Includes summary of key provisions of U.S. GAAP vs. IFRS

WILEY

IFRS 2006

Interpretation and Application of International Financial Reporting Standards

Barry J. Epstein

with contributions by Abbas Ali Mirza

WILEY

IFRS 2006

Interpretation and Application of International Accounting and Financial Reporting Standards

Barry J. Epstein
Abbas Ali Mirza

WILEY
JOHN WILEY & SONS, INC.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey
Published simultaneously in Canada.

For general information on our other products and services, please contact our Customer Care Department within the US at 800-762-2974, outside the US at 317-572-3993 or fax 317-572-4002.

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic books. For more information about Wiley products, visit our Web site at www.wiley.com.

ISBN 13: 978-0471-72688-3
ISBN 0-471-72688-5

Printed in the United States of America
10 9 8 7 6 5 4 3 2 1

PREFACE

IFRS: Interpretation and Application of International Financial Reporting 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 IFRS. Accordingly, the paramount goal has been to incorporate meaningful, real-world-type examples in guiding users in the application of IFRS 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 IFRS in sufficient detail to serve as a valuable adjunct to, or substitute for, accounting textbooks. Not merely a reiteration of currently promulgated IFRS, 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 authors' belief that proper application of IFRS demands an understanding of the logical underpinnings of its technical requirements. This is perhaps more true of IFRS than of various national GAAP sets of standards, since IFRS 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 accompanying examples. A comprehensive checklist following the main text offers practical guidance to preparing financial statements in accordance with IFRS. Also included is a revised, detailed, tabular comparison between IFRS and US national GAAP, keyed to the chapters of this book. Also included is a set of three comprehensive financial statements that illustrate application of financial reporting standards to different types of enterprises. A feature added to the 2004 edition—copious examples of actual informative disclosures made by companies reporting under IFRS—has been expanded and are included in the relevant chapters of this book.

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, Suite 502, DeKalb, Illinois 60115, prior to May 15, 2006, for consideration for the 2007 edition.

Barry J. Epstein
Abbas Ali Mirza
November 2005

ABOUT THE AUTHORS

Barry J. Epstein, PhD, CPA, a partner in the firm Russell Novak & Company, has almost forty years' experience in the public accounting profession, as auditor, technical director/ partner for several national and local firms, and as a consulting and testifying accounting and auditing expert on over seventy litigation matters to date. His current practice is concentrated on providing technical consultations to CPA firms and corporations on US GAAP and IFRS accounting and financial reporting matters; on US and international auditing standards; matters involving financial analysis; forensic accounting investigations; and on corporate governance matters. He regularly serves as an expert on litigation matters, including assignments for both the private sector and governmental agencies.

Dr. Epstein is a widely published authority on accounting and auditing. His current publications include *Wiley GAAP*, now in its 2nd edition, for which he is the lead coauthor. He has also appeared on over a dozen national radio and television programs discussing the crisis in corporate financial reporting and corporate governance, and has presented over a hundred educational programs to professional and corporate groups in the US and internationally. He previously chaired the Audit Committee of the AICPA's Board of Examiners, responsible for the Uniform CPA Examination, and has served on other professional panels at state and national levels.

Dr Epstein holds degrees from DePaul University (Chicago—BSC, accounting and finance, 1967) University of Chicago (MBA, economics and industrial relations, 1969), and University of Pittsburgh (PhD, information systems and finance, 1979).

Dr. Epstein wishes to acknowledge the contributions of coauthor Abbas Ali Mirza, particularly in the original conception of this book in 1996.

Abbas Ali Mirza, CPA, ACA, AICWA, has brought his expertise in auditing, finance, and taxation to a variety of positions with major international firms in the US, India, and the Middle East. He is currently a partner with Deloitte & Touche, based in the United Arab Emirates, where he is responsible for audit clients and is a member of the firm's regional Assurance and Advisory Committee, responsible for technical and learning support throughout the region. He is a frequent speaker and workshop leader at global conferences on international financial reporting, has coauthored regular newspaper columns and written features for the media in the Middle East and India, and has been widely quoted as a commentator on business issues.

