

## 6.16: International Accounting Standards

### Learning Objectives

1. Learn the value of accounting in international business.
2. Describe the role of accounting standards.
3. Recognize the difficulties caused by countries using different accounting standards.

### The Role of Accounting in International Business

The purpose of accounting is to communicate the organization's financial position to company managers, investors, banks, and the government. **Accounting standards** provide a system of rules and principles that prescribe the format and content of financial statements. Through this consistent reporting, a firm's managers and investors can assess the financial health of the firm. Accounting standards cover topics such as how to account for inventories, depreciation, research and development costs, income taxes, investments, intangible assets, and employee benefits. Investors and banks use these financial statements to determine whether to invest in or loan capital to the firm, while governments use the statements to ensure that the companies are paying their fair share of taxes.

As countries developed different cultures, languages, and social and economic traditions, they developed different accounting practices as well. In an increasingly globalized world, however, these differences are not optimal for the smooth functioning of international business.

### The Emergence of New International Accounting Standards

The International Accounting Standards Board (IASB) is the major entity proposing international standards of accounting. Originally formed in 1973 as the International Accounting Standards Committee (IASC) and renamed the International Accounting Standards Board in 2001, the IASB is an independent agency that develops accounting standards known as **international financial reporting standards (IFRS)**. "History," International Accounting Standards Board, accessed November 26, 2010, [www.ifrs.org/Home.htm](http://www.ifrs.org/Home.htm).

The IASB is composed of fifteen representatives from professional accounting firms from many countries. "About the IFRS Foundation and the IASB," IFRS Foundation, accessed November 25, 2010, [www.ifrs.org/The+organisation/IASCF+and+IASB.htm](http://www.ifrs.org/The+organisation/IASCF+and+IASB.htm). These board members formulate the international reporting standards. For a standard to be approved, 75 percent of the board members must agree. Often, getting agreement is difficult given the social, economic, legal, and cultural differences among countries. As a result, most IASB statements provide two acceptable alternatives. Two alternatives aren't as solid or straightforward as one, but it's better than having a dozen different options.

Adherence to the IASB's standards is voluntary, but many countries have mandated use of IFRS. For example, all companies listed on EU stock exchanges are required to use IFRS. European Commission, "Report to the European Securities Committee and to the European Parliament," April 6, 2010, accessed November 26, 2010, [eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=com:2010:0292:fin:en:html](http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=com:2010:0292:fin:en:html). The same is true for all companies listed on South Africa's Johannesburg Stock Exchange and Turkey's Istanbul Stock Exchange. In all, over one hundred nations have adopted or permitted companies to use the IASB's standards to report their financial results. Neil Baker, "IFAC Calls for Crucial Reporting Roadmap," *Compliance Week*, July 27, 2009, accessed November 26, 2010, [www.complianceweek.com/blog/glimpses/2009/07/27/ifac-calls-for-reporting-roadmap](http://www.complianceweek.com/blog/glimpses/2009/07/27/ifac-calls-for-reporting-roadmap).

The United States doesn't mandate using the IFRS. Instead, the United States has the Financial Accounting Standards Board (FASB), which issues standards known as **generally accepted accounting principles (GAAP)**. The US currently mandates following GAAP. However, the FASB and IASB are working on harmonizing the accounting standards; many IASB standards are similar to FASB ones. The United States is moving toward adopting the IFRS but hasn't committed to a specific time frame. Marie Leone, "Harvey Goldschmid Named IASB Trustee," *CFO*, December 11, 2009, accessed November 26, 2010, [www.cfo.com/printable/article.cfm/14461503](http://www.cfo.com/printable/article.cfm/14461503).

The primary reason for adopting one standard internationally is that if different accounting standards are used, it's difficult for investors or lenders to compare the financial health of two companies. In addition, if a single international standard is used, multinational firms won't have to prepare different reports for the different countries in which they operate.

Accounting standards can be complex; and this makes modification of standards difficult. In addition, differing practices among various nations add to the complications of a unified accounting format. For example, in the United States and Great Britain, individual investors provide a substantial source of capital to companies, so accounting rules are designed to help individual investors. CIRCA, “International Accounting Norms: Background and Recent Developments in the EU,” accessed November 26, 2010, [circa.europa.eu/irc/dsis/acstat/info/data/en/accounting%20for%20website.htm](http://circa.europa.eu/irc/dsis/acstat/info/data/en/accounting%20for%20website.htm). In contrast, the tradition in Switzerland, Germany, and Japan is for companies to rely more on banks for funding. Companies in these countries have a tighter relationship with banks. This means that less information is disclosed to the public. It also results in accounting rules that value assets conservatively to protect a bank’s investment. In other countries, the government steps in to make loans or invest in companies whose activities are in the “national interest.”

