1998

FASB Perspectives on the Development of International Accounting Standards

James J. Leisenring

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by
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March 9, 1998

[Introductory note: James J. Leisenring joined the staff of the Financial Accounting Standards Board in 1982 as director of research and technical activities and became chairman of the Emerging Issues Task Force when it was formed in 1984. He was appointed as a member of the FASB in October 1987 and was appointed its vice chairman effective January 1, 1988. Mr. Leisenring is currently serving a five-year term as a member of the FASB that was effective on July 1, 1995.

Prior to joining the Board, he was a partner and director of accounting and auditing for Bristol, Leisenring, Herkner & Co. of Battle Creek, Michigan, a firm that is now a part of Plante & Moran. He served as chairman of the Auditing Standards Board of the American Institute of CPAs and has been a member of several other Institute committees. From 1964 to 1969 he was a member of the faculty of Western Michigan University.

Mr. Leisenring received his BA from Albion College and an MBA from Western Michigan University. In 1981 he was named Accountant of the Year by the national Beta Alpha Psi accounting fraternity.]

It is an honor to be asked to present the Emanuel Saxe Lecture at Baruch College this evening.

The Mission Statement of the Financial Accounting Standards Board (FASB) states, "Accounting standards are essential to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, and understandable financial information."

The Mission Statement also concludes:

"The Board believes that this broad public interest is best served by developing neutral standards that result in accounting for similar transactions and circumstances similarly and for different transactions and circumstances differently."

Those two conclusions are fundamental to our mission, and there is nothing about an international border that would suggest those same conclusions aren't as appropriate for cross-border international reporting and accounting standard setting as they are here in the United States. That, of course, is based on the assumption that we are talking about open capital markets, not those controlled by a government. Indeed, the Board's Mission Statement also states that we will "promote the international comparability of accounting standards concurrent with improving the quality of financial reporting."

The Strategic Plan of the FASB indicates that our efforts in international activities should be guided by the belief that the ultimate goal of internationalization of accounting standards should be a body of superior accounting standards. Later, I will discuss the attributes we think are essential for accounting standards to be judged of high quality.

ENVIRONMENTAL INFLUENCES ON ACCOUNTING STANDARDS

Accounting standards are influenced by the economic and social environment in which they are established and applied. Several characteristics of the U.S. environment are important in that regard. These characteristics also influence the ways in which the United States adapts to and promotes the internationalization of accounting standards.

The first and most dominant of these characteristics is heavy reliance on open capital markets. In the United States, both debt and equity capital are raised in large measure through marketable securities issued in active auction markets where buyers are both individual and institutional investors. Bank loans and private placements are important, but they are priced and transacted in the shadow of the auction markets. U.S. law prohibits banks from owning significant equity interests in industrial companies. Thus, unlike the close, long-term banking relationships that are common in Germany, Japan, and some other countries--bound by such ties as equity interests and interlocking directorates--capital seekers and capital suppliers in U.S. markets tend to be independent, with both parties looking for targets of opportunity.

A second and closely related characteristic of the U.S. environment is that U.S. financial accounting standards are designed almost exclusively to facilitate investor-creditor decision making. Audited general-purpose external financial statements help bridge the information gap between suppliers and seekers of capital. Financial statements are a substitute for close relationships whereby capital suppliers have continuing access to confidential information about the entities in which they invest.

A third characteristic of the U.S. environment is an extensive network of capital market regulation. The Securities and Exchange Commission (SEC) and no less than five bank regulatory agencies at the national level are augmented by similar regulatory agencies in the 50 states. All of the national regulators have the power, if they choose to exercise it, to impose accounting requirements for regulatory purposes. But, unlike in some other countries, our regulators don't assess the merits of any investments.

In that regard, a fourth characteristic of the U.S. environment is a tradition of private-sector standard setting for generally accepted accounting principles (GAAP). The SEC has the authority to set accounting standards for securities market registrants, but the Commission has always relied on the private sector--first on the American Institute of Certified Public Accountants (AICPA) and now on the FASB. As a matter of long-standing policy and, more recently, as a matter of law, bank regulators also look primarily to private-sector standards, but they often impose special requirements for regulatory reporting purposes.

A fifth characteristic is the nearly total separation of financial and tax accounting. There is really only one instance in which U.S. tax law directly imposes constraints on general purpose financial reporting.(2) This separation differs markedly from some other industrial countries, notably Germany and Japan.