Mr. Mirza is also a member of the Accounting Standards Committee of the Securities & Exchange Board of India, and is involved in professional and regulatory affairs in India and Dubai, UAE. He has spoken at several United Nations conferences on financial reporting and corporate governance matters, and is associated with a number of other professional initiatives germane to worldwide adoption of IFRS.

CONTENTS

1 INTRODUCTION TO INTERNATIONAL FINANCIAL REPORTING STANDARDS

The year 2005 marked the start of a new era in global business, and the fulfillment of a thirty-year effort to create the financial reporting rules for a worldwide capital market. For during that year's financial reporting cycle, as many as 7,000 listed companies in the 25 European Union member states, plus many others in countries such as Russia, Australia, South Africa and New Zealand, were expected (in the EU, required) to produce annual financial statements in compliance with a single set of international rules—International Financial Reporting Standards (IFRS). Many others, while not publicly held and not currently required to comply with IFRS, will do so either immediately or over time, in order to conform to what is clearly becoming the new worldwide standard. Since there are about 15,000 SEC-registered companies in the USA that use US GAAP (plus countless nonpublicly held companies reporting under GAAP), the vast majority of the world's large businesses will now be reporting under one or the other of these two comprehensive systems of accounting and financial reporting rules.

Encouraging this process, the standard setters have agreed to try to converge their measurement and recognition rules, so that differences between these two sets of requirements are already disappearing. In fact, the chairman of the US standard setter has suggested that by 2010 there would be no major differences left, and the SEC has speculated that the remaining differences might become so trivial that the currently required reconciliations required in Form 20-F filings by foreign registrants might be dispensed with entirely well before the end of the decade. However, there are undoubtedly many obstacles left to overcome, particularly as national securities regulators learn to live with the idea of using rules developed outside their jurisdiction by an autonomous panel of experts.

Origins and Early History of the IASB

Financial reporting in the developed world evolved from two broad models, whose objectives were somewhat different. The earliest systematized form of accounting regulation developed in continental Europe, starting in France in 1673. Here a requirement for an annual fair value balance sheet was introduced by the government as a means of protecting the economy from bankruptcies. This form of accounting at the initiative of the state to control economic actors was copied by other states and later incorporated in the 1807 Napoleonic Commercial Code. This method of regulating the economy expanded rapidly throughout continental Europe, partly through Napoleon's efforts and partly through a willingness on the part of European regulators to borrow ideas from each other. This "code law" family of reporting practices was much developed by Germany after its 1870 unification, with the emphasis moving away from market values to historical cost and systematic depreciation. It was used later by governments as the basis of tax assessment when taxes on profits started to be introduced, mostly in the early twentieth century.

This model of accounting serves primarily as a means of moderating relationships between the individual company and the state. It serves for tax assessment, and to limit dividend payments, and it is also a means of protecting the running of the economy by sanctioning individual businesses that are not financially sound or were run imprudently. While the model has been adapted for stock market reporting and group (consolidated) structures, this is not its main focus.

The other model did not appear until the nineteenth century and arose as a consequence of the industrial revolution. Industrialization created the need for large concentrations of capital to undertake industrial projects (initially, canals and railways) and to spread risks between many investors. In this model the financial report provided a means of monitoring the activities of large businesses in order to inform their (nonmanagement) shareholders. Financial reporting for capital markets purposes developed initially in the UK, in a common-law environment where the state legislated as little as possible and left a large degree of interpretation to practice and for the sanction of the courts. This approach was rapidly adopted by the US as it, too, became industrialized. As the US developed the idea of groups of companies controlled from a single head office (towards the end of the nineteenth century), this philosophy of financial reporting started to become focused on consolidated accounts and the group, rather than the individual company. For different reasons neither the UK nor the US governments saw this reporting framework as appropriate for income tax purposes, and in this tradition, while the financial reports inform the assessment process, taxation retains a separate stream of law, which has had little influence on financial reporting.

