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2003

# Interpretation and Application of International Accounting Standards

Barry J. Epstein
Abbas Ali Mirza

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# PREFACE

*IAS: Interpretation and Application of International Accounting Standards* provides analytical explanations and copious illustrations of all current accounting principles promulgated by the IASB (and its predecessor, the IASC). The book integrates principles promulgated by the Board—international financial reporting standards (IFRS) and the earlier international accounting standards (IAS)—and by the Board's body for responding to more narrowly focused issues—the International Financial Reporting Interpretations Committee (IFRIC), which succeeded the Standing Interpretations Committee (SIC). These materials have been synthesized into a user-oriented topical format, eliminating the need for readers to first be knowledgeable about the names or numbers of the salient professional standards.

The focus of the book is the practitioner and the myriad practical problems faced in applying IAS. Accordingly, the paramount goal has been to incorporate meaningful, real-world-type examples in guiding users in the application of IAS to complex fact situations that must be dealt with in the actual practice of accounting. In addition to this emphasis, a major strength of the book is that it does explain the theory of IAS in sufficient detail to serve as a valuable adjunct to, or substitute for, accounting textbooks. Not merely a reiteration of currently promulgated IAS, it provides the user with the underlying conceptual basis for the rules, to enable the reasoning by analogy that is so necessary in dealing with a complex, fast-changing world of commercial arrangements and structures. It is based on the author's belief that proper application of IAS demands an understanding of the logical underpinnings of its technical requirements. This is perhaps more true of IAS than of various national GAAP sets of standards, since IAS is by design more "principles based" and hence less prescriptive, leaving practitioners with a proportionately greater challenge in actually applying the rules.

Each chapter of this book, or major section thereof, provides an overview discussion of the perspective and key issues associated with the topics covered; a listing of the professional pronouncements that guide practice; and a detailed discussion of the concepts and the accompanying examples. A comprehensive checklist following the main text offers practical guidance to preparing financial statements in accordance with IAS. New to the current edition is a detailed, tabular comparison between IAS and both US and UK national GAAP, keyed to the chapters of this book. Also new this year is a set of three comprehensive financial statements that illustrate application of financial reporting standards to different types of enterprises.

The authors' wish is that this book will serve practitioners, faculty, and students as a reliable reference tool, to facilitate their understanding of, and ability to apply, the complexities of the authoritative literature. Comments from readers, both as to errors and omissions and as to proposed improvements for future editions, should be addressed to Barry J. Epstein, c/o John Wiley & Sons, Inc., 155 N. 3rd Street, DeKalb, Illinois 60115, prior to May 15, 2003, for consideration for the 2004 edition.

Barry J. Epstein
Abbas Ali Mirza
November 2002

# ABOUT THE AUTHORS

**Barry J. Epstein,** PhD, CPA, has served in senior technical positions with several regional and national CPA firms over the past twenty-seven years, after earlier stints as a corporate finance officer and a college professor. He is currently a partner with Chicago-based Gleeson, Sklar, Sawyers & Cumpata, LLP, where he specializes in accounting and auditing technical consultation and corporate governance advisory and litigation consulting services. His work in the litigation field often involves accountants' malpractice defense, as well as contractual dispute resolution, and other matters in which the application of professional standards plays a significant role.

Dr. Epstein has authored or coauthored six books, including *Wiley GAAP 2003*, and professional articles, and previously wrote a regular business column for a major newspaper. He has served on numerous state and local professional and technical committees, was a member of the AICPA Board of Examiners for five years, has lectured throughout the US, as well as in several other nations, and has been regularly involved in technical training for CPA firms and for attorneys, bankers other professionals. His professional memberships include the American Institute of CPAs, Illinois CPA Society, and the American Accounting Association.

**Abbas Ali Mirza,** CPA, ACA, AICWA, has been affiliated with major international accounting firms in the US, India, and the Middle East, and is currently a partner with Deloitte & Touche, based in the United Arab Emirates, where he is responsible for major audit clients and, as a member of the firm's regional Assurance & Advisory Committee, he is also responsible for training and technical support to the firm's offices in the region. Mr. Mirza provides international accounting, auditing, finance, and taxation services to a wide range of industries and businesses.

A frequent principal speaker and a workshop leader at global conferences on international accounting standards and on US GAAP, Mr. Mirza has also authored regular columns and features for English-language publications in the Middle East and India. Mr. Mirza is a member of the Accounting Standards Committee of the Securities & Exchange Board of India (SEBI); is the Chairman of the Managing Committee of the Institute of Chartered Accountants of India, Dubai Chapter; serves on the Standards and Ethics Committee of the UAE's official Accountants' and Auditors' Association (AAA); and chairs the International Accounting Standards Steering Committee of the AAA.

