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International Convergence towards Principles-Based Accounting Standards

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Abstract

The accounting profession is a field that functions through a set of complex and contradictory standards. As a result of the ever-increasing complexities brought on by a rules-based standard approach, several countries and regions including Japan, China, Hong Kong, the European Union, and the United States have all begun to converge their respective generally accepted accounting standards towards more principles-based accounting standards. The research conducted examines through a comparison of various nations and regions generally accepted accounting principles for important issues to determine which, if any, are deemed to have an objective-oriented standard; also, if the comparison does not result in an objective-oriented standard, then derive any modifications that may need to be made to have the particular standard qualify as an objective-oriented or principles-based standard. The important concepts compared included: intangible assets, accounting for impairment, related party transactions, financial instruments with a specific focus on derivatives and hedges, stock options and share-based payments, business combinations, and segment reporting. This study serves as a preliminary comparison for principles-based standard setting. Taking into consideration that definitive plans for revision of current regional and national accounting standards have not been finalized, this particular study gives some insight as to the possible direction or possible revisions that will be made to implement a unified, principles-based accounting standard set.

Introduction

The accounting profession is a field that functions through a set of complex and contradictory standards. Accounting standard-setting bodies such as the International Accounting Standards Board (IASB), the US Financial Accounting Standards Board (FASB), and several international entities have over the past decade come under scrutiny by various finance-related governing bodies, such as the Securities Exchange Commission (SEC) because the impact of their standards of financial reporting have

become increasingly less effective and allow firms to creatively opaque their financial portrait and even go to such extremes as to hide fraudulent activities in the case of Enron. Although the purpose of rules-based accounting is “to address as many potential contingencies as possible,” executive managers have managed to exploit loopholes within those rules to create beneficial opportunities for their companies (*Shortridge and Myring, 2004*). These flaws within accounting standards created confusion amongst the users of the information presented in corporations’ financial statements, namely shareholders, financial institutions, and prospective investors.

The business environment has changed dramatically since most financial reporting standards were established and modified. As such, the standards that have been set in place for the business world to follow have become, “an endless plethora of rules, rather than a set of overarching principles understandable to anyone with a basic business and accounting background, [that] dictates accounting treatments,” (*Quinn, 1999*). As a result of the ever-increasing complexities brought on by a rules-based standard approach, the US FASB and the IASB have decided to converge and conform to a more principles-based approach with the recognition of the International Financial Reporting Standards (IFRS), also known as the International Accounting Standards (IAS). “By implementing a principles-based approach, control could be defined more broadly and thus determin[e] control consolidation,” (*Smith and Hogan, 2004*).

Several countries and regions including Japan, Hong Kong, China, the European Union, and the United States are all converging their respective generally accepted accounting standards to resemble IFRS. “As corporate activities have grown increasingly international, and international commonality is sought in business accounting,” the

challenge becomes developing standards that reflect the constantly changing global business environment (*Ministry of Economy, Trade and Industry, 2004*). “Business accounting has developed over a number of years in individual countries based on the market realities that are unique to each capital market, including regulatory systems,” (*Ministry of Economy, Trade and Industry, 2004*). In Japan, for example, “business accounting [has] evolved as it [has] fulfilled certain roles in meeting the requirements of the Securities Exchange Law, Commercial Code, and Corporate Income Tax Law,” (*Ministry of Economy, Trade and Industry, 2004*). Taking into account that, “business activities with and within China have been expanding at enormous speed...the Chinese Ministry of Finance...has set itself the objectives of fostering investors’ confidence in financial information [and] increase transparency of financial reporting,” (*Deloitte, 2005*). Business accounting in the United States “has evolved over history...mainly for the protection of investors,” (*Ministry of Economy, Trade and Industry, 2004*). However, despite investors’ “preference for the use of standards that match the realities of the country in which the main business operation of the corporation is conducted,...[a] greater demand for integration of financial reporting content,” has created the movement towards international standard convergence which is the primary focus of this paper (*Ministry of Economy, Trade and Industry, 2004*).

