

## Appendix 3.04.14 Convergence and Global Reporting

### Assumptions about convergence

#### Convergence and standards over time

Sherman and Young (2016)<sup>1</sup> are quite damning in their indictment of reporting:

Despite the raft of reforms, corporate accounting remains murky. Companies continue to find ways to game the system, while the emergence of online platforms, which has dramatically changed the competitive environment for all businesses, has cast into stark relief the shortcomings of traditional performance indicators. This status report looks at the most important developments of financial reporting in recent years, particularly the impact of the new rules governing revenue recognition, the persistent proliferation of unofficial performance measures, and the challenges of fairly assessing asset values.

We also look at the more insidious—and perhaps more destructive—practice of manipulating not the numbers in financial reports but the operating decisions that affect those numbers in an effort to achieve short-term results.

They examined the problem in terms of a number of major attributes<sup>2</sup>:

#### Universal Standards

....The convergence of US GAAP and the European adopted IFRS has stalled. The authors consider the implication of failing to reconcile GAAP and IFS. In our book on Financial Failures<sup>3</sup>, we see the problems of Autonomy, a UK software firm, taken over by the US HP conglomerate and the differences produced when the firm switched Autonomy's accounting rules from IFRS to US GAAP (allegedly).

Consider the implications of failing to reconcile GAAP and IFRS. The analysis of investment targets, acquisitions, or competitors will in many cases continue to require comparison of financial statements under two distinct accounting regimes: Pfizer versus GlaxoSmithKline, Exxon versus BP, Walmart versus Carrefour – in each case, one company uses GAAP and the other uses IFRS. The impact on results is hardly trivial. Take the British confectionary company Cadbury. Just before it was acquired by the US firm Kraft, in 2009, it reported IFRS-based profits of \$690 million. Under GAAP

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<sup>1</sup> 'Where Financial Reporting Still falls Short' by H. David Sherman and S. David Young, *Harvard Business Review*, July-August Issue 2016.

<sup>2</sup> Ibid.

<sup>3</sup> Bhaskar, K., and Flower, J., *Disruption in the Audit Market: The Future of the Big Four*, Routledge, April 2019.

See Bhaskar et al, See: *Disruption in the Audit Market: The Future of the Big Four*, Routledge, April 2019. Comments available

<http://www.fin-rep.org/which-book/financial-failures-scandals-from-enron-to-carillion/>

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those profits totalled only \$594 million – almost 14% lower. Similarly, Cadbury’s GAAP-based return on equity was 9% – a full five percentage points lower than it was under IFRS (14%). Such differences are large enough to change an acquisition decision.

Outside Europe IFRS regulations can vary from country to country with each country having its own system of regulation and compliance; in many countries (especially in the fastest-growing emerging regions) compliance and enforcement are weak. The quality and independence of the accounting profession are also often patchy.

Also while several countries, among them Australia and Canada, have adopted the complete, unadulterated version of IFRS, emerging countries such as China and India have created their own versions of the IFRS system by the removal of some passages and additions to the official standard promulgated by the International Accounting Standards Board (IASB).

### **Revenue Recognition**

This is a thorny problem with several companies recently having failures in their financial and reporting systems due to problems in this area. Sherman and Young<sup>4</sup> illustrate this issue with the sale of a smartphone or an internet service or a £30 million software package to an individual or a company: the contract for that product or service often includes future upgrades, enhancements, or device changes whose costs cannot be predicted at the time of the sale. Therefore, it is impossible to determine how much profit the sale will generate.

Under the old GAAP rules, if there was no objective way to measure such costs beforehand, a business would not be allowed to record any revenue from that sale until all upgrade requirements had been delivered and their costs known—which could take a few years. Although this changes with IFRS 15, US GAAP will also nominally adhere to IFRS 15 on revenue recognition discussed earlier. Hence the shortcomings of revenue-recognition practices have also caused companies to increasingly use unofficial measures to report financial performance, especially for businesses operating in the virtual space.

Sherman and Young<sup>5</sup> gave this example of how the tech and internet companies might have responded:

For example, in 2015 Twitter reported a GAAP net loss of \$521 million; it also offered not one, but two non-GAAP earnings measures that showed positive income: adjusted EBITDA of \$557 million and non-GAAP net income of \$276 million.

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<sup>4</sup> Op. Cit. 2016.