Finally, accounting rules in China follow neither IFRS nor GAAP, which makes it hard for investors to gauge the true value of a company. Doug McIntyre, “Chinese Accounting: Greek to Many,” *Forbes*, June 18, 2007, accessed November 26, 2010, <http://www.forbes.com/2007/06/18/china-accounting-gaap-pf-education-investopedia.html>. To address this issue, some large Chinese companies report results in both Chinese accounting standards and the IASB’s standards. The two accounting standards can show quite different results for the same company, which is why convergence proponents advocate using one global accounting standard.

## Characteristics of International Accounting Standards and Their Implications for International Business

On one hand, having to adhere to GAAP rules as well as IFRS rules creates extra labor and paperwork for multinational firms. For example, a US company seeking to raise funds in Germany has to prepare a financial report according to IFRS accounting rules as well as US GAAP rules. Further problems arise when different country accounting rules make the financial statements look different. If the same transaction is accounted for in different ways based on different country accounting rules, the comparability of financial reports is undermined.

In some instances, the differences between US GAAP rules and IFRS are significant. For example, the last-in, first-out (LIFO) accounting method is allowed by GAAP but banned by IFRS. Some firms, such as aluminum company Alcoa, receive a tax benefit from using the LIFO method. Marie Leone, “Unfazed by IFRS,” *CFO*, April 30, 2010, accessed August 10, 2010, [www.cfo.com/article.cfm/14495043](http://www.cfo.com/article.cfm/14495043). If IFRS is mandated for all US companies, firms like Alcoa may need to make significant cash-tax payments. This is why US adoption of IFRS is taking time, and why the FASB and IASB are working hard to harmonize the standards.

On the positive side, other companies, like IBM, may gain greater efficiencies and stronger controls from a move to IFRS. For example, converting to IFRS would make it possible for IBM to create a globally shared service center for accounting, rather than having accounting departments in different regions. Marie Leone, “Unfazed by IFRS,” *CFO*, April 30, 2010, accessed August 10, 2010, [www.cfo.com/article.cfm/14495043](http://www.cfo.com/article.cfm/14495043).

US adoption of the IASB’s global accounting standards would be useful to big multinational companies. Tyco International, for example, is the parent of 1,200 legal entities, 900 of them outside the United States. For Tyco, having to follow only IFRS rules would be positive, because it would enable Tyco to prepare financials on the same basis worldwide and to more freely move accounting staff from country to country and business to business. Nonetheless, given Tyco’s massive network of information systems, making the switch would still be “a tremendous amount of work,” according to John Davidson, the company’s controller and chief accounting officer. David McCann, “IFRS: Jekyll or Hyde?,” *CFO*, November 20, 2009, accessed October 28, 2010, [www.cfo.com/article.cfm/14456597/c\\_14457492](http://www.cfo.com/article.cfm/14456597/c_14457492).

Some smaller public companies, however, would see only costs from a move to IFRS. Davey Tree Expert Company, for example, which only does business in the United States and Canada, sees no benefits. Because the company is unlikely to ever list on any national exchange, the argument that unified standards would allow comparability of financials has no value. David McCann, “IFRS: Jekyll or Hyde?,” *CFO*, November 20, 2009, accessed October 28, 2010, [www.cfo.com/article.cfm/14456597/c\\_14457492](http://www.cfo.com/article.cfm/14456597/c_14457492).

An interim step toward the United States adopting IFRS is to permit US firms that operate globally to file only under IFRS, rather than under both GAAP and IFRS, thereby reducing their financial-statement preparation costs.

### KEY TAKEAWAYS

- The purpose of accounting is to communicate an organization’s financial position to company managers, investors, banks, and the government. Accounting provides a system of rules and principles that prescribe the format and content of financial

statements. Through this consistent reporting, a company's managers and investors can assess the financial health of the firm.

- Historically, countries have followed different accounting standards. If different accounting standards are used, however, it's difficult for investors or lenders to compare two companies or determine their financial condition. US firms and any listed on a US stock exchange must prepare financial statements in accordance with the US Financial Accounting Standards Board (FASB) standards, which are known as generally accepted accounting principles (GAAP). Firms based in the European Union (EU) follow standards adopted by the International Accounting Standards Board (IASB) known as international financial reporting standards (IFRS). Over one hundred nations have adopted or permit companies to use IFRS to report their financial results. The United States is moving toward adopting IFRS but hasn't committed to a time frame. The FASB and IASB are working on harmonizing the two accounting standards.
- The three main advantages of a single set of international accounting standards are (1) an increased comparability between firms, which reduces investor risk and facilitates cross-border financing and investment; (2) a reduction in the cost of preparing consolidated financial statements for multinational firms; and (3) the improved reliability and credibility of financial reports.

## EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What is the purpose of accounting?
2. Why do countries have different accounting standards?
3. What are the advantages of a single set of international accounting standards?
4. Which set of accounting standards does the United States follow?
5. Why are some governments reluctant to follow IFRS?

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