Harmonization Gap In Financial Reporting - A Descriptive Analysis

** Dr. Sandeep Goel*

INTRODUCTION

Financial information is one which is universally appealing to all the groups of users across the globe. Finance literature in particular came a long way in explaining the various financial disclosure practices of the firms and highlighting the need for harmonization of them. With the increasing pace of globalization and rapid economic and production exchanges across the globe, there is a rationale justification of such accounting harmonization.

As business goes global, pressure is increasing for adoption of a single set of accounting standards worldwide. The statement is clear in practice, both with the International Accounting Standards Board attempting to pull together one set of global standards, and with the U.S. Financial Accounting Standards Board agreeing to an attempt to converge U.S. standards with international standards.

Global differences in accounting have important economic impacts. For example, global differences in accounting impact investment around the world at various levels. It also appears that some aspects of accounting are very *"sticky,"* suggesting there will need to be a strong set of actions and incentives to get us to truly comparable global accounting.

Today, as everyone is aware, most large corporations and enterprises and companies all across the globe are indulging in financial frauds. There are several groups of people who are, today, questioning actual relevance of financial reporting for the purpose of decision making in a corporation or enterprise, anywhere in the world. In Australia, for example, two major factors have motivated the analysis and study of the present day accounting profession, and they are the recent collapses on account of the fraudulent practices in the profession, and the governmental intervention in regulating the financial affairs of the corporations.

HARMONIZATION: THE CONCEPTUAL FRAMEWORK

Reporting is nothing but the communication of accounting information of an entity (individual, firm, company, government enterprise) to a user or group of users. *Financial reporting* connotes communication of published financial information of an enterprise to third parties, viz. shareholders, creditors, customers, governmental authorities and the public. Corporate financial disclosure through publishing annual reports plays a important role in the efficient and effective growth of an economy. As international trade is inevitable for every economy, it becomes obvious that the respective countries should speak the same business language. Here, *Harmonization of Accounting Practices* comes into picture.

'Harmonization In Accounting' means the identical accounting policies adopted by the enterprises all through the country. As the rate of adoption of any of the policies used in the accountability increases, the harmonization of the accounting applications increases accordingly. On the contrary, the harmonization level decreases. So, *'Harmonization'* is about *following the same set of accounting standards*.

There is no denying the fact that the quantum and quality of information will vary according to the needs of the user country. The scope of adequate uniformity can be explained in terms of following five interconnected questions:

1. User
2. Purpose
3. Quantum
4. Mode
5. Timing

Also, the qualitative characteristics of relevance, materiality, understandability, comparability, consistency, reliability and freedom from bias are to be kept in mind for signifying the harmonization of international accounting standards. The reason being that these attributes denote the quality of information, and hence, the user needs these for grasping the concept of adequate disclosure in financial reporting.

* *Assistant Professor (Finance),* Management Development Institute, Sukhrali, Gurgaon. E-mail: sandeep@mdi.ac.in

The major **Financial Statements,** which are of utmost importance to almost every group of users are : Income Statement and Balance Sheet. Income Statement depicts the net income of a business and Balance Sheet tells you the financial health of the concern. Given below is the list of major financial disclosures by a corporate.

Table1: Major Disclosures In A Balance Sheet

Liabilities	Assets
Owners' funds	**Fixed Assets**
Share Capital:	- Tangible
-Equity Share Capital	- Intangible
-Preference Share Capital	Investments
Reserves and surplus:	**Current Assets, Loans & Advances**
-Revenue Reserves	
-Capital Reserves	
Borrowed funds	
Secured Loans	
Unsecured Loans	
Current Liabilities & Provisions	

Table 2 : Major Disclosures In An Income Statement

Turnover
Raw material consumed
Office and Selling Expenses
Depreciation
Interest
Income Tax
Dividend
Appropriations

Table 3: Disclosure of Other Items

Accounting Policies
Depreciation Policy
-Method of depreciation and rate of depreciation
Inventory Valuation
- Inventory system and method of valuation
Treatment of Goodwill
-Method of valuation
Valuation of Fixed Assets
Treatment of Contingent Liabilities
Information about Major Plants/ Units
Value of Imports and Exports