<sup>5</sup> ‘Where Financial Reporting Still falls Short’ by H. David Sherman and S. David Young, *Harvard Business* Routledge Focus on Business and Management: Recent Financial Failures Volume 3 Disruption in Financial Reporting Appendix to Chapter 4: Regulation, Reporting & Auditing Landscape Appendix 3.04.6 UK GAAP Review, July-August Issue 2016.

Revenue recognition will remain a problem. In Chapter 7 Carillion, Capita and General Electric all have issues with this concept. Despite convergence, we think there will be continuing issues.

### **Unofficial Earnings Measure**

Sherman and Young<sup>6</sup> do not like these alternative measures, neither the non-financial ones nor the financial ones. We disagree and advocate the great use of both. They believe that such metrics as visit, and page views – usual analytics metrics for internet use – try to convince analysts and investors that their businesses have value despite the absence of profits (and sometimes even of revenue). We believe the number of users and/or use is more important than actual revenue – it shows potential revenue as with Facebook. Though with the Elon Musk company Tesla, we think that its valuation being greater than Ford's reeks more of a bubble than real underlying profit potential.

### **Fair value accounting**

There are three measures for determining the value of a firm's assets:

- Historical cost – the price originally paid
- Fair value (or mark-to-market) – the amount those assets would bring in if sold today
- Level 3 assets fair value or mark-to-model. Level 3 assets are assets whose fair value cannot be determined by using observable inputs or measures, such as market prices or models. Level 3 assets are typically very illiquid, and fair values can only be calculated using estimates or risk-adjusted value ranges. Mark-to-model refers to the practice of pricing a position or portfolio at prices determined by financial models, in contrast to allowing the market to determine the price. Often the use of models is necessary where a market for the financial product is not available, such as with complex financial instruments.

Just a note on the three levels of assets. Level 2 assets are the middle classification based on how reliably their fair market values can be calculated. Level 1 assets are the easiest (such as listed stocks, bonds), while Level 3 assets can only be valued based on internal models or "guesstimates" and have no observable market prices.

Sherman and Young<sup>7</sup> gave an example of the valuation problems that might arise. For example, RBS recognised a charge to earnings in the second quarter of 2011 of £733 million, after a 51% write-down from the balance sheet value of £1.45 billion for its Greek government bond portfolio. In doing this, RBS followed the IFRS fair value principle, which states that if observable market prices are available, they must be used. On that basis, RBS noted that market prices had dipped by just over half the price paid for those bonds when they were issued.

However, two French financial institutions, BNP Paribas and CNP Assurances, looked at the very same data and chose to write the bonds down by only 21%. They rejected the market prices on the questionable grounds that the market was too illiquid to provide a "fair" valuation.

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<sup>6</sup> Ibid

<sup>7</sup> Ibid.

Instead, they resorted to so-called “level 3” fair value estimates in a process known as mark-to-model (in contrast to the mark-to-market valuations used by RBS bank).

### **Convergence and standards over time**

Considering the western blocs, the US, Europe and the UK with some sort of Brexit. The most likely result under ex-Prime Minister Theresa May was a Brexit where the UK was not necessarily part of EU regulations but in financial terms would have to go for some sort of equivalence. On the other hand many of the highest value listed companies carry out substantial business in EU countries and may be required to meet EU regulations as a condition of continuing that business in subsidiaries in EU countries. If that is the case, it may be easiest to just roughly conform the consolidation using the same principles and regulations – as long as they do not cross UK regulations. Normally the UK is a little more demanding than EU in general.

A Conservative party deal under Prime Minister Boris Johnson or a harder Brexit under someone who believes in a Nigel Farage type no deal Brexit could result in a low regulation future where the UK substantially diverges from the EU with a roll back of all regulations including the banks (notwithstanding their wholesale problems in GFC).

### **European convergence**

Accountancy Europe (covering 1 million professionals, 28 member states, 51 institutes, and 37 countries [Switzerland excluded]) reports<sup>8</sup>. Overall there are 17 different mandatory audit firm rotation regimes across the EU:

EU Audit Reform: implemented in all countries except Iceland and Norway.

Non-audit services additional prohibitions:

- a) Norm is as per EU regulation
- b) White list approach: Poland, Netherlands
- c) Additional prohibitions: **UK** and France

Non-audit services possible exemptions for tax and valuation services<sup>9</sup>.

- a) No exemption: Portugal, France, Italy, Slovenia, Netherlands, Poland
- b) Tax: Austria, Bulgaria, Lithuania
- c) Tax and valuation: **UK**, Ireland, Iceland, Spain, Belgium, Germany, Czech Republic, Slovakia, Hungary, Croatia, Romania, Malta, Greece, Cyprus, Latvia, Estonia, Norway, Sweden, Finland, Denmark

Non-audit services – allowed cap.