The “primary benefit of principles-based accounting rests in its broad guidelines that can be applied to numerous situations. Broad principles avoid the pitfalls associated with precise requirements that allow contracts to be written specifically to manipulate their intent,” (*Shortridge and Myring, 2004*). There are several other benefits to implementing a principle-based approach. “Under a principles-based approach the

principles in accounting standards...would apply more broadly...thereby providing few exceptions to the principles,” (*FASB: Simplification and Codification Project, November 2002*). “An objective of [the principles-based] approach [would] be to eliminate exceptions that are intended to achieve desired accounting results...which may obscure the underlying economics of the related transactions and events,” (*FASB: Simplification and Codification Project, November 2002*). Another objective and benefit to adopting principles-based standards is “to provide interpretive and implementation guidance that focuses only on significant matters addressed in the standards, thereby increasing the need to apply professional judgment in situations not addressed,” (*Shortridge and Myring, 2004*). Another benefit that results from the implementation of a principles-based approach is that they “provide accounting statements that more accurately reflect a company’s actual performance,” (*Shortridge and Myring, 2004*). This is one of the benefits that provide the Securities and Exchange Commission with a reason to support this landmark change in accounting standard setting.

Although the International Financial Reporting Standards are more of principles-based or objective-oriented accounting standards, it still possesses some rules-based aspects. Principles-based standard setting begins with “laying out the key objectives of good reporting in the subject area and then provides guidance explaining the objective and relating it to some common examples,” (*FASB: Simplification and Codification Project, November 2002*). This research paper examines through a comparison of various nations and regions generally accepted accounting principles for important concepts to determine which, if any, are deemed to have an objective-oriented standard; also, if the comparison does not result in an objective-oriented standard, then derive any

modifications that may need to be made to have the particular standard qualify as an objective-oriented or principles-based standard. The important concepts compared included: intangible assets, accounting for impairment, related party transactions, financial instruments with a specific focus on derivatives and hedges, stock options and share-based payments, business combinations, and segment reporting. The comparison encompassed Japanese GAAP, Hong Kong Financial Reporting Standards (FRS), People's Republic of China GAAP, US GAAP, and International Financial Reporting Standards/International Accounting Standards (IFRS/IAS).

The results differed over the various concepts. US GAAP qualified as a more principles-based standard for intangible assets. The method used by US GAAP for recording and measuring intangible assets (at fair value) and its method of depreciation (impairment testing) reflected the economic substance of the transaction more accurately which is a benefit that results from a principles-based accounting standard. The IFRS for accounting for impairment resembled a principles-based standard because it also reflected the economic substance of an event/transaction by not amortizing but periodically testing for impairment. The loss resulting from the impairment test, if any, is measured using the recoverable amount- which involves the asset's fair market value- as a basis for allocation. Also, as an alternative, IFRS allows for other rational methods to be used which is in accordance with the broad characteristic of a principles-based accounting standard. The Hong Kong FRS for related party transactions gives a more broadly defined and inclusive definition for a related party that coincides with the characteristic of a principles-based standard. However, a modification would need to be made to the standard to require the disclosure of related parties that did not result in a transaction in

order to best meet the needs of the users of the financial statements. The US GAAP standard for financial instruments, specifically derivatives and hedges, provides a more principles-based approach because it provides a more comprehensive method of evaluation. In terms of stock options and share-based payments, the IFRS allows for increased flexibility in determining the fair value of the stock option because the measurement is not confined to an option pricing model, but allows for the use of valuation techniques which can be employed to estimate stock option value. The US GAAP standard prescribing the accounting treatment of business combinations qualifies as a more principles-based standard. The universal treatment of all classifications of business combinations, the purchase accounting method, minimizes exceptions and the need for interpretive guidance, another beneficial characteristic of a principles-based standard. The objective of the standard also increases its qualification because it requires the reporting of the economic substance of the transaction by reporting the business combination at fair value. US GAAP is also a more principles-based standard in terms of segment reporting. The objective of the standard is accomplished and users of the financial statements are more easily able to comprehend management's decisions by viewing their operating segments and are consequently better informed to make significant investment decisions of their own.