The second model of financial reporting, generally regarded as the Anglo-Saxon financial reporting approach, can be characterized as focusing on the relationship between the business and the investor, and on the flow of information to the capital markets. Government still uses reporting as a means of regulating economic activity (e.g., the SEC's mission is to protect the investor and ensure that the securities markets run efficiently), but the financial report is aimed at the investor, not the government.

Neither of the two above-described approaches to financial reporting is particularly useful in an agricultural economy, or to one that consists entirely of microbusinesses, in the opinion of many observers. Nonetheless, as countries have developed economically (or as they were colonized) they have adopted variants of one or the other of these two models.

IFRS are an example of the second, capital market-oriented, systems of financial reporting rules. The original international standard setter, the International Accounting Standards Committee (IASC), was formed in 1973, during a period of considerable change in accounting regulation. In the US the Financial Accounting Standards Board (FASB) had just been created, in the UK the first national standard setter had recently been organized, the EU was working on the main plank of its own accounting harmonization plan (the Fourth Directive), and both the UN and the OECD were shortly to create their own accounting committees. The IASC was launched in the wake of the 1972 World Accounting Congress (a five-yearly get-together of the international profession) after an informal meeting between representatives of the British profession (Institute of Chartered Accountants in England and Wales—ICAEW) and the American profession (American Institute of Certified Public Accountants—AICPA).

A rapid set of negotiations resulted in the professional bodies of Canada, Australia, Mexico, Japan, France, Germany, the Netherlands, and New Zealand being invited to join with the US and UK to form the international body. Due to pressure (coupled with a financial subsidy) from the UK, the IASC was established in London, where its successor, the IASB, remains today.

The actual reasons for the IASC's creation are unclear. A need for a common language of business was felt, to deal with a growing volume of international business, but other, more political motives abounded also. For example, some believe that the major motivation was that the British wanted to create an international standard setter to trump the regional initiatives within the EU, which leaned heavily to the Code model of reporting, in contrast to what was the norm in the UK and almost all English-speaking nations.

In the first phase of its existence, the IASC had mixed fortunes. Once the International Federation of Accountants (IFAC) was formed in 1977 (at the next World Congress of Accountants), the IASC had to fight off attempts to become a part of IFAC. It managed to resist, coming to a compromise where IASC remained independent but all IFAC members were automatically members of IASC, and IFAC was able to nominate the membership of the standard-setting Board.

Both the UN and OECD were active in international rule making in the 1970s but the IASC successfully persuaded them that they should leave recognition and measurement rules to the IASC. However, having established itself as the unique international rule maker, IASC had great difficulty in persuading anyone to use its rules. Although member professional bodies were theoretically committed to pushing for the use of IFRS at the national level, in practice few national bodies were influential in standard setting in their respective countries, and others (including the US and UK) preferred their national standards to whatever IASC might propose. In Europe, IFRS were used by some reporting entities in Italy and Switzerland, and national standard setters in some countries such as Malaysia began to use IFRS as an input to their national rules, while not necessarily adopting them as written by the IASC or giving explicit recognition to the fact that IFRS were being adopted in part as national GAAP.

IASC entered a new phase in 1987, which led directly to its 2001 reorganization, when the then-Secretary General, David Cairns, encouraged by the US SEC, negotiated an agreement with the International Organization of Securities Commissions (IOSCO). IOSCO was looking for a common international "passport" with which companies could be accepted for a secondary listing in the jurisdiction of any IOSCO member. The concept was that, whatever the listing rules in a company's primary stock exc hange, there would be a common minimum package which all stock exchanges would accept from foreign companies seeking a secondary listing. IOSCO was prepared to use IFRS as the financial reporting basis for this passport, provided that the international standards could be brought up to the level IOSCO stipulated. For the first time, the IASC would have a clear client and a clear role for its standards.