Table 4 : Summarized Statements And Techniques Of Disclosure

Ratios
Cash Flow Statement
Summarized Statements
- Cost/ Expenditure
- Research and development
New Techniques
- Segment Reporting
-Inflation Accounting
-Human Resource Accounting
- Value Added Statements

ACCOUNTING STANDARDS: THE PILLARS

The fundamental field on which harmonization in accounting practices is concentrated, is the accounting standards. *'Accounting Standards'* are the policy documents (authoritative statements of best accounting practices) issued by recognized expert accountancy bodies relating to various aspects of measurement, treatment and disclosure of accounting transactions and events. As related to the codification of Generally Accepted Accounting Principles (GAAP), these are stated to be norms of accounting policies and practices by way of codes or guidelines to direct as to how the items, which go to make up the financial statements should be dealt with in accounts and presented in the annual accounts. The aim of setting standards is to bring about uniformity in financial reporting and to ensure consistency and comparability in the data published by enterprises.

In the recent years, the accounting standards have attained great importance. On one hand, the organizations make every effort to harmonize their standards with each other, on the other hand, the countries make necessary adjustments for harmonization to international standards. Harmonization in accounting standards shall serve many of the following benefits:

- Decrease in the costs of data collection;

- Increase in the comparison of the information;
- Facilitation in the fund movements;
- Decrease in the audit costs and increase in the efficiency of the audit.

Accounting Standards are used as one of the main compulsory regulatory mechanisms for preparation of general-purpose financial reports and subsequent audit of the same, in almost all countries of the world. Accounting standards are devised to furnish useful information to different users of the financial statements, to such as shareholders, creditors, lenders, management, investors, suppliers, competitors, researchers, regulatory bodies and society at large and so on. In fact, such statements are designed and prescribed so as to improve & benchmark the quality of financial reporting.The rapid growth of international trade and internationalization of firms, the developments of new communication technologies, and the emergence of international competitive forces is perturbing the financial environment to a great extent. Under this global business scenario, the residents of the business community are in urgent need of a common accounting language that should be spoken by all of them across the globe.

So, a financial reporting system of global standards is a pre-requisite for attracting foreign as well as present and prospective investors at home alike that should be achieved through harmonization of accounting standards.

ACCOUNTING STANDARDS: THE UNIVERSAL PHENOMENON

Accounting standards are being established both at the national and international levels. But the variety of accounting standards and principles among the nations of the world has been a sustainable problem for globalizing the business environment.

There are several standard setting bodies and organizations that are now actively involved in the process of harmonization of accounting practices. The most remarkable phenomenon in the sphere of promoting global harmonization process in accounting is the emergence of international accounting standards.

The International Accounting Committee (IASC), now International Accounting Standards Board (IASB) was formed on 29th June 1973, by the recognized professional accounting bodies in Canada, Australia, France, Japan, Germany, Mexico, Netherlands, United Kingdom and the United States of America, with its secretariat and head quarters in London.

National standard setting bodies like Financial Accounting Standards Boards (FASB) of USA, Accounting Standards Boards (ASB) of UK, and Indian Accounting Standards (IAS) in India generally frame accounting standards in the line of IASC after due consideration of the local laws and conditions.

In India, the Accounting Standards Board (ASB) was constituted by the Institute of Chartered Accountants of India (ICAI) on 21st April 1977 with the function of formulating accounting standards.

The following Table 5 presents the comparative analysis of Indian accounting standards with International accounting standards and US GAAP.

Table 5: Comparative Statement Of Indian Accounting Standards And International Accounting Standards

Basis	International Accounting Standards (IAS)	Indian Accounting Standards
Number	41	32
Formulating Body	IASB	ASB

Source: www.icai.org

Note: In addition to 41 IAS, there are 8 IFRS as well.

DO WE NEED TO HARMONIZE THE ACCOUNTING STANDARDS OF DIFFERENT BODIES?

Cross country listings would be a matter of ease, if the harmonization of financial accounting and reporting were to come into effect. In addition, there would also be a meaningful transfer and transmission of pertinent and relevant financial information to investors, statisticians, and various users of the financial information. This has in fact, today, led to the development of issue of reconciliation of various International Accounting Standards, and of the US Generally Accepted Accounting Practices, and other related issues.