This study is to serve as a preliminary comparison for principles-based standard setting. Taking into consideration that definitive plans for revision of current regional and national accounting standards have not been finalized, this particular study gives some insights as to the possible direction or possible revisions that will be made to implement a unified, principles-based accounting standard set.

Background

“With the growth of global corporate activities, international commonality is being sought in global standards for business accounting,” (*Ministry of Economy, Trade and Industry, 2004*). Corporate accounting scandals have plagued the United States and brought the issue of “standards overload” to the FASB’s attention, (*FASB: Codification and Simplification Efforts, February 2002*). This term describes the Financial Accounting Standards Board’s “concern about not only the volume of accounting rules and the level of complexity and detail of those rules, but also the resulting profusion of footnote disclosures and the difficulty of finding all the accounting rules on a particular subject,” (*FASB: Codification and Simplification Efforts, February 2002*). However, the issue is not only being addressed as a priority in the US.

The ball began to roll with the European Union. In 2002 the European Commission announced that “it will require all companies whose securities are listed in the European Union to adopt the IFRS, [beginning] in January 2005. In addition, an European Union directive require corporations based outside the EU that have their securities listed in the European markets to use ‘the IFRS or other standards that are deemed to be equivalent to the IFRS’ in their financial statements for continuing disclosure in the EU market or new listings of their securities in the EU market,” (*Ministry of Economy, Trade and Industry, 2004*). In addition to this new requirement for US corporations the FASB decided to reevaluate the direction that their rules-based approach to setting accounting standards was taking in the US and international economy. “The FASB’s mission statement indicates that high-quality accounting

standards that improve the transparency of information ‘are essential to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, and understandable financial information,’ (*FASB: Principle-Based Approach to US Standard Setting, October 2002*). “The Board agreed to evaluate the feasibility of issuing standards that emphasize basic principles and objectives rather than issuing standards that include detailed rules, exceptions and alternatives to the underlying principles,” (*FASB: Codification and Simplification Efforts, February 2002*). In order to comply with European Union requirements and to develop more streamlined standards, other countries including Japan, Hong Kong, and China have begun converging their respective standards with the IFRS.

Data

Taking into consideration the fact that the International Financial Reporting Standards have been adopted as the primary set of accounting standards in the European Union and the mandatory requirement that these standards or an equivalent set of standards must be used by companies in the European market in their financial statements, the International Financial Reporting Standards will be used as a benchmark for comparison. The comparison of IFRS will be against generally accepted accounting principles from various countries and regions that play a relatively large role in today’s global economy. These areas consist of: Japan, Hong Kong, the People’s Republic of China, and the United States (the European Union has already implemented the IFRS as its primary set of accounting standards). The scope of the comparison will not be the entire set of IFRS standards but rather a review of standards that relate to specific

accounting issues that have presented difficulties in the world of accounting, mainly in terms of complexity, manipulation, and/or scandal. These issues include: intangible assets, accounting for impairment, related party transactions, financial instruments: derivatives and hedges, business combinations, and segment reporting.

Results

Intangible Assets

To better compare the differences between each region's GAAP and the IFRS and to determine which of these standards best resembles an objective-oriented standard for accounting for intangible assets, the definition is needed. Taking into consideration that the IFRS are considered to be based upon a more principles-based approach, the definition of an intangible asset is taken from IAS 30, *Intangible Assets*. An intangible asset is "an identifiable non-monetary asset without physical substance. An asset is a resource that is controlled by the enterprise as a result of past events and from which future economic benefits (inflows of cash or other assets) are expected," (*IAS: Summary of IAS 30, 2005*). Thus, 3 critical attributes of an intangible asset are:

- Identifiability (separable, or arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations)
- Control (power to obtain benefits from the asset)
- Future economic benefits (such as revenues or reduced future costs)

The definition serves as the objective or principle for the standard.