Historically, a major criticism of IFRS was that it essentially endorsed all accounting methods then in wide usage, effectively becoming a "lowest common denominator" set of standards. The trend in national GAAP was to narrow the range of acceptable alternatives, although uniformity was not anticipated in the near term. The IOSCO agreement provoked frenetic activity to improve the existing standards by removing the many alternative treatments which were permitted under the standards. The IASC launched its comparability and improvements project to develop a "core set of standards" as demanded by IOSCO. These were complete by 1993, not without disagreements between members, but—to the great frustration of the IASC—were then not accepted by IOSCO. IASC leaders were unhappy, amongst other things, that IOSCO seemingly wanted to cherry-pick individual standards, rather than endorse the IASC's process and thus all the standards created thereby.

Ultimately, the collaboration was relaunched in 1995, with IASC under new leadership, and this began a further frenetic period where existing standards were again reviewed and revised, and new standards were created to fill perceived gaps. This time the set of standards included, amongst others, IAS 39, on recognition and measurement of financial instruments, which had been accepted, at the very last moment and with great difficulty, as a compromise, purportedly interim standard.

At the same time, the IASC had established a committee to contemplate its future structure. In part, this was the result of pressure exerted by the US SEC and the US private sector standard setter, the FASB, which were seemingly concerned that IFRS were not being developed by "due process." While there may have been other agendas by some of the parties (the FASB, for example, was opposed to IFRS at the time and hoped that US GAAP would instead be accepted by other nations), in fact the IFRS were in need of strengthening, particularly as to reducing the range of diverse but accepted alternatives for similar transactions and events.

If IASC was to be the standard setter endorsed by the world's stock exchange regulators, it would need a structure that reflected that level of responsibility. The historical Anglo-Saxon standard-setting model—where professional accountants set the rules for themselves—had largely been abandoned in the twenty-five years since the IASC was formed, and standards were mostly being set by dedicated and independent national boards such as the FASB, and not by profession-dominated bodies like the AICPA. The choice, as restructuring became inevitable, was between a large, representative approach—much like the existing IASC structure, but where national standard setters sent representatives—or a small, professional body of experienced standard setters which worked independently.

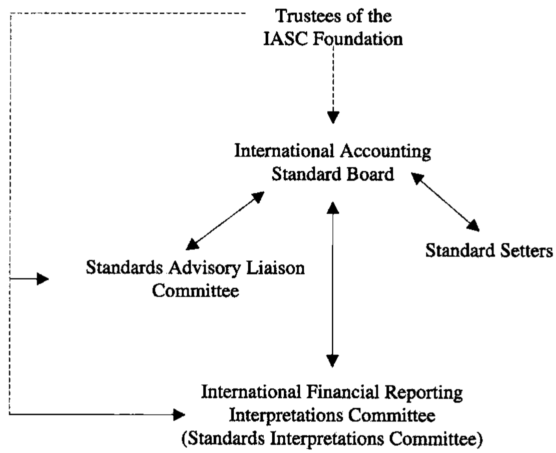
The end of this phase of the international standard setting, and the resolution of these issues, came about within a short period in 2000. In May, IOSCO members voted at their annual meeting to endorse IASC standards, albeit subject to a number of reservations (see discussion later in this chapter). This was a considerable step forward for the IASC, which was quickly surpassed by an announcement in June 2000 that the European Commission intended to adopt IFRS as the requirement for primary listings in all member states. This planned full endorsement by the EU eclipsed the less than enthusiastic IOSCO announcement, and since then the EU has appeared to be the more influential body as far as gaining acceptance for IFRS is concerned.

In July 2000, IASC members voted to abandon the old structure based on professional bodies and adopt a new structure: beginning in 2001, standards would be set by a professional board, financed by voluntary contributions raised by a new oversight body.

The New Structure

The formal structure put in place in 2000 has the IASC Foundation, a Delaware corporation, as its keystone. The Trustees of the IASC Foundation have both the responsibility to raise the $15 million a year needed to finance standard setting, and the responsibility of appointing members to the International Accounting Standards Board (IASB), the

International Financial Reporting Interpretations Committee (IFRIC) and the Standards Advisory Council (SAC).