- a) 70% cap is the norm. **UK** voluntary split by many of the larger accounting firms.
- b) 30% cap (much tighter) Portugal.

Mandatory audit firm rotation – intimal duration of engagement:

- a) 10 years is the norm including the **UK**
- b) Exceptions to the norm:

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<sup>8</sup> Accountancy Europe is the new name for Federation of the European Accountants.

<sup>9</sup> Derogation of prohibition of certain tax and valuation services within the following conditions of the Regulation: a) Impact on the audited financial statements is immaterial or none, b) Evaluation of this impact on the financial statements is documented in the additional report to the audit committee, and c) Principles of independence, as included in the EU Directive, are applied by the statutory auditor.

9 years for bank – Greece. 8 years for banks – Romania. 5 years for SIFIs<sup>10</sup> – Cyprus.

c) 7-9 years – Portugal, Belgium, Bulgaria,

d) 5 years – Poland.

Mandatory joint audits: France, Bulgaria. Allowable in Germany, Denmark, Norway, Finland, Cyprus, Spain, Belgium, Sweden.

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<sup>10</sup> Systemically important financial institution

## **Reporting time horizons**

We have put our assumptions about the regulatory standards over time for each US, UK and EU/Europe.

**Table 5.1 Time Horizon Scenarios and Regulatory Standards**

	<b>US</b>	<b>UK</b>	<b>Europe</b>
Pre GFC/2007	Scandal driven	Scandal driven, EU harmonisation	Increasing, harmonisation
GFC to 2016	Increasing rules and standards mainly as a reaction to GFC	Increasing rules and standards mainly as a reaction to GFC. Plus harmonisation with EU	Increasing rules and standards mainly as a reaction to GFC. Plus harmonisation with EU
Post 2017 to early 2020s <b>(Short-term)</b>	Relaxation of rules and standards. Roll-back of SEC regulations. Roll-back slightly or weaker interpretation and enforcement of the two acts: Dodd-Franks Act and the Sarbanes-Oxley Act. Reliance on court cases when things go wrong	Increasing rules and standards but diverging from the more relaxed atmosphere of the US, but still be keeping in step (with modifications and additions) with the EU. Reaction to Carillion and other recent failures. Audit market changes: FRC/ARGA, CMA, Kingman and Brydon reviews.	Clarification and evolutions of existing major changes. Recovery from GFC still occurring and high unemployment creates an environment where increasing controls and additional information only trickles through. EU does not experience the UK audit market changes.
Early 2020s to 2030-ish <b>(Medium-term)</b>	After a delay may tend to follow the EU when the post-Trump era emerges and increasing regulation is once again established.	Wider country-by-country reporting. A degree of deregulation after BREXIT.	Increasing rules and standards dealing with country-by-country reporting, non-financial information (NFI), ethics, human rights, environment and greater harmonisation
2030-ish to 2050 <b>(Long-term)</b>	New US and International standards slightly less severe than the EU ones. Some US peculiarities allowing for greater use of court cases.	Depends on Brexit and how the relationship with the EU evolves over time.	Continuing set of new EU Standards dealing with NFI, ethics, human rights, environment and greater harmonisation. Also tighter control of auditing.

## **Current divergence of reporting standards:**

### **Will the US always be different?**

The US Generally Accepted Accounting Principles, or US GAAP, is the accounting standard adopted by the US Securities and Exchange Commission (SEC). While the SEC has stated that it intends to move from US GAAP to the International Financial Reporting Standards (IFRS), the latter differ considerably from GAAP and progress has been slow and uncertain. In general, the SEC requires certain standards that go down to specifics for different industries and sectors.