Intangible assets have presented several issues and questions regarding the initial recognition and measurement. Japanese GAAP requires that intangible assets be recognized on a cost basis. However, no other detailed provisions have been included in the Japanese GAAP to further specify the treatment of intangible assets in regards to measurement. According to Hong Kong FRS, an intangible asset will be recorded at cost if “it is probable that future economic benefits attributable to the asset will flow to the enterprise,” and if the cost can be measured reliably. If the particular asset does not meet these criteria, it will be considered an expenditure which will be expensed as it is incurred. PRC GAAP recognized intangible assets using acquisition cost as a basis of measurement and provides no other treatments for intangible assets. The US GAAP records intangible assets using a different basis from Japanese GAAP, Hong Kong FRS, and PRC GAAP. US GAAP recognizes and measures intangible assets at fair value when acquired. However, consistent with Japan, Hong Kong, and PRC accounting standards, IFRS capitalizes intangible assets on a cost basis and is required to meet the same criteria as stated in Hong Kong FRS.

In addition to initial recognition and measurement, another aspect of intangible assets analyzed was the depreciation method and depreciation period through which intangible assets will be amortized. Japanese GAAP amortizes the acquisition cost of the intangible assets in each accounting year over the useful life of the asset using a consistent amortization method. Hong Kong FRS, amortizes an intangible asset over the useful life of the asset, only for a definitive period of time. A rebuttable presumption is generally used by Hong Kong FRS that the useful life of an intangible asset may not exceed 20 years from the date the asset becomes available for use. However, if an

enterprise can provide persuasive evidence that the useful life of an intangible asset is greater than 20 years, then the enterprise should amortize the intangible asset over the best estimate of useful life and:

- test for impairment at least annually, and
- disclose the justification for rebutting the 20-year maximum presumption as well as the factor(s) that helped determine the useful life used for amortization.

PRC GAAP amortizes the cost of an intangible asset evenly over its expected useful life, beginning in the month of acquisition. The contract written for a Chinese intangible asset should state a beneficial period which would be the useful life to be amortized. If the expected useful life of the intangible asset determined by the enterprise exceeds the beneficial period stated in the contract or the effective period stipulated by law, the amortization should be the shorter of the two. However, if the contract and the law do not state an expected useful life then the amortization period is not to exceed 10 years.

The US GAAP states that the depreciation method for intangible assets must reflect trend in which economic benefits are consumed or depleted. If a trend is not determinable, the straight-line depreciation method must be used. In addition, if the useful life of the intangible asset cannot be used, then the asset is not depreciated. IFRS is similar to the US GAAP standard with the only difference found in the wording: “the depreciation method [of an intangible asset] must reflect a pattern of consumption of economic benefits,” (*Ministry of Economy, Trade and Industry, 2004*). If such a method cannot be determined then straight-line depreciation will be used. Also, if the useful life cannot be determined, the asset cannot be depreciated.

Relying upon the definition of an intangible asset as defined by the IFRS, it would appear that the more objective-oriented or principles-based standard for recognizing an intangible asset and measuring and implementing a depreciation method for the intangible assets would be the standards used by US GAAP. Rather than recording the intangible asset at cost, US GAAP requires that the acquired intangible asset be recorded and measured at fair value, which reduces the possibility of recording the asset at either an over or under-valued level. Also, the depreciation must reflect the trend in which the economic benefits of the asset are consumed or depleted. Both of these elements provide a clearer, more transparent portrait of a company's intangible assets which will be beneficial to the users of such information.

Accounting for Impairment

Aside from the difficulties of accounting for intangible assets, another difficult accounting issue that almost always accompanies intangible asset is the accounting for impairment. As with intangible assets, the definition of impairment can be used as the objective for the standard that outlines the recognition, measurement, and relation to the impairment of goodwill.