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# CONTENTS

# 1 INTRODUCTION TO INTERNATIONAL ACCOUNTING STANDARDS

## NEED FOR ACCOUNTING STANDARDS

**Development of accounting and financial reporting.** Accounting was created as a means of measuring and reporting upon economic activity. Renaissance-era monk Fra Luca Pacioli is normally credited with the invention of double-entry bookkeeping, designed for use of traders operating in fourteenth and fifteenth century Italian city-states. From there, the use of double entry bookkeeping largely followed evolving trading patterns.

Thus, double entry bookkeeping has been traced to Germany and France, and then to Great Britain, where it became widely proliferated via the commercial activities in the seventeenth and eighteenth century of the British Empire. The industrialization of North America and the Commonwealth countries, partially in response to British investments in the insurance and railroad industries, led to the further spread of double entry bookkeeping. Contemporaneously, Dutch accounting followed the discoveries and settlements made in Indonesia and South Africa. Other patterns of influence can be traced from their European origins throughout the world, as from Spain to Latin American nations. Later, with its economic ascendancy, the United States became the prime developer of accounting theory and exported its favored financial reporting model around the globe.

Different practices and regulations tended to evolve to meet local needs and economic characteristics. Some of the factors affecting these variations include the degree of centralization in the economy, ranging from state control to unfettered free enterprise; the nature of economic activity, from simple agrarian societies to the most sophisticated and complex business enterprises; the stage of economic development, from emerging economies to fully matured postindustrial ones; the pattern and pace of economic growth, ranging from stagnation of the former Communist economies to the explosive growth of certain Asian economies in the 1990s; and the history of price stability or inflationary experience of the nation's economy. In addition, the nature of the nation's legal system has profoundly impacted its approach to accounting and financial reporting.

**Accounting and reporting models.** To serve the needs of (primarily) business entities reporting on their economic activities, an accounting profession developed. This gained momentum when absentee ownership and professional management became the model for larger business enterprises. Once the era of laissez faire had passed into history, virtually every nation, having every variant of economic and legal systems, imposed some type of regulation over the accounting profession. This was done either by means of direct government regulation, or indirectly via professional self-regulation (often under implied threat of direct supervision should that prove unsatisfactory).

Accounting and reporting practices, despite real variations among the nations, have nonetheless been rather remarkably consistent. This is perhaps logical, given that all these practices were intended to accomplish the very same goals. Over time, even the diversity that once existed has become much diminished, as the systems of the more dominant economic powers (particularly the US and the UK) became the preferred sets of practices for enterprises hoping to one day engage in significant activity in those nations or those (e.g., Commonwealth members) aligned with them.

Historically, the major dichotomy of accounting standards was between those that evolved in nations adhering to a common law tradition and those that had code law. Those that had codified rules of behavior tended to formally prescribe accounting and financial reporting matters as well, and most often the role of financial reporting was made subservient to the nation's system of taxation. Under such systems, actions (e.g., financial reporting) can only be taken if specifically allowed under the law. The Napoleonic Code is the prototype of code law, and indeed most of the nations that were dominated by France during that era have subscribed to this approach. Before the very recent rise of IAS, both France and Germany had highly prescriptive financial reporting systems, for example.

Nations having a common law tradition, on the other hand, have more permissive systems, generally only setting rules governing those actions (e.g., fraudulent financial reporting) that cannot be taken. Financial reporting requirements tend to not be defined in national laws of common law countries; instead, rules have developed largely through the efforts of the private sector. These are often the product of the professional societies, assisted by the work of academicians. In common law countries, the goals of financial reporting are often at variance with those of national tax policy.

By the middle of the twentieth century, there were a relative handful of distinct accounting models in broad use. Thus, Latin American nations' systems tended to rely on regular adjustments for the effect of changing prices, made necessary by those nations' problems with persistent and often virulent inflation. Nations such as the UK and US having price stability (albeit with intermittent bouts of serious inflation, particularly in the 1970s) evolved very similar sets of accounting rules. Other countries, typically from the code law tradition, had tightly circumscribed financial reporting practices oriented to the twin goals of protecting the interests of creditors and ensuring the effectiveness of taxation.

More recently, international accounting standards (established by the International Accounting Standards Board, formerly the International Accounting Standards Committee) have been gaining many adherents. In the past few years, certain watershed events, such as the European Union's decision to mandate the use of international accounting standards (which will be referred to hereinafter as IAS) by 2005, have greatly enhanced the stature of this set of accounting standards and improved the likelihood of its becoming the global norm.