A final characteristic of the U.S. environment is a high incidence of litigation. The objective of U.S. securities law is investor protection, which requires fair and equal treatment of investors, founded on full disclosure to all market participants of information about the financial and other risks of investment alternatives. The law abhors insider trading, misleading or substandard financial reporting, substandard auditing, and, of course, financial fraud. And we have a host of lawyers ready to litigate at the slightest sign of financial impropriety.

All of these factors have played a prominent role in the development of U.S. accounting standards. But differences in domestic business organization and capitalization, legal and political systems, and historical and cultural factors influence all national accounting systems. Like the United States, other countries' accounting systems have developed in response to the environment in each country.

In today's global economy we have to cope not only with the pressures of the domestic environment, but also with the protocols and complexities of reaching multijurisdictional agreements. Since the eighties, there has been an increasing awareness that accounting can be an impediment to cross-border financing, and thus there has been a demand for comparability in financial reporting among companies of different domestic origin.

CONCERNS IN THE CURRENT INTERNATIONAL ENVIRONMENT

The globalization of capital markets is an irreversible process, and there are many potential benefits to be gained from mutually recognized and respected international accounting standards. Common standards cut the costs of doing business across borders by reducing the need for supplementary information. They make information more comparable, thereby enhancing evaluation and analysis by users of financial statements and reducing user costs. Users become more confident of the information they are provided, and presumably this reduced uncertainty promotes an efficient allocation of resources and reduced capital costs.

Comparability, which has always been one of the driving forces of U.S. accounting standards, has become the focus of cross-border financial reporting. Comparability assumes there is a common measuring yardstick by which to distinguish similarities and differences that informed users can rely upon in making decisions about providing resources, that companies can rely upon to conclude whether they have properly prepared financial statements, and that securities regulators can rely upon to adequately detect potential misinformation in a timely manner.

Standards also help maintain the credibility of financial reporting to the public and increase the efficiency of auditing that information. By providing mutually accepted financial information and thereby opening access to various capital markets, multinational enterprises can reap the benefits of greater visibility, greater liquidity, better share prices, lower costs of capital, and better access to investors.

There are inherent problems with setting international standards, however. Because of the competing perspectives of different nations, along with the universal tendency to resist change, too often cooperation comes only from compromise and sometimes to the detriment of quality. A fundamental problem with accounting standards is that the compromise in the negotiation of the standards often leads to a "lowest-common-denominator" approach. The belief often is that any agreement is better than no agreement. This often will lead to suboptimal standards at best. The International Accounting Standards Committee (IASC) has faced, and continues to face, these issues in attempting to develop mutually recognized international accounting standards. While the lowest common denominator is not the target of IASC standards, the standards often contain so much purposeful ambiguity that when applied, they will not enhance comparability.

On the regulatory side, another problem arises even if international accounting standards exist. Some actions that are designed to promote international comparability may actually *detract* from comparability within a particular market. For instance, if the SEC were to allow foreign issuers to use IASC accounting standards in U.S. capital markets without reconciliation to U.S. GAAP that action would raise concerns about comparability between foreign and domestic issuers. Unfortunately, eliminating reconciliation takes valuable information out of the hands of financial statement users--information that is intended to compensate for noncomparability.

Tolerating the use of different standards by foreign and domestic companies not only detracts from comparability, but may also undermine our domestic financial reporting. If different standards are acceptable for foreign companies to use when listing in U.S. capital markets, it becomes difficult to justify different requirements for our domestic companies. Introducing differences in financial accounting standards in domestic capital markets where they did not exist before is the antithesis of harmonization, and the ultimate effect of various proposals in the United States to ease requirements for foreign issuers could significantly erode comparability. At some point, differences will have to be eliminated.

The FASB believes that increased comparability in financial reporting levels the playing field for both foreign and domestic companies. Standardizing the requirements for accessing capital markets also is important. At the same time, however, we must be concerned about the way we make the transition from the current system of independent, national standard setters to an emerging global system.

Though we believe strongly in the need for market forces to be able to work freely in the global economy, we are unwilling to accept international standards derived from a lowest-common-denominator approach simply in the name of internationalization. In working toward an acceptable body of international standards, standard setters must work together to minimize differences while improving the quality of financial reporting around the world.

