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International financial reporting standards — credible and reliable? An overview

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ABSTRACT

The study discusses how IFRS's objective of the harmonization of accounting standards and improvement of quality of financial reporting may have been negatively affected due to public authorities' influences in the European Union (EU), the U.S., the U.K. and China. In addition, we discuss issues related to the inconsistent interpretations and implementations of IFRS as principle-based accounting standards. Moreover, we discuss how the funding system of the IASB may (or may not) have affected its independence. The review of relevant literature and discussion is critical to IFRS adoption/convergence efforts in the U.S.

1. Introduction

The adoption of the International Financial Reporting Standards (IFRS) by public firms around the world is one of the most significant financial accounting and reporting changes in accounting history. Currently, over 100 countries have implemented IFRS or at least have taken steps in adopting these standards in the future (Sacho & Oberholster, 2008). In Europe, every publicly traded company in the European Union (EU) member state is required to apply IFRS when preparing the consolidated financial statements (IASPlus (a). (n.d.). In the U.S., the Securities and Exchange Commission (SEC) has allowed non-US firms to file financial statements in accordance with IFRS of the IASB without reconciliation (SEC, 2007). In Asia, countries with substantial economies, such as Japan, India and China, are either in the process of transitioning to IFRS or have already converged to IFRS (PwC, 2008). In addition, most listed companies worldwide are directly or indirectly affected by IFRS issued by the International Accounting Standard Board (IASB).

Accounting standards setting is shaped by both economical and political considerations (Ball, 2006). On the one hand, the IASB has to consider the interests of different parties including multinational corporations, audit firms, investment banks, international organizations, and various public authorities in Europe, China, the U.S. and elsewhere (Véron, 2007a). On the other hand, countries that are notably affected by the IASB standards have a stronger interest in the IASB's work and are seeking to influence it.

Although researchers argue that "accounting standards are as much a product of political action as they are of careful logic or empirical findings" (Keiso, Weygandt, & Warfield, 2007, p. 15), many believe that accounting standards can lose credibility and reliability if they are open to political intervention and professional interpretations (Fogarty, Mohamed, & Edward, 1994). The purpose of this paper is to: (1) discuss how political influences from public authorities and interest groups may have affected the IASB's rule setting; (2) discuss the effects of uneven implementations and interpretations of IFRS; and (3) examine whether the funding system has affected the IASB's independence and thus reliability and credibility of IFRS.

Increasing pressure on the IASB from authorities and interest groups may undermine its independence, and thus questioning the reliability and credibility of IFRS. This study suggests that, in some cases, political influences from authorities, regulators and interest groups have led the IASB to make potentially unjustifiable changes to IFRS. Moreover, the objective of IFRS is to set globally accepted accounting standards to improve the comparability of financial information (SEC, 2008). Being principle-based standards, the inconsistent applications and interpretations of IFRS and the lack of IASB enforceability authority lead many countries to adopt some version of IFRS, not necessarily IFRS originally issued by the IASB. Many countries declare that their national rules converge to IFRS but they rarely (if at all) reach full compliance. Depending on the local political, cultural, legal and economic environments, countries may implement IFRS differently. As such, although the main promise of IFRS is to allow users to better compare financial statements across industries and countries, the inconsistency of implementation and interpretation may jeopardize the comparability of financial statements issued under IFRS (Nobes, 2008). If comparability is not attained, compounded by political influences on the IASB standard-setting process and its funding system, reliability and credibility of IFRS is most likely compromised.

This study contributes to the existing debate over the U.S. as a "potential" major adopter of IFRS and thus lending credibility to IFRS. The U.S. SEC has slowed down the IFRS roadmap originally set for limited U.S. issuers by extending the comment period to April 20, 2009 from February 20, 2009 (Financial Accounting Foundation (FAF), 2009). Currently, many reports question IASB's independence and the quality of IFRS (Reason, 2009). Our study presents anecdotal evidence that the due process used by IASB to adopt certain international

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standards and how the due process may have been circumvented in some cases. The study also sheds some light on whether principle-based standards and the IASB's funding system may have affected IFRS quality. The discussion is important because the reliability and credibility of accounting standards used to prepare the financial information makes this information useful.[1] In 1999, the FASB issued a document titled International Accounting Standard Setting: A Vision for the Future, setting forth its views of “an ideal global financial reporting system that includes a single set of high-quality accounting standards set by an independent standard setter”.

The FASB also indicated the following in a letter to the SEC in March 2009:

> The current global financial crisis has revealed a weakness in an international system composed of multiple sets of accounting standards — the presence of real or perceived differences between these standards enable the pursuit of accounting arbitrage that, if unchecked, could result in a “race to the bottom” in financial reporting. We are, therefore, encouraged by the fact that many countries around the world also see the benefits of a common financial reporting language. We believe that the U.S. must be an active participant in the international effort to achieve a common global financial reporting language. (FAF, 2009, File number S7-27-08).