**Table 5.2 Forecast Regulator Frameworks**

	<b>US</b>	<b>UK</b>	<b>Europe</b>
Regulatory body with fining powers	SEC, FASB, Others	EU, ARGA/FRC and post BREXIT UK gov and perhaps the US regime?	EU and national governments
GAAP (Generally accepted accounting principles)	US GAAP plus additional SEC requirements	IFRS GAAP plus additional from EU and ARGA/FRC	IFRS GAAP plus additional from EU and national governments
Banks	Sarbanes–Oxley Act 2002 Dodd-Franks Act 2010	FCA regulations plus (some of) MiFID I & II. Brackets our interpretation.	MiFID I & II MiFID II more enforced but not to full extent
Regulators	SEC FRS OCC	ARGA/FRC FCA PRA/Bank of England	EMSA EFRAG ARC Country regulators
Differences	Significant from IFRS, EU and the UK’s FRC/ARGA.  New rules for auditors from 2019.  Roll-back of other regulations expected.	In general a little more onerous than most of the EU. But this will change and from 2020 the EU may be more onerous than the UK, though convergence and equivalence may mean that the regulations are more or less the same. But the UK will always have a few additional items and quirks.	In general more onerous than US except individual sector requirements.  Post 2020 will be more onerous than the UK.  Country-by-country reporting and more on non-financial, environmental and human rights information and reporting.

### **US divergence**

At present the main issue (still unresolved) is whether the US should retain its own national system of regulation (based on the SEC’s authority and the FASB) or join the international

system. If rolling back regulations wins then as noted previously, there will be a divergence, at least initially. We think the US will diverge (post-Trump). The business community, regardless of politics, has more or less decided that regulations have gone too far. US financial reporting has always been based on a much more prescriptive methodology. Bright line rules have always been the objective. It is consistent with a country dominated by lawyers. However, corporate life covers so many possibilities it is impossible to legislate for all of them and, as scandals such as Enron have shown, there will always be intelligent lawyers and accountants who try to finesse imperfections in the rules.

### **Convergence US to Europe/IFRS**

Thus US had originally decided to adopt for convergence towards IFRS and one international standard. But then various statements in 2014 and beyond makes abundantly clear that the FASB has no intention of surrendering its right and authority to set the financial reporting standards for American corporations. It has relegated the development of comparable global reporting standards to the status of ‘an aspirational goal’. Hence, our conclusion is that, for the foreseeable future, international standard setting will be marked by continued rivalry between the FASB and the IASB. The Trump administration reinforces this decision.

This has to be put in context however. US investors often look overseas for investment opportunities and estimates suggest that over \$10 trillion of US capital is invested in foreign securities. The US also remains open to non-US companies that prepare their financial statements using IFRS and are listed on US markets. PwC reports that there are currently approximately 500 non-US filers with market capitalisation in the multiple of trillions of US dollars that use IFRS without reconciliation to US GAAP.



### **Mark to market / Fair value accounting**

Problems can occur when the market-based measurement does not accurately represent the underlying asset's true value. This can occur when a company is forced to calculate the selling price of these assets or liabilities during unfavourable or volatile times, such as a financial crisis. For example, if the liquidity is low or investors are fearful, the current selling price of a bank's assets could be much less than the value under normal liquidity conditions. The result would be a lowered shareholders' equity. This case occurred during the financial crisis of 2008/09 where many securities held on banks' balance sheets could not be valued efficiently as the markets had disappeared from them. During April 2009, however, the Financial Accounting Standards Board (FASB) voted on and approved new guidelines that would allow for the valuation to be based on a price that would be received in an orderly market rather than a forced liquidation, starting during the first quarter of 2009.

### **Extending IFRS?**

There is a problem, however, in adopting more of the IFRS standards. The argument is that following the 3,500 plus IFRS standards takes away the principle of prudence and moves towards fair value – and we have just seen there can be criticisms. Also, it is quite burdensome especially for smaller companies.

So the criticism is that accounting is less prudent by undermining or even jettisoning the principle that financial statements must be 'true and fair'. IFRS makes more use of the fair value model (IFRS 13) of accounting as opposed to depreciated historical cost. Critics have blamed the fair value model for disproportionately overstating banks' profitability and in turn overstating profit, enabling excessive dividends to be paid. Moreover, IFRS has fostered a culture of box-ticking. The box-ticking concept has also been criticised as being applied too harshly in the UK – as practitioners have discussed in this book. That said the US tends to adopt the box-ticking culture to a greater extent than in the UK. This is discussed in the next chapters.

Stella Fearnley,<sup>11</sup> is a well know academic and critique of the IFRS, warns that

‘When IFRS was trumpeted as a great innovation, little attention was paid to the unintended consequences that allowed banks to report inflated profits via a mark-to-market regime and under provisioning for loan losses.’<sup>12</sup>

Blaming the banks' failure on accounting measures is a theme taken up by many, probably with some justification.

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<sup>11</sup> Professor of Accounting at Bournemouth University

<sup>12</sup> Opinion, 'Debate: statutory audit will be defunct by 2030', *Economia*, 8 January, 2018.