HIGH QUALITY ACCOUNTING STANDARDS

We cannot call for superior or high quality accounting standards without articulating what we mean by high quality. Recently, the EASB set forth its views on this matter in a working paper.(3) I quote from the introduction to that paper:

> This paper describes the attributes of high-quality accounting standards that contribute to high-quality financial reporting. This paper is based on the premise that high-quality financial reporting is financial reporting that provides decision-useful information for outside investors, creditors, and others who make similar decisions about allocation of resources in the economy.
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> A reasonably complete set of neutral accounting standards that require relevant, reliable information that is decision-useful for outside investors, creditors, and others who make similar decisions would constitute a high-quality set of accounting standards. Each of those accounting standards should:
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> a. Be consistent with the guidance provided by an underlying conceptual framework.
> b. Avoid or minimize alternative accounting procedures, explicit or implicit, because comparability and consistency enhance the usefulness of information.
> c. Be unambiguous so that the standard is understandable by preparers and auditors who must apply the standard and by users who must deal with the information produced by the standard.

We believe these characteristics are essential for any set of accounting standards to meet the demands for decision-useful information in our capital markets.

The FASB strives to achieve standards of this quality domestically and in our international activities, and we believe this can best be done in a very open process. Our working paper also concludes:

> Accounting standards in their formative stage must be subjected to rigorous procedures that encourage all interest groups to communicate their views to the standard setter. Similarly, the deliberative process of the standard setter should be open to observation by all interest groups so that the public is informed on a timely basis about important developments pertaining to the standard setter's projects. A standard setter's consideration of the diverse views and concerns of its constituents enhances the overall quality of the final accounting standard by improving the standard setter's judgment about matters such as, to cite just two examples, why certain information is or is not relevant in particular circumstances or why certain information is or is not reliable if provided by a particular method or procedure.

FASB'S INTERNATIONAL INITIATIVES

The FASB formally responded to the challenge of the need for international comparability by developing a strategic plan for international activities in 1991, which was most recently reviewed in 1995. In the most recent plan, we identified the ultimate goal or the ideal state of international accounting standards to be a body of superior standards accepted in all countries as GAAP for general-purpose external financial statements. This goal is, of course, beyond the control of any one standard setter. Each individual standard setter can, however, contribute to the achievement of that goal.

In the years since we set forth our objectives and strategies in our international plan, we have undertaken a significant number of international initiatives. Our activities include standard-setting activities, as well as other activities.

Standard-setting activities involve direct cooperation with other standard-setting organizations to resolve specific issues and to work toward reducing differences in accounting standards between nations. Initiatives have included a joint standard-setting project on segment reporting with Canada and working in parallel with the IASC on the topic of earnings per share. Also, we joined with Canada, Mexico, and Chile in the wake of the North American Free Trade Agreement to analyze similarities and differences between accounting standards in our four countries.

Perhaps our most important activity is our participation in a working group often referred to as the G4+1. It is not a very accurate description. Just as the Big Ten Athletic Conference has eleven teams, the G4+1 consists of five standard-setting bodies plus the IASC as the +1 participant. (The participating standard-setting bodies are from Australia, Canada, the United Kingdom, New Zealand, and the United States.) While all of these organizations are based in English language countries, language is not the common bond that brought the group together.

Each of these standard setters explicitly accepts that the purpose of financial reporting is decision-useful information for outside investors, creditors, or potential investors and creditors. That assumption also is fundamental to our conclusion on high-quality accounting standards. Decision-useful information is not, however, universally accepted as the purpose of external financial reporting.

At the present time, the G4+1 standard-setting bodies plus representatives of standard setters in the Nordic Federation, Japan, Germany, and France have begun work on a comprehensive financial instruments standard. Whether progress can be achieved by this group will be closely observed.

We also have given consideration to adopting standards of other standard-setting bodies for areas where current U.S. GAAP is limited, problematic, or nonexistent. A recent example of this is our consolidations project, in which the Board's consideration of the Australian standard and similar control-based standards in other countries has resulted in a focus on control, rather than ownership, as a basis for consolidation. The Board has also agreed to consider very carefully the conclusions of other standard setters in developing its conclusion about the appropriate accounting for business combinations.

We have made it a priority to maintain an international network that promotes cooperative relations and communication between the FASB and other standard-setting organizations aside from specific issues. We continue to expand our communications with other standard setters around the globe through visiting standard setters in other countries, exchanging, publications, making speeches, and attending international conferences.