The Standards Advisory Council (SAC) meets with the IASB three times a year, generally for two days. The SAC consists of about 50 members, nominated in their personal (not organizational) capacity, but are usually supported by organizations that have an interest in international reporting. Members currently include analysts, corporate executives, auditors, standard setters, and stock exchange regulators. The members are supposed to serve as a channel for communication between the IASB and its wider group of constituents, to suggest topics for the IASB's agenda, and to discuss IASB proposals.

The International Financial Reporting Interpretations Committee (IFRIC) is a committee comprised mostly of technical partners in audit firms but also includes preparers and users. It succeeds the Standards Interpretations Committee (SIC), which had been created by the IASC. SIC/IFRIC's function is to answer technical queries from constituents about how to interpret IFRS—in effect, filling in the cracks between different rules. In recent times it has also proposed modifications to standards to the IASB, in response to perceived operational difficulties or need to improve consistency. IFRIC liaises with the US Emerging Issues Task Force and similar bodies liaison as standard setters, to try at preserve convergence at the level of interpretation. It is also establishing relations with stock exchange regulators, who may be involved in making decisions about the acceptability of accounting practices, which will have the effect of interpreting IFRS.

The liaison standard setters are national bodies from Australia, Canada, France, Germany, UK, USA, and Japan. Each of these bodies has a special relationship with a Board member, who normally maintains an office with the national standard setter and is responsible for liaison between the international body and the national body. This, together with the SAC, was the solution arrived at by the old IASC in an attempt to preserve some geographical representativeness. However, this has been somewhat overtaken by events: as far as the EU is concerned, its interaction with the IASB is through EFRAG (see below), which has no formal liaison member of the Board. The IASB Deputy Chairman has performed this function, but while France, Germany and the UK individually have liaison, EFRAG and the European Commission are, so far, outside this structure.

Furthermore, there are many national standard setters, particularly from developing countries, that have no seat on the SAC, and therefore have no direct link with the IASB, despite the fact that many of them seek to reflect IASB standards in their national standards.

At the October 2002 World Congress in Hong Kong, the IASB held an open meeting for national standard setters, which was met with enthusiasm. As a result, IASB began to provide time concurrent with formal liaison standard setters' meetings for any other interested standard setters to attend. While this practice is not enshrined in either the Constitution or the IASB's operating procedures, both are under review at the moment and changes may be in place for 2005.

Process of IFRS Standard Setting

The IASB has a formal due process which is set out in the *Preface to IFRS*, revised in 2001. As a minimum, a proposed standard should be exposed for comment, and these comments should be reviewed before issuance of a final standard, with debates open to the public. However, this formal process is rounded out in practice, with wider consultation taking place on an informal basis.

The IASB's agenda is determined in various ways. Suggestions are made by the Trustees, the SAC, liaison standard setters, the international audit firms and others. These are debated by the Board and tentative conclusions are discussed with the various consultative bodies. The IASB also has a joint agenda committee with the FASB. Long-range projects are first put on the research agenda, which means that preliminary work is being done on collecting information about the problem and potential solutions. Projects can also arrive on the current agenda outside that route.

The agenda has been dominated in the years since 2001 by the need to round out the legacy standards, so that there would be a full range of standards for European companies moving to IFRS in 2005, as well as to carry out urgent modifications in the name of convergence (acquisition accounting and goodwill) and improvements to existing standards. These needs have largely been met as of mid-2004.

Once a project reaches the current agenda, the formal process is that the staff (a group of about 20 technical staff permanently employed by the IASB) drafts papers which are then discussed by the Board in open meetings. Following that debate, the staff rewrites the paper, or writes a new paper which is debated at a subsequent meeting. In theory there is an internal process where the staff proposes solutions, and the Board either accepts or rejects them. In practice the process is more involved: sometimes (especially for projects like financial instruments) specific Board members are allocated a special responsibility for the project, and they discuss the problems regularly with the relevant staff, helping to build the papers that come to the Board. Equally, Board members may write or speak directly to the staff outside of the formal meeting process to indicate concerns about one thing or another.