In terms of identifying when to recognize impairment, the differences can be found in the definitions of impairment used by the various standards. Japanese GAAP and US GAAP state that "impairment loss is recognized when the sum of undiscounted future cash flows is less than the book value," (*Ministry of Economy, Trade and Industry, 2004*). This is different from Hong Kong FRS, PRC GAAP, and IFRS- which are all identical- in that "impairment loss is immediately recognized when the recoverable

amount is less than the book value,” (*Ministry of Economy, Trade and Industry, 2004*). For this particular criterion the term “recoverable amount” is defined, according to IAS 36, as the greater of the fair value of an asset less its net selling price and its value in use. To clarify, fair value is defined as the amount to be received as a result of the sale of an asset through a transaction between knowledgeable and willing parties. Also, the term value in use represents the discounted present value of estimated future cash flows that are to arise as a result of the continued use of an asset and its disposal at the end of its useful life. Discounting future cash flows allows for a more realistic determination of impairment loss to be calculated.

The criterion for measurement of an impairment loss is also different based on terms used. Japanese GAAP, Hong Kong FRS, PRC GAAP, and IFRS are all identical in that the impairment loss is calculated as the difference between the book value and the recoverable amount. US GAAP determines the impairment loss to be the difference between an asset’s book value and its fair value. Using the recoverable amount, in the calculation for measuring impairment loss also gives a more economically accurate depiction of the asset and its value to not only the enterprise, but the investors that use the information to make investment decisions.

One of the more imperative aspects of asset impairment that has created a large amount of debate is the impairment of goodwill. Japanese GAAP tests for impairment “on a unit that is large enough to include both a group of assets that are associated with the operation” through which goodwill is attributable as well as the goodwill itself, (*Ministry of Economy, Trade and Industry, 2004*). As a general rule, the increase in impairment loss is first allocated to goodwill. The remainder of the recognized

impairment loss is then allocated over the individual component assets using a rational method which is generally an allocation based on the proportions of book values. PRC GAAP does not, however, perform impairment tests on goodwill, also known as equity investment differences. Equity investment differences/goodwill is amortized over an investment period, stipulated in the investment contract, or not for longer than 10 years if an investment period has not been specified. US GAAP goodwill impairment follows a 2-step process. The first step is to determine the reporting unit of an asset is less than its book value. If this scenario is true the “fair value of goodwill is computed by deducting from the fair value of the reporting unit the fair value of all recognized and unrecognized assets and liabilities. The excess of the carrying amount of goodwill over this amount is recognized as impairment loss,” (*Ministry of Economy, Trade and Industry, 2004*). The IFRS uses the recoverable amount deducted from the book value of a cash-generating unit to determine the impairment loss of goodwill. The loss is “recognized at the level of the smallest unit to which goodwill can be allocated,” (Report on Internationalization, 8). Similar to Japanese GAAP, the IFRS treatment for the impairment loss is first allocated to goodwill and then the remainder is allocated over the individual component assets using a rational method which is generally a proportional basis determined by the individual component assets’ book values.

Accounting for impairment allows for intangible assets including assets such as goodwill to reflect realistic, economic value. Simply using amortization against this special classification of assets does not properly reflect the potential return or the value of the asset that the market believes it to have. Therefore, the more principles-based standard that allows for intangible assets to have a fair market value is the standard used

by the IFRS, where the recoverable amount is used as a measurement and allocated as a basis for impairment loss. The IFRS also allows for rational methods to be used as allocation of the impairment of goodwill which allows for flexibility, one of the effects of implementing principles-based standards.

Related Party Transactions

Related party transactions have begun to be an aspect of business heavily scrutinized and monitored to ensure that corporations operate fairly. Therefore disclosures of related party transactions are another necessary aspect to observe.