What are the motives for the harmonization of financial accounting and reporting? Why is it so important today? How is harmonizing analyzed? It must be remembered that the primary objective of any financial accounting statement would be to provide the relevant information about the financial position, the financial adaptability, and the performance of the enterprise, in such a manner that it would prove to be useful to a large number of users who may be involved in making financial decisions for the company. However, one must also remember that the harmonization of accounting principles and reporting, on an international scale, would be a tough proposition. Today, for example, the EEC, or the European Economic Community and the International Standards Accounting Committee have both joined hands in trying to find the best way to harmonize accounting principles and reporting, and it is hoped that the result would be able to exert its influence on the Fourth Directive. In other words, the applicability of the Fourth Directive to the annual financial statements of the numerous public and private organizations that operate within the EEC would make this harmonization statement an extremely important facet of accounting unity.

It has been observed from published annual accounts of various Indian and foreign companies that there are divergent accounting practices for the same transaction. This in effect is defeating the comparability of financial statements. The reasons for different accounting practices are either:

a) Too many alternative accounting treatments in the accounting standards; or

b) Lack of harmony among government, standards setting body, and regulatory agencies.

Adoption of different accounting standards causes difficulties in making relative evaluation of performance of companies. This phenomenon hinders the valuation and eventually, the decision-making process of an organization.

CASES

When a multinational company (MNC) has to report under the standards of both the countries, it might lead to some extremely odd results. For instance, Daimler Benz, who was the first German to secure stock market listing in the United States, reported a net profit of DM 158 m for the six months to June 1998 based on German GAAP. The U.S GAAP reconciliation statement revealed that the company had incurred a loss of DM.949m.

Similarly, British Telecom Inc. reported a net profit of £1767 for the year ended 31-3-1994 under the UK GAAP, but under the US GAAP reconciliation, the net profit reduced to £1476. Although there are different solutions that have been suggested to resolve the problems associated with filling financial statements across national boundaries like reciprocity and reconciliation, they are not free from limitations. To overcome these problems, harmonization of accounting standards has already been started. Accounting harmonization is not an end by itself, but it is a means to an end. The ultimate objective of harmonizing accounting practices among countries is to foster international comparability of accounts. But still, the harmonization process has a long way to go. Many standard setting bodies and regulators of different nations are ardent protectors of their local standards; they are in no mood to allow their job being taken over by a foreign entity.

Thus, winning the consent of these bodies is vital for international accounting standards to don the mantle of common accounting code, which will make these countries globally competitive.

ISSUES IN ADOPTING GLOBAL ACCOUNTING STANDARDS

This is definitely a problem. The US is the largest market and it is important for IASC standards to be harmonized with those prevailing there. The US lobby is strong, and they have formed the G4 nations, with the UK, Canada, and Australia (with New Zealand) as the other members. IASC merely enjoys observer status in the meetings of the G4, and cannot vote. Even when the standards are only slightly different, the US accounting body treats them as a big difference, the idea being to show that their standards are the best.

INTERNATIONAL ACCOUNTING PRACTICES

❁**India - Indian Accounting Standards:** In India, the Statements on Accounting Standards are issued by the Institute of Chartered Accountants of India (ICAI) to establish standards that have to be complied with to ensure that financial statements are prepared in accordance with generally accepted accounting standards in India (India GAAP).

The main reason for the prevailing divergent accounting practices is - the Accounting Standards, the provisions of the Income Tax Act, 1961 and Indian Companies Act ,1956 do not go together.

(a) Company Law And Accounting Standards: In India, though accounting standards setting is presently being done by ICAI, one could discern a tentative and halfhearted foray by company legislation into the making of accounting rules of Measurement and reporting. This action by itself is not the sore point, but the failure to keep pace with the changes and simultaneously not allowing scope for some one else to do it is disturbing. A study of the requirement of company law regarding the financial statements reveal several lacunae like earning per share, information about future cash flows, consolidation, mergers, acquisitions etc.