The process usually involves: (1) discussion of a paper outlining the principal issues; (2) preparation of an Exposure Draft that incorporates the tentative decisions taken by the Board—during which process many of these are redebated, sometimes several times; (3) publication of the Exposure Draft; (4) analysis of comments received on the Exposure Draft; (5) debate and issue of the final standard, accompanied by application guidance and a document setting out the *Basis for Conclusions* (the reasons why the Board rejected some solutions and preferred others). Final ballots on the Exposure Draft and the final standard are carried out in secret, but otherwise the process is quite open, with outsiders able to consult project summaries on the IASB Web site and attend Board meetings if they wish. Of course, the informal exchanges between staff and Board on a day-to-day basis are not visible to the public, nor are the meetings where the Board takes strategic and administrative decisions.

The basic due process can be modified in different circumstances. If the project is controversial or particularly difficult, the Board may issue a discussion paper before proceeding to Exposure Draft stage. It reissued a discussion paper on stock options before proceeding to

IFRS 2, *Share-Based Payment.* It is also doing this with its reporting performance project and its project on standards for small and medium-sized enterprises. Such a discussion paper may just set out what the staff considers to be the issues, or it may do that as well as indicate the Board's preliminary views.

The Board may also hold some form of public consultation during the process. When revising IAS 39, *Financial Instruments: Recognition and Measurement* in 2003, it held round table discussions. Respondents to the Exposure Draft were invited to participate in small groups with Board members where they could put forward their views and engage in debate.

Apart from these formal consultative processes, the Board also carries out field trials of some standards (as it recently did on performance reporting and insurance), where volunteer preparers apply proposed new standards. The international audit firms receive Board papers as a result of their membership on IFRIC and are also invited to comment informally at various stages of standard development.

Constraints

The debate within the Board demonstrates the existence of certain pervasive constraints that will influence the decisions taken by the Board. A prime concern is *convergence.* In October 2002 the IASB signed an agreement with the FASB (the Norwalk Agreement) stating that the two boards would seek to remove differences and converge on high-quality standards. This agreement set in motion short-term adjustments and both standard setters have since issued Exposure Drafts changing their rules to converge with the other on certain issues. It also involves long-term development of joint projects (business combinations, performance reporting, revenue recognition, etc.).

This desire for convergence is driven by the perception that international investment is made more risky by the use of multiple reporting frameworks, and that the global market needs a single global reporting base—but also specifically by the knowledge that European companies wish to be listed in the US, and have to provide reconciliations of their equity and earnings to US GAAP when they do this (foreign companies registered with the SEC have to prepare the annual filing on Form 20-F which, if the entity does not prepare reports under US GAAP, requires a reconciliation between the entity's IFRS or national GAAP and US GAAP for earnings and equity. This reconciliation is costly to prepare and leads to companies publishing in effect two different operating results for the year, which is not always understood or appreciated by the market). If IFRS were substantially the same as US GAAP, the Form 20-F reconciliations hopefully would fade away (and the SEC has confirmed this is the likely outcome), so for European companies, convergence with US GAAP is an important issue.

A major concern for financial reporting is that of *consistency*, but this is a complex matter, since the Board has something of a hierarchy of consistency. As a paramount consideration, the Board would want a new standard to be consistent with its *Conceptual Framework* (discussed below). Thereafter, there may be a conflict between being consistent with US GAAP and being consistent with existing IAS/IFRS. However, there is little or no desire to maintain consistency with standards marked for extinction or major revision. For example, IASB believes that a number of extant standards are inconsistent with the *Framework* and need to be changed (e.g., IAS 20 on government grants), or are ineffective or obsolete (e.g., IAS 17 on leases), so there is little purpose in seeking to make a new standard consistent with them. Equally, since it aims to converge with US GAAP, it seems illogical to adopt a solution that is inconsistent with US GAAP, which will then have to be reconsidered as part of the convergence program.

Those members of the Board who have worked in North America are concerned that standards avoid creating abuse opportunities. Experience has sadly shown that there often will be attempts by preparers to engineer around accounting standards in order to be able to achieve the earnings or balance sheet amounts desired. This concern is sometimes manifested as a desire to avoid allowing exceptions. There is a justifiable perception that many standards become very complicated because they contain many exceptions to a simple basic rule.

