, (Arthur Andersen & Co.: 1974), p. 65
- 10 A. K. Mason, 'The Development of International Financial Reporting Standards', ICRA Paper No. 17, (1978)
- 11 Nobes & Parker, p. 337
- 12 E. Stamp 'International Standards to Serve the Public Interest' in Brennan, p. 122
- 13 Nobes & Parker, p. 332