(b) Income Tax Act And Accounting Standards: The Income Tax Act does not recognize the accounting standards for most of the items while computing income under the head *"Profits & Gains of Business or Profession"*. Section 145(2) of the I.T. Act has empowered the Central Government to prescribe accounting standards. The standards prescribed so far constitute a rehash of the related accounting standards prescribed by ICAI for corporate accounting. On a close scrutiny of these standards, one is left wondering about the purpose and value of this effort. Examples are application of prudence substance over form, adherence to principles of going concern etc.

c) Other Regulations And Accounting Standards : In respect of banks, financial institutions, and finance companies, the Reserve Bank of India (RBI) pronounces policies among others, revenue recognition, provisioning and assets classifications. Similarly, the Foreign Exchange Dealers Association (FEDAI) provides guidelines regarding accounting for foreign exchange transactions. Since the Securities & Exchange Board of India (SEBI) is an important regulatory body, it would also like to have its own accounting standards and in fact, it has started the process by notifying cash flow reporting format. It is also in the process of issuing a standard on the accounting policies for mutual funds. It appears as if several authorities in our country are keen to have a say in the matter of framing accounting rules of measurement and reporting. The tentative and half hearted legal and regulatory intervention in accounting in our country has come in the way of development of robust, continuously evolving and dynamic accounting theory and standards.

Financial reporting in India has become a messy affair. Multiple institutions - especially SEBI, the RBI, the CBDT and the DCA - have assumed the role of setting accounting standards. Until a few years back, financial reporting used to be a private affair between the management and the auditor. Armed with a dozen or so accounting standards - many of them quite outdated- though the auditors certified the same *'true and fair'* script over and over again. Going by the current state of affairs, it will be quite some time before it could actually contribute anything tangible. But then how long will this muddling go on?

Let us have a closer look at the scene in the UK and the US too, the usual sources of standards.

❁**The UK:** Until 1990, AS in UK were issued by the accountancy profession consisting of six mainline accountancy bodies. Following the corporate collapses of BCCI, Polypeck, and so on, the government began taking greater interest in the standard-setting process. A corporate body called Financial Reporting Council (FRC) was created with about 30 members, mostly drawn from the accountancy profession and the corporate world and with representations from the government and the legal profession as well. The FRC has a policy-making role and acts as an interface between the government and those concerned with financial reporting, such as standard-setters, users, preparers, and so on. Its role is to ensure good financial reporting. The FRC has two subsidiaries - the Accounting Standard Board (ASB) and the Financial Reporting Review Panel (FRRP). The ASB's 10 members (two full-time) are mainly preparers and auditors, with government nominees only acting as observers. The ASB issues and withdraws standards, while the FRRP enforces them. The FRRP members - of around 20 - are mainly preparers, with a few from the audit/legal profession as well. It has statutory powers to force corporates to correct apparent departures and deviation from accepted AS. Past examples show that it has been effective in implementing the standards. ASB has an offshoot called the Urgent Issues Task Force (UITF), which seeks to arrive at consensus where conflicting interpretations about an accounting treatment may exist. Called UITF abstracts, it has issued consensus on issues as contemporary as treatment of Website development expenses, Y2K expenses, barter transactions for advertising, and so on. The 15 UITF members mainly represent of the audit profession and the corporate sector.

❁**The US:** AS in US are issued by a seven-member body called the Financial Accounting Standards Board (FASB). All its members are full time CPAs, and are independent of their previous occupations. FASB projects and agenda are decided by an FAS Advisory Council consisting of more than 30 members representing auditors, preparers and users of financial reports.

The members of the FASB and its Advisory Council are selected by a board of trustees consisting of representatives from the audit and accounting profession, the government, and so on.

The SEC, *a la* SEBI, has the statutory authority to establish accounting and reporting standards for all the listed companies. The SEC formally authorizes the standards issued by the FASB as binding on all US-listed companies.

The American Institute of Certified Public Accountants (AICPA) is a body of CPAs who qualify from one of the 54 state boards of accounting and is not, unlike the ICAI, an examining body. AICPA provides technical support to the FASB for standard-setting. The Emergent Issues Task Force (EITF) is an AICPA arm, which deals with issues of contemporary importance.

☸ **Global Standards:** The International Financial Reporting Standards are issued now by a restructured (on US lines) International Accounting Standards Board (IASB), which consists of 14 members of mostly auditors, preparers and users from different countries. The IFRS have gained worldwide acceptability.