Related party transactions are defined in IAS 24 as a “transfer of resources, services, or obligations between related parties, regardless of whether a price is charged,” (*IAS: Summary of IAS 24, 2005*). These forms of transactions are treated differently based upon the country or region an enterprise operates in. For example, Japanese GAAP does not disclose related party transactions. The reason for this is that in the Japanese culture, the method and effectiveness through which business is conducted is through close, personal relationships. It is therefore logical that related party transactions would not be disclosed because there would be too many transactions to disclose. Hong Kong FRS requires the disclosure similar to those required by IFRS regarding related party transactions with a few exceptions. “Parties subject to common joint control or common significant influence” are specifically included as related parties in the Hong Kong Financial Reporting Standards. The Hong Kong standard also requires the disclosure of transactions between state-controlled enterprises. Another unique aspect to the Hong Kong standard is that if there are related parties and transactions have not arisen from

these relationships then no disclosure is required. PRC GAAP requires disclosure for those relationships where “a party has the power to, directly or indirectly, control, jointly control or exercise significant influence over the financial and operating policy decisions of another party, or two or more parties are subject to control from the same party,” (*Deloitte, 2005*). However, unlike Hong Kong FRS, PRC GAAP does not consider state-owned enterprises as related parties simply because they are owned by the government. US GAAP has a more strict definition for the term related party in which specific relationships are listed as related parties along with any party that “can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests,” (*FASB: FAS 57, 1982*). This definition is identical to the definition used in the Hong Kong FRS which states that “parties are considered to be related if one party has the ability to control the other party or to exercise significant influence or joint control over the other party in making financial and operating decisions,” (*IAS: Summary of IAS 24, 2005*).

Considering the objective of the benchmark standard, upon which each of the other standards are compared, is to “ensure that an entity’s financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties,” the Hong Kong standard is the closest to a principles-based standard for related party transactions. The Hong Kong standard gives a broad, more inclusive definition and qualification of a related party and a

related party transaction and includes parties that share control and/or significant influence. A modification to the Hong Kong standard that would further qualify it as principles-based standard is to require a disclosure of related parties regardless of whether a transaction actually transpired between the parties or not. This modification would help draw investors' attention to potential effects that might happen as a result of the existence of related parties.

Financial Instruments: Derivatives and Hedges

The globalization of business has led to the development of innovative and complex methods companies can utilize to manage the amount of risk they are willing to expose themselves to. These complex financial instruments have sparked a great amount of controversy which has, in part, been created by the equally difficult accounting standards under which these financial instruments are to be measured and treated. It is, therefore, imperative to compare the accounting measurements and treatments for two of the most complex financial instruments traded in today's marketplace- derivatives and hedges.

The accounting measurement and treatment of derivatives is, for the most part, fairly consistent. Japanese GAAP values derivatives at market value and recognizes valuation gains and losses through current-year income. The gain and loss treatment of the derivative stated in Japanese GAAP is also the same treatment used by US GAAP and IFRS. The only difference between the three standard sets is that both US GAAP and IFRS measure derivatives at fair value. There is not an existing equivalent standard within the Hong Kong FRS. However, it is important to note that an Exposure Draft,

modeled after IAS 39, *Financial Instruments: Recognition and Measurement*, has been developed to address the discrepancy for derivative and hedge accounting. PRC GAAP does not have specific requirements related to derivatives other than the general treatment of disclosing the financial instrument as an off-balance sheet item.

Hedges have become a popular method of managing risk for several corporations; however, in these different countries and regions the classification and treatment of such hedges are not equal. Japanese GAAP use the deferred hedge accounting method to account for hedges. There are no specific classifications of hedges other than a general definition: “hedge transactions consist of those that offset the market fluctuations of assets or liabilities that underlie the hedges (equivalent to fair value hedges), and those that avoid the fluctuations of cash flows (equivalent to cash flow hedges),” (*Ministry of Economy, Trade and Industry, 2004*). Both the IFRS and PRC GAAP do not have specific requirements regarding the accounting treatment for hedges. US GAAP and IFRS are virtually identical in recognition and treatment of hedges. Hedges are classified into two broad categories- fair value hedges and cash flow hedges. Profit or loss of fair value hedges are recognized by adjusting the carrying amount of the portion attributable to the risks of an asset/liability/firm commitment underlying the hedge. The difference between US GAAP and IFRS is the financial statement item through which gains and losses on a cash flow hedge are reported. US GAAP requires that the portion of the gains or losses of an effective hedge is recognized through comprehensive income. The IFRS requires that those same gains or losses are recognized directly through the statement of changes in equity.