Moreover, prior studies show that IFRS is value-relevant when compared to other sets of accounting principles (e.g. Liu & Liu, 2007; Armstrong, Barth, Jagolinzer, & Riedl, 2010; Barth, Landsman, & Lang, 2008). The study attempts to present the opposing views on how IFRS may not be of high quality and therefore, adopting IFRS may not improve the quality of financial reporting but rather may distort it. The different versions of IFRS adopted in different countries may also raise questions if the convergence project should work and whether the U.S. would indeed use IFRS or rather a U.S version of IFRS. Looking through the comments letters from different groups (posted on the U.S. SEC's website and SEC, 2009), users' interests fall into three main categories: the first category indicates a preference of convergence rather than adoption; a second category indicates a preference of picking a date of convergence for the major accounting issues such as consolidation, leases and pension accounting; a third category indicates a preference of picking a date for the adoption of IFRS.

Whichever the case might be, reliability and relevance of financial information are not only a function of the reliability and credibility of the standards used. It is also a function of the applicability of these accounting standards in a given economic, legal, cultural and political system where the actual implementation of the standards should indeed capture the essence of the standard intended. We suggest in this overview, that some of these objectives may not be achieved because of the political influence over IFRS, and simply because what suits one country, may not suit another country, and the interpretability choices of the principle-based standards.

2. Historical background of IASB

In the era of globalization, the world has become a small village. The trends of globalization and the need for harmonized accounting standards induced the creation of the International Accounting Standards Committee (IASC). In 1973, leading professional accountants from Australia, Canada, France, Germany, Japan, Mexico, Netherlands, U.K., Ireland, and the U.S. reached an agreement to establish the IASC (Sacho & Oberholster, 2008). The IASC was a private-fund company and its members were from these member-countries. Two years later, Belgium, India, Israel, New Zealand, Pakistan and Zimbabwe joined the Committee as associate members (Véron, 2007a). Many other countries and national accounting bodies continued joining the Committee until 1987 (Camfferman & Zeff, 2007). In 1981, the World Bank, the United Nations, the Organization for Economic Co-operation and Development (OECD), and other market participants formed the IASC's Consultative Group (Véron, 2007a). The International Organization of Securities Commissions (IOSCO) joined the group in 1987.[2] In 1990, the European Commission (EC) and the U.S. Financial Accounting Standard Board (FASB) joined the IASC meetings as observers (Véron, 2007a).

During the early stage of its development, the IASC tried to compromise diversified accounting principles and practices from different countries into the International Accounting Standards (IAS). In order to achieve this goal, the IASC provided many accounting alternatives that came from different national standards. Ironically, IAS were “criticized as being broad and ineffective” (Roberts, Slater, & Kantor, 1996). The IOSCO aims at having harmonized accounting standards to be used globally. The objective of IOSCO induced the IASC to improve its standards to gain world acceptance. As a result, the IASC issued E32, “Comparability of Financial Statements” (also referred to as the Comparability Project), as a response to the request from IOSCO in January, 1989 (Roberts et al., 1996). In the following year, the IASC issued the “Statement of Intent: Comparability of Financial Statements” (IASPlus (c), n.d).

The Comparability Project's goal is to gain world recognition and improve consistency by reducing accounting alternatives in the standards (Roberts et al., 1996). In 2000, IOSCO recommended its members to use the IAS (Véron, 2007a,b). This endorsement paved the road for IAS's wider acceptance. By 2002, the European Union (EU) required all public firms to adopt IFRS in the fiscal year after January 1, 2005 which was the IASB's another significant achievement (Armstrong et al., 2010).

Prior to 2001, each IASC member could nominate two representatives and one technical advisor to the committee. The IASC had additional non-voting observer members from market participant, including IOSCO, the FASB, and the EC. The IASC had voluntary advisory groups, including the Consultative Group, the Standard Interpretations Committee, the Advisory Council and the Steering Committee, to support its work (IASPlus (a), n.d.). In the late 1990s, the IASC was aware that its structure had no longer fit its growth and decided to restructure. As a result, in 2000, a new statutory ‘Constitution’ was adopted and the reform created the Delaware-based IASC Foundation (IASCF) and its subsidiary entity, the London-based IASB (IASCF, 2009, p.4). In addition, the ‘Constitution’ is subjected to review every 5 years.

According to the ‘Constitution’ (IASCF, 2000), the IASB has a two-tiered structure, one is the administration body called IASCF and another is the technical body called IASB. The IASCF is a non-profit corporation and is responsible for strategic planning, board member appointments and fund raising; the IASB operates independently and is responsible for setting standards. The IASCF had 19 Trustees before 2005 and increased to 22 as a result of ‘Constitution’ revision in 2005 (IASPlus (d), n.d.).[3] The IASB has 14 members, of which 12 are full-time and 2 are part-time, all appointed by the Trustees from IASCF (IASCF, 2000, paragraph 19). Full-time board members are not allowed to have any on-going relationship with his/her former employer. The foremost qualification for IASB members was ‘technical expertise’ (IASCF, 2000, paragraph 20) which was strongly suggested by the U.S. Securities and Exchange Commission (SEC). However, the

[1] In the U.S., the mission of the Financial Accounting Standards Board (FASB), is to “establish financial accounting and reporting standards for public, private, and not-for-profit entities (other than governmental entities), through an independent and open process, resulting in financial reports that provide useful information for investors, creditors, and other external decision makers” (FAF, 2009, p. 1).

[2] IOSCO is an international organization that consists of the regulators of securities and futures markets around the world.

[3] Since 2005, the 22 Trustees are ‘six Trustees appointed from North America; six Trustees from Europe; six Trustees from then Asia/Oceania region; and four Trustees from any area, subject to establishing overall geographical balance (IASCF, 2009, paragraph 6).