**Setting accounting standards.** The accounting standard-setting process has proceeded somewhat differently in the major nations of the developed world. In the United States and the United Kingdom—having experienced similar traditions of common law, capitalism, highly educated and professional workforces, large and sophisticated companies that raise equity capital in the public markets, and a belief in the responsibility of managements to report on their stewardship to the owners of the respective businesses—independent accounting professions have largely controlled the setting of accounting standards. In both nations, the principle of full disclosure has been of central importance: financial statements are expected to be transparent, so that users, generally assumed to be investors and creditors, are able to understand fully the nature of the reporting enterprise's operations and finances. Tax reporting is a distinct and separate matter, which does not drive financial reporting.

In the US, reporting by publicly held enterprises has been subject to oversight by the Securities and Exchange Commission, which has the statutory right to set accounting principles, which it has virtually never exercised. In the UK, there is no equivalent to the US SEC, but the autonomous Financial Reporting Review Panel (FRRP) does examine financial statements in order to determine whether there has been a failure to provide a "true and fair view" as a result of a departure from an accounting standard, and has the authority to seek revisions, by court order if necessary, when failures are found to exist.

Despite the vast similarities, there are notable differences between the UK and US accounting systems. For example, there are many legal and institutional regulations that apply only to public companies in the UK, while in the United States the only accounting rules that are limited to public companies under current generally accepted accounting principles (GAAP) are those related to segment reporting and earnings per share disclosures.

In contrast to the United States and the United Kingdom, the nations of Europe and Japan, which also have capitalist economic systems, historically have relied far less on public equity markets and much more on bank financing—a distinction that is now fading as the move to global equity markets has gained momentum. When creditors held sway over corporate accounting, practices such as the use of "hidden reserves" that protected their interests at the possible expense of shareholders' interests were common. The acceptance of IAS in Japan and most recently in the EC effectively means that this bias will no longer be tolerated.

Even under the former regimes, financial reporting in the code law nations was similar to that in the common law ones. Thus, for example, basic underlying concepts such as accrual basis accounting and the going concern assumption were fundamental to both systems. However, in some important areas, there were substantial distinctions; for example, companies in France and Germany rarely displayed deferred income tax liabilities even though the concept was accepted, since most tax deductions were conditioned on the item being expensed currently for financial reporting purposes. Also, consistent with the conservative reporting bias of those reporting models, reserves were required to be set aside (e.g., as a set percentage of annual earnings, sometimes subject to a cap), which were not based on actual, estimated obligations of any sort—a practice that was long clearly banned under UK and US GAAP.

In the late 1990s there was a short-lived reaction in Europe against the growing dominance of UK, US, and IAS financial reporting standards. A plan was proposed to sponsor the development of a set of continental European or EU accounting standards, which presumably would have retained the creditor-oriented bias that previously had served to make European financial reporting more conservative than in Anglophone nations. However, this idea was quickly dropped, and the EU has now endorsed IAS, with a mandate that it be fully implemented by listed companies in preparing consolidated financial statements by January 1, 2005.

Arguably, these recent developments leave the real competition for the role of de facto world accounting standards between US GAAP and the IAS. While the US standard setter has certainly not conceded the fight, there have been important signs that momentum has shifted to the IAS.

US GAAP contains by far the largest number of specific rules, currently comprising several still-effective Accounting Research Bulletins, 31 APB Opinions, 146 FASB Statements, and scores of Interpretations and Technical Bulletins, and Statements of Position and Accounting Guides issued by the AICPA, as well as other relevant professional literature.

Many of these were prescribed in reaction to attempts to evade the spirit of earlier standards—for example, the basic standard on lease accounting was supplemented by dozens of interpretations, amendments and lesser forms of guidance, as companies sought to avoid capitalization of obligations under finance leases. In many cases, efforts to block evasive maneuvers were frustrated, as the ever more specific rules suggested new opportunities to create further evasions. Over the decades, US GAAP has become largely "rules based," whereas it was once far more "principles based."

The International Accounting Standards Committee (the IASC), originally, and now its successor, the International Accounting Standards Board (the IASB), has made clear the intention to not duplicate this body of guidance, and to adhere to a philosophy of providing general guidance rather than detailed standards addressing every nuance of business practice. While this is undoubtedly sincerely based on a belief in such an approach, it is also true that (until the restructuring that created the IASB) the IASC lacked the financial resources to create a US GAAP-like set of detailed standards.