IASB also manifests some concerns about the practicality of the solutions it mandates. While preparers might think that it is not sympathetic enough in this regard, it actually has limited the extent to which it requires restatements of previous years' reported results when the rules change, particularly in IFRS 1, *First-Time Adoption*. The *Framework* does include a cost/benefit constraint—that the costs of the financial reporting should not be greater than the benefits to be gained from the information—which is often mentioned in debate, although IASB considers that preparers are not the best ones to measure the benefits of disclosure.

There is also a procedural constraint that the Board has to manage, which is the relationship between the Exposure Draft and the final standard. IASB's due process requires that there should be nothing introduced in the final standard that was not exposed at the Exposure Draft stage, otherwise there would have to be reexposure of the material. This means that where there are several solutions possible, or a line can be drawn in several places, IASB may tend towards the most extreme position in the Exposure Draft, so as not to narrow its choices when redebating in the light of constituents' comments.

Conceptual Framework for Financial Reporting

The IASB inherited the IASC's *Framework for the Preparation and Presentation of Financial Statements* (the *Framework*). Like the other current conceptual frameworks among Anglo-Saxon standard setters, this derives from the US conceptual framework, or at least those parts of it completed in the 1970s. The *Framework* states that "the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions." The information needs of investors are deemed to be of paramount concern, but if financial statements meet their needs, other users' needs would generally also be satisfied.

The *Framework* holds that users need to evaluate the ability of the enterprise to generate cash and the timing and certainty of its generation. The financial position is affected by the economic resources controlled by the entity, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates.

The qualitative characteristics of financial statements are understandability, relevance, reliability and comparability. Reliability comprises representational faithfulness, substance over form, completeness, neutrality and prudence. It suggests that these are subject to a cost/benefit constraint, and that in practice there will often be a trade-off between characteristics. The *Framework* does not specifically include a "true and fair" requirement, but says that application of the specified qualitative characteristics should result in statements that present fairly or are true and fair (but note that IAS 1, *Presentation of Financial Statement,* does refer to the true and fair requirement).

Of great importance are the definitions of assets and liabilities. According to IASB, "an asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise." A liability is a "present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying future benefits." Equity is simply a residual arrived at by deducting the liabilities from assets. Neither asset nor liability are recognized in the financial statements unless they have a cost or value that can be measured reliably—which, as the *Framework* acknowledges, means that some assets and liabilities may remain unrecognized.

The asset and liability definitions have, in the past, not been central to financial reporting standards, many of which were instead guided by a "performance" view of the financial statements. For example, IAS 20 on government grants was suspended in 2004, in part because it allows government grants to be treated as a deferred credit and amortized to earnings, while a deferred credit does not meet the *Framework* definition of a liability. Similarly, IFRS 3 requires that where negative goodwill is identified in a business combination, this should be released to the income statement immediately—IAS 22 treated it as a deferred credit, which does not qualify as a liability.

Both FASB and IASB now intend to analyze solutions to reporting issues in terms of whether they cause any changes in assets or liabilities. The revenue recognition project which both are pursuing is an example of this. This project has tentatively embraced the view that where an entity receives an order and has a legally enforceable contract to supply goods or services, the entity has both an asset (the right to receive future revenue) and a liability (the obligation to fulfill the order) and it follows that, depending upon the measurement of the asset and the liability, some earnings could be recognized at that point. This would be a sharp departure from existing GAAP, under which executory contracts are almost never formally recognized, and never create earnings.

The IASB *Framework* is relatively silent on measurement issues. The three paragraphs that address this matter merely mention that several different measurement bases are available and that historical cost is the most common. Revaluation of tangible fixed assets is, for example, perfectly acceptable under IFRS for the moment. In practice IFRS have a mixed attribute model, based mainly in historical cost, but using value in use (the present value of expected future cash flows from the use of the asset within the entity) for impairment and fair value (market value) for some financial instruments, biological assets, business combinations and investment properties.