These are followed in over a dozen countries and form the basis for the national standards of about 45 other countries. IFRS makes an ideal starting point for discussions on harmonization of international standards.

The Europeon Union is likely to adopt IFRS for all listed companies by 2005, following which; a lot of convergence is expected with the UK GAAP. But the perceived superiority of the US GAAP has scuttled all harmonization plans initiated thus far.

There seems to be a tilt towards IFRS, especially after the Enron fiasco. As regards the *desi* standards, they are separately `*developed*', based on, and similar to, the international standards.

CONVERGENCE OF INTERNATIONAL ACCOUNTING STANDARDS

In the preceding section, we have seen that there are a number of differences between the accounting applications of countries. Such differences arise from the different economic, political, social, and cultural conditions. The differences between the countries are grouped under four headlines:

1. Determination of the accounting applications by the professional bodies or legal regulations.

2. Flexibility and uniform accounting practices.

3. Prudence and optimism in evaluation.

4. Confidentiality and transparency in the disclosure of the information.

Increase in the number of the international companies and the developments in the international capital markets have led to efforts to reduce such differences. Many organizations have tried to harmonize the accounting standards according to the harmonization concept. These organizations (as discussed above) may be listed as follows:

☸ International Accounting Standards Board (IASB),

☸ European Union Commission (EUC),

☸ International Organization of Securities Exchange Commissioners (IOSCO),

☸ International Federation of Accountants (IFAC),

☸ United Nations Economic & Social Council (ECOSOC),

☸ Organization for Economic Cooperation and Development (OECD).

These organizations aim at principally international harmonization and IASB is the one of the most important organization which is gathered around.

International Accountings Standards really benefit if being recognized at the national level rather than by voluntary adoption by individual companies. If you adopt the standards nationally, then all the regulators, auditors, analysts, management teams, etc. know that they have a single set of standards to understand and implement. This allows all of those entities to focus resources on making that single set of standards work in the intended manner. Without that strong knowledge base, even well-intentioned practitioners just may not have the skill set to properly implement the standards. So, one of the things is that oversight by a regulator, who is actively involved with the standards greatly increases the comparability of implementation across countries. So you can see that country-level adoption could be both economically more efficient and make the accounting much more credible to outsiders who need to rely on it.

In addition to the domestic scale issue, there is also an international scale advantage. Once outsiders realize that understanding the accounting is much less of a barrier, they are more likely to invest in a company. By adopting at a country level, this accounting decision becomes very visible to outsiders. If only individual companies adopt, they then must also attract the attention of investors to let them know that the company is using the familiar form of accounting. Add to that the credibility issues from above, and you can see the advantage an individual firm gets from countrywide adoption.

Finally, countrywide adoption allows the nation more ability to influence the standard-setting process. We have recently seen Europe push for a stronger position in influencing the IASB, based on being the largest user of the standards. By adopting as a country, it is much easier to push for a board position or some other method of impacting standard setting.

☸ **Leader In The Implementation Of IAS - Who? :** Europe is really the leader right now. The EU decision to adopt IAS (the actual standards are now called International Financial Reporting Standards, or IFRS) pushed them to the forefront in this area. After that, individual countries such as Australia and Canada announced they would be converging with IAS soon. By this point, many countries have indicated that they intend to be on IAS within the foreseeable future, so it has really picked up steam.

CONCLUSION

So, it can be said that harmonized disclosure of the accounting information on the part of the respective countries becomes inevitable keeping in view the growing market dynamics. ***Most of the global managers would love to have one set of solid accounting standards, rather than having to deal with "translation" issues.***

The vision of a harmonized accounting world may inspire many minds, but in the practical field, it is hard to go about embracing a situation where accounting principles and procedures are perfectly harmonized among countries through out the world.

The development of harmonized accounting rules and a uniformity of approach among countries towards education and training of professional accountants should accompany principles. Furthermore, the harmonization of accounting rules and principles among countries should also be accompanied by inter country harmonization in auditing principles and standards.

Differences are still there, but they are narrowing. It is expected that the pace of progress in the sphere of harmonization will accelerate further in the coming years.

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