The distinction between these two philosophies may have become exaggerated in popular perception, in any event. Thus, in the aftermath of recent accounting debacles at companies such as Enron and WorldCom, claims were made that these scandals would not have occurred had IAS-type "principles-based" standards been in place. However, the malefactors in those cases had violated, not complied with, US GAAP, and thus it is not clear at all that violations would not have occurred equally under an IAS reporting regime. In fact, audit failure and management fraud were probably more important explanations than were choice of accounting standards. In any event, IAS have probably not yet been put to a similar test, so it is far from certain that Enronesque accounting catastrophes would not occur under that reporting system.

Notwithstanding the mixed evidence, the recently enacted Sarbanes-Oxley Act of 2002, which was rushed through Congress in reaction to these outrages, requires the US SEC "to conduct a study on the adoption by the United States financial reporting system of a principles-based accounting system." While the ultimate outcome is unknown at this early date, it would be very surprising indeed if US GAAP as currently codified were to be stripped of its detailed guidance to a significant degree. More likely, perhaps, would be for new standards, as they developed, to veer somewhat more toward the "principles-based" end of the spectrum than has been the case over most of the FASB's thirty-year history.

### Need for International Accounting Standards

Although historically differing national traditions and circumstances such as price instability contributed to the development of varying sets of financial reporting standards, with the greatly magnified emphasis on international commerce and capital flows over the past thirty years, the need for global accounting standards has been increasingly recognized.

Multinational companies (MNC) have grown dramatically in both size and importance over this period, assuming dominant roles in many market segments and affecting almost every country, every government, and every person. From a financial reporting perspective, the complexity of conducting international business operations across national borders, each with a different set of business regulations and often different accounting methods, presents a daunting challenge for both individual accountants and for the professional bodies that establish accounting and auditing standards. A diversity of applicable accounting, auditing, and tax standards and regulations may negatively impact such enterprises' abilities to prepare reliable financial information necessary for both reporting to their stakeholders and for the careful analysis of investment opportunities vital to their further growth. As the number of countries of activity increases, so too do the potential complications.

As noted above, over recent years the disparities of accounting practices among nations have declined markedly. The European adoption of IAS beginning in 2005 will eliminate a large fraction of remaining variations, essentially leaving US GAAP, UK GAAP, and IAS as the "big three" comprehensive sets of standards—with UK-IAS convergence likely to occur as well. The hope is to eliminate the final set of disparities, between US GAAP and IAS, over the next ten years or so, and both standard setters are seriously committed to such convergence.

One very large impediment has been the US SEC's refusal to recognize the validity of IAS as a basis for filing registration statements and periodic reports under US securities laws, other than when accompanied by a reconciliation to US GAAP for major captions in the income statement and balance sheet. The SEC solicited comments on a possible rule relaxation, but has not indicated the nature of responses received or its inclination to actually move forward with changes to filing requirements. Conditional acceptance of IAS by the international body of national securities regulatory authorities was a positive development but did leave open the possibility that continued reconciliations could still be required, which would prevent the rapid move toward IAS as an "Esperanto" for worldwide financial reporting. These developments are discussed further below.

**The International Accounting Standards Committee (predecessor of the current International Accounting Standards Board)**

The International Accounting Standards Committee was founded in 1973 by representatives of professional bodies in Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom, Ireland, and the United States, and grew to include representatives from ninety-one countries. From 1983 until December 2000, the IASC's members had included all the professional accountancy bodies that are members of the International Federation of Accountants (IFAC); as of January 2000, these comprised 143 member bodies in 104 countries, representing over two million accountants.

From its formation, the IASC engaged in a standard-setting program that has now gained worldwide recognition. Prior to the transition to the new IASB (discussed below), the IASC had issued forty-one international accounting standards (IAS), of which, after a series of revisions, thirty-four remain in force. Also issued to date have been a number of Exposure Drafts (at least one of which preceded the final issuance of each standard). A number of Interpretations of these standards have also been issued by the former Standing Interpretations Committee (SIC). A listing of standards and SIC issued to date that remain currently operative appears in Appendix A to this chapter.

A conceptual release on the *Framework for the Preparation and Presentation of Financial Statements* (the *Framework*), which was issued in 1989, was intended to be the IASC's conceptual foundation upon which later accounting standards would be built, and it has largely served this purpose. This document identifies the expected beneficiaries of financial reporting, the objective of the reporting process, the key underlying assumptions (going concern and accrual basis), the qualitative characteristics of financial statements (the primary ones being understandability, relevance, reliability, and comparability; there are a number of secondary ones as well), and the elements of the financial statements (assets, liabilities, equity, income, and expenses). It also sets forth the twin criteria for recognition of an item in the financial statements (the probability that the economic benefits associated with it will flow to or from the entity, and the reliability of measurement of the item).