Hierarchy of Standards

The *Framework* is used by IASB members and staff in their debate, and they expect that those commenting on Exposure Drafts will articulate their arguments in terms of the *Framework*. However, the *Framework* is not intended normally to be used directly by preparers and auditors in determining their accounting methods. In its 2003 revision of IAS 8, IASB introduced a hierarchy of accounting rules that should be followed by preparers in seeking solutions to accounting problems. This hierarchy says that the most authoritative guidance is IFRS, and the preparer should seek guidance as follows:

1 IAS/IFRS and SIC/IFRIC Interpretations, when these specifically apply to a transaction or condition.
2. In the absence of such a directly applicable standard, judgement is to be used to develop and apply an accounting policy that is relevant to the economic decision-making needs of the users, and is reliable in that the financial statements: represent faithfully the financial position, financial performance and cash flows of the reporting entity; reflect the economic substance of transactions, events and conditions, rather than merely the legal forms thereof; are neutral; are prudent; and are complete in all material respects.
3. If this is not possible, the preparer should then look to recent pronouncements of other standard setters which use a similar conceptual framework to develop its stan-

dards, as well as other accounting literature and industry practices that do not conflict with higher level guidance.
4. Only if that also fails should the preparer look to the IASB *Framework* directly.

In effect, therefore, if IFRS do not cover a subject, the preparer should look to national GAAP, and the most obvious choice is US GAAP, partly because that is the most complete set of standards, and partly because in the global capital market, US GAAP is the alternative best understood (and use of US GAAP removes reconciliation items on the Form 20-F for foreign SEC registrants). In any event, given the professed intention of IFRS and US GAAP to converge, it would make little sense to seek guidance in any other set of standards, unless US GAAP were also silent on the matter needing clarification.

The IASB and the US

Although IASC and FASB were created almost contemporaneously, FASB largely ignored IASB until the 1990s. It was only at the beginning of the 1990s that FASB started to become interested in IASC. This was the period when IASC was starting to work with IOSCO, a body in which the SEC has always had a powerful voice. In effect, both the SEC and FASB were starting to look to the international, and IASC was also starting to take initiatives to encourage standard setters to meet together occasionally to debate technical issues of common interest.

IOSCO's efforts to create a single passport for secondary listings, and IASC's role as its standard setter, while intended to operate worldwide, would have the greatest significance for foreign issuers in terms of the US market. If the SEC were to accept IFRS in place of US GAAP, there would be no need for a Form 20-F reconciliation, and access to the US markets would be greatly facilitated. The SEC has therefore been a key actor in the later evolution of IASC. It encouraged IASC to build a relationship with IOSCO in 1987. It also observed that there were too many options under IAS. When IASC restarted its IOSCO work in 1995, the SEC issued a statement (April 1996) saying that, to be acceptable, IFRS must satisfy three criteria.

1. They must include a core set of standards that constituted a comprehensive basis of accounting;
2. The standards must be high quality, and enable investors to analyze performance meaningfully both across time periods and between companies; and
3. The standards must be rigorously interpreted and applied, otherwise comparability and transparency would not be achieved.

The plan with IOSCO involved IASC completion of its core set of standards, then handing these over to IOSCO, which in turn would ask its members to evaluate them, and finally IOSCO would issue its verdict. It was in this context the SEC issued a "concept release" in 2000, in which it asked for comments on the acceptability of the core set of standards, but crucially on whether there was a sufficient compliance and enforcement mechanism to ensure that standards were consistently and rigorously applied by preparers, that auditors would ensure this and stock exchange regulators would check compliance.

This latter element is something which is beyond the control of the IASC and IASB. The Standards Interpretations Committee was formed to help ensure uniform interpretation, and IFRIC has taken a number of initiatives to build liaison channels with stock exchange regulators and national interpretations bodies, but the rest is in the hands of the auditors, the audit oversight bodies, and the stock exchange oversight bodies. The SEC concepts release resulted in many comment letters, which can be viewed on the SEC Web site (www.sec.gov), but in the five years since its issue, the SEC has taken no definitive position.