Available at:

<https://economia.icaew.com/opinion/january-2018/debate-statutory-audit-will-be-defunct-by-2030>

Accessed August 2018.

### **Overall impact of IFRS adoption**

However, some studies have shown a positive overall assessment of the adoption of IFRS. For example, one study by Lourenço and Branco 2015<sup>13</sup> characterises the results of serious scientific academic research on the effect of adopting the IFRS that have been published in the most prestigious journals in the field of accounting at the international level and it identifies avenues for further research. Based on the analysis of a set of 67 articles published by the accounting journals that make up the Social Sciences Citation Index published between 2000 and 2013.

They conclude that, as a general rule, IFRS adoption has a positive effect on information quality, the capital market, analysts' ability to predict, comparability, and information use. Nevertheless, this effect depends on some factors, such as country's characteristics (namely, the enforcement level [good in Europe]) and companies' characteristics [again mainly positive for UK and European companies]).

### **BEPS (anti-tax avoidance measures)**

Base erosion and profit shifting (BEPS) refers to tax planning strategies used by multinational companies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity. The project headed by the OECD was initiated by the G20 in 2012. It is being adopted by the EU. The UK may adopt a version of this country by country reporting.

BEPS's primarily legal strategies aim to move profits to where they are taxed at lower rates and expenses to where they are relieved at higher rates. The result is a tendency to associate more profit with legal constructs and intangible rights and obligations, and reduce the share of profits associated with substantive operations involving the interaction of people with one another.

The BEPS project addresses issues varying from transparency to financing to transfer pricing; BEPS will impact any business that operates in multiple territories. And it is likely that the UK will join and become a full and active member of the BEPS initiative. BEPS becomes active before we leave the EU.

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<sup>13</sup> Lourenço, I., M., E., C., and Branco, M., E., M., D., C., 2015, 'Main Consequences of IFRS Adoption: Analysis of Existing Literature and Suggestions for Further Research', *Revista Contabilidade & Finanças*, July 2015.

Available at:

[http://www.scielo.br/scielo.php?pid=S1519-70772015000200126&script=sci\\_arttext&tlng=pt](http://www.scielo.br/scielo.php?pid=S1519-70772015000200126&script=sci_arttext&tlng=pt)

or

<http://www.scielo.br/pdf/rcf/2015nahead/1519-7077-rcf-201500090.pdf>

Accessed August 2018.

### **Mandatory country-by-country (CBCR)**

The UK has already adopted this for tax purposes. The EU will extend this to all PIEs and listed companies<sup>14</sup>.

An EU amendment (The amendment to the Administrative Cooperation Directive) requires Multinational Enterprise Groups (MNE Groups) which operate in the EU and which have a consolidated group revenue of at least €750 million, to provide information on revenues, profits, income tax paid, income tax accrued, capital, earnings, tangible assets and the number of employees on a country-by-country basis. Each constituent entity of the MNE Group together with its jurisdiction of tax residence and main business activities must also be reported. The information, which shall be presented in the same format as that required by the OECD, shall be aggregated on a per country basis and must be provided in respect of the MNE Group's worldwide operations. This applies to both EU Group residents and those whose headquarters are outside the EU.

### **Standardisation of EU tax**

One issue that we do not think the UK will ever feel entirely comfortable with, even if the UK re-joins the EU in some shape or form in the distant future, is sharing any common harmonisation of tax regimes throughout the EU. Either now or after 2030. This may change by 2050, but the betting is that the UK will always want its own tax systems regardless or not of whether it has joined the Eurozone.

This applies to personal and corporate taxation. Though corporate taxation is likely to be harmonised in the EU first. This could come in via the CCCTB, the Common Consolidated Corporate Tax Base (CCCTB). This is a proposal for a common tax scheme for the European Union developed by the European Commission and first proposed in March 2011, it would create a single set of rules for how EU corporations calculate their EU taxes and provide the ability to consolidate EU taxes. Although much delayed, we envisage this being implemented in the early 2020s for the EU countries – perhaps with some opt-out clauses.

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<sup>14</sup> Has to be in in XML format from 2016. See for further details:  
<https://www.gov.uk/government/news/hmrc-confirms-country-by-country-reporting-format-for-multinationals>  
and  
<https://www.gov.uk/government/publications/amendments-to-country-by-country-reporting-2017/amendments-to-country-by-country-reporting-2017>  
Accessed August 2018.