**Objectives of standard setting under the Constitution of the IASC Foundation.** The objectives of IASC as set forth in its original constitution (approved in 1992) were twofold. The first was to formulate and publish, in the public interest, accounting standards to be observed in the presentation of financial statements and to promote their worldwide acceptance and observance and the second was to work generally for the improvement and **harmonization** of regulations, accounting standards, and procedures relating to the presentation of financial statements. The new Constitution of the International Accounting Standards Committee Foundation (IASC Foundation), that was approved by the members of IASC in May 2000 and was revised by the trustees of the IASC Foundation in March and July 2002, has expanded the objectives of the IASC Foundation, as set forth below.

1. To develop in the public interest a single set of high-quality, understandable, and enforceable global accounting standards that require high-quality, transparent, and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions;
2. To promote the use and rigorous application of those standards; and
3. To bring about **convergence** of national accounting standards and International Accounting Standards to high-quality solutions.

It is significant that the emphasis has now shifted from mere "harmonization" to the actual "convergence" of the various national accounting standards and the International Accounting Standards (which are prospectively to be called International Financial Reporting Standards [IFRS]).

The significant achievements of the former IASC and the new IASB are explained in detail later in this chapter.

**The international "due process."** In May 2002, the IASB issued the *Preface to International Financial Reporting* (the *Preface*). This addresses, in addition to a number of other matters, the steps set out in the "due process" of the IASB and the International Financial Reporting Interpretations Committee (IFRIC). These are summarized below.

**IASB's due process.** International Financial Reporting Standards (IFRS) are to be developed through an international system of due process involving many interested parties around the globe, including accountants, financial analysts and other users of financial statements, regulators, stock exchanges, academics, and the business community at large. A Standards Advisory Board (SAC) advises the IASB about the projects it should add to its agenda. The standard-setting "due process" generally encompasses the following steps:

- The IASB staff identify and review all issues related to the topic under consideration, and examine the application of the IASB's *Framework* to the issues.
- The requirements of national accounting standards on the topic (including practices within various jurisdictions) are examined, and views are exchanged about related issues with national standard setters.
- The SAC is consulted on the advisability of including the topic in the IASB's agenda.
- An advisory group is formed to advise the IASB on the project.
- A discussion document is published for public comment.

- An Exposure Draft (ED), approved by at least eight votes of the IASB members and incorporating dissenting opinions and a basis for conclusions, is published for public comment.
- All comments received on discussion documents and ED are considered.
- The holding of public hearings and the conducting of field tests are considered and, if deemed desirable, are held and conducted.
- The Standard is voted upon; if the approval of at least eight board members is obtained, it is published—incorporating dissenting opinions and a basis for conclusion, explaining, among other things, how the IASB dealt with public comments on the ED.

The IASB deliberates in meetings that are open to public observation.

**International Financial Reporting Interpretations Committee's (IFRIC) due process.** The former Standard Interpretations Committee (SIC) was reconstituted in December 2001 as the IFRIC. This required that the IASC Foundation's constitution be revised, which it was by the IASC Foundation trustees following public consultation in March 2002.

Interpretations of IFRS will be developed by the IFRIC for approval by the IASB. The due process for interpretations of IFRS would normally include the following steps:

- The IASB staff identify and review all issues related to the Interpretation and examine existing national standards and practices.
- IFRIC studies national standards and practices.
- A draft Interpretation is published for comment if no more than three IFRIC members have voted against the proposal.
- The normal comment period is sixty days, but for urgent issues the trustees have agreed to shorten it to thirty days.
- Comments received on the draft Interpretation are considered by IFRIC within a reasonable period of time.
- If no more than three IFRIC members have voted against the proposal, IFRIC approves the final Interpretation and submits it to the IASB for approval.
- The final Interpretation is voted upon and is considered approved if at least eight Board members vote affirmatively.

IFRIC deliberates in meetings open to public observation.

### Historical Stages of Development in the International Accounting Standard-Setting Process (prior to the formation of the IASB)

Reviewing the history of the IASC, from its inception until the date of its transformation to the new IASB (addressed separately later in this chapter), it is possible to identify three stages through which it passed, each of which was characterized by rather different foci and objectives. These phases were, respectively, the early years during which it attempted to demonstrate attention to all the major accounting issues; the middle period of consolidation when allowable alternative treatments were reduced as part of the effort to improve comparability; and the final era when a core set of standards necessary to obtain the support of the international capital markets was completed. The important achievements of each of these eras are summarized in the following paragraphs.

**First phase.** In its earliest years, the IASC attempted to establish a common body of standards on major accounting topics, such as for inventory, for leases, and for long-lived assets. This consisted largely of inventorying and then endorsing virtually all the main-