Perhaps more important, we also have undertaken to create an organization-wide awareness and to ensure that the FASB processes take a global perspective. We have concentrated on increasing our staff and Board members' knowledge of international issues and their impact. Individual staff members are assigned to monitor the accounting developments in all the major countries as well as in various international organizations. The FASB has also actively pursued opportunities to hire foreign nationals directly. In addition, we have arranged exchanges of staff with the Australian standard-setting organization, had our staff assigned in the United Kingdom, and are exploring exchange opportunities with other standard setters.

In late 1996 we completed a very comprehensive comparison of U.S. GAAP and the standards of the IASC. As indicated in the introduction to the study:

> (The) report is designed to assist investors, analysts, regulators, standard setters, and others in coping with the challenge of international comparability. Specifically, the four objectives of the study were:
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> - To provide a basis for the FASB and the IASC to raise the quality of their standards while narrowing the differences between them;
> - To provide a tool for investors, financial analysts, and other users of financial statements to use in comparing U.S. firms with firms that use IASC standards;
> - To provide an information base that can be used in assessing the acceptability of IASC standards for securities listings in the United States;
> - To provide insights into the relative strengths of the IASC and FASB structures and processes for serving the ongoing information needs of U.S. capital markets.

In all of our activities we look for exposure to new insights and ideas from other national and international standard setters and from financial statement users, preparers, auditors, and educators in other countries. This affords us the opportunity to evaluate and revise our international plan to maintain its effectiveness and relevancy.

For instance, the original strategic plan was based on the premise that domestic financial reporting needs would continue to be the FASBs first priority and that other national standard setters would likewise look first to their domestic needs. We now recognize that international issues are so intertwined with domestic issues that there is no way to clearly separate the two. Foreign standards that differ from U.S. standards present analytic obstacles for U.S. investors and concerns for U.S. companies. Thus, the FASB's obligation to its domestic constituents demands that it attempt to narrow the range of difference between U.S. and foreign standards. Addressing those problems is as much a part of the FASB's domestic agenda as it is of international concern.

LOOKING FORWARD

The FASB perspective on the development of international accounting standards is, we think, based on the realities of both our domestic environment and the international standard-setting environment. The FASB's obligation to the domestic environment necessarily limits its direct contribution to international comparability. However, we realize that accounting standard-setting in the United States cannot realistically be self-centered, and domestic priorities must extend to encompass international implications.

Thus, there is a symbiotic relationship between accounting standards and capital markets. Domestic accounting standards play an important role in domestic capital markets. As capital markets become increasingly internationalized, domestic priorities may clash with international pressures. This is increasingly more apparent in the United States, where foreign companies seek to take advantage of a market where "the amount of money available ... is by far the largest pool in the world, and the number of investors, whether institutional or individual, is broader than in any other country".(4)

The FASB plans to continue with its current international contributions and recognizes that our role is evolving, as is the role of other national and international accounting organizations. I believe that the FASB has an important role to play in the international accounting environment. We have learned many lessons over the past 20 years or so, and we gain experience every day. There is no need to reinvent the wheel in the international arena. Our experience provides a vantage point, a stepping stone, from which both ourselves and others can move forward. We need not start from ground zero.

The timing could not be better; we are still at the beginning of an era. The choices we make today about how we will approach the internationalization challenge will have far-reaching implications for tomorrow. It is time to construct the fundamental building blocks for future harmony in a considered and careful manner, and not create ad hoc compromises that diminish comparability or standards that sacrifice quality.

These are the key issues we must focus on: comparability and quality. We also believe that the type of standards that will meet our objectives will by necessity be created in a very open environment with a due process available to all interested parties.

In our efforts at the FASB we are striving to help ensure that the internationalization of accounting is synonymous with the highest possible quality of financial reporting.

FOOTNOTES

(1) Expressions of individual views by members of the FASB and its staff are encouraged. The views expressed in this paper are those of Mr. Leisenring. Official positions of the FASB are determined only after extensive due process and deliberation.

(2) U.S. tax law requires that if LIFO is used for inventory measurement for tax purposes, it also must be used for financial reporting.

(3) FASB working paper for American Accounting Association - FASB Financial Reporting Issues Conference, December 1997.

(4) John A. Jensen, Jr., quoted in the *Wall Street Journal*, "Foreign Firms Raise More and More Money in the U.S. Markets," October 5, 1993, p. Al.