“To achieve better transparency of business accounting in the face of globalization in the securities and financial markets, disclosure of market value information in footnotes alone is not sufficient,” (*Ministry of Economy, Trade and Industry, 2004*). Now users of the information presented in financial statements expect complex financial instruments such as derivatives and hedges evaluated at fair value. They also expect the gains and losses associated with the financial instruments properly presented on the income statement, in the current period they are incurred, as opposed to the statement of changes in equity. Hence, US GAAP is the more principles-based standard because it provides a comprehensive method for evaluating derivatives and hedges. As more of these financial instruments become traded and utilized by corporations more frequently, the importance of determining effective methods of reporting and disclosing financial instruments will become a critical standard of accounting.

Stock Options and Share-Based Payment

Stock options, or share-based payment, have also been another complication and scandalous aspect of business operations for today’s corporations. Governing bodies such as the Securities and Exchanges Commission have begun to require more disclosure and increased scrutiny over precisely what is reported and how the options are measured in the financial statements. Therefore, it is important to explore and compare the various standards that have been implemented in regards to the issue of stock options and share-based payment.

Stock options, or share-based payments, provide the users of the financial statements with a clearer picture of what total executive compensation actually is. Therefore, measuring stock options are very important. Japanese GAAP does not provide any specific requirements regarding stock options. The reason for this is that stock options are viewed as free distributions with no subscription rights under the Japanese Commercial Code and hence, have no issue price. As a result of this neither an expense nor a liability is recognized. Hong Kong FRS does not have an equivalent standard to address or prescribe a treatment for this issue. PRC GAAP also has no specific requirements for share-based payment other than to disclose it as an off-balance sheet item. US GAAP and IFRS, however, have standards to better address the issue. US GAAP recognizes and measures stock options at fair value by using an option pricing model on the grant date, which is the general practice. When an exception to the general rule arises, the stock option is measured at its intrinsic value on the expense measurement date. The IFRS uses the option's fair value which is based on market prices or an estimate derived from a valuations technique when market prices are unavailable as of the grant date.

Stock option and share-based payment recording and disclosure require that proper market valuation be presented in the financial statements. IFRS relating to stock options requires that the market price be used to record stock options, provided that they are available. However, it is when market prices are not available that valuation techniques are used to estimate the stock option value. This allows for more flexibility than US GAAP because option pricing models are not the only method of determining

the fair value of the stock option. This flexibility considers it to be a more principles-based standard than all other equivalent standards compared.

Business Combinations

Business combinations have presented great difficulty not only for accounting standard setters, but for governing and regulating bodies who have, in the past, detected fraudulent activities by management of corporations through business combinations. According the IAS 22, the IFRS on accounting for business combinations, the objective of the standard is to “prescribe the accounting treatment for business combinations,” (*IAS: Summary of IAS 22, 2004*). It is an important factor to focus on in this comparison is the universal treatment of business combinations because it can eliminate or minimize exceptions to the basic principles of the standard to quality as a more principles-based standard. Two aspects of each standard are compared: the classification of business combinations and accounting treatments for those classifications, and the treatment of the positive and negative goodwill related to business combinations.

The classification and accounting treatment of business combinations are the most important determinant of a principles-based standard. Japanese GAAP classifies business combinations into two categories: acquisitions and uniting of interests. The purchase accounting method is used to record acquisitions while the pooling of interests accounting method is used to record uniting of interests. The prescribed treatments are clearly not universal and do not provide uniformity for treatment. Hong Kong FRS related to business combinations does not even consider or address a merger, or uniting of interests. The definition of a business combination, according to Hong Kong FRS, “is

the bringing together of separate enterprises into one economic entity as a result of one enterprise obtaining control over the net assets and operations of another enterprise,” (*HKICPA: SSAP 30, 2001*). All business combinations under this definition are recorded according to the purchase accounting method. However, since Hong Kong FRS does not include or consider mergers as business combinations, it provides a loophole in the accounting standard and therefore cannot be counted as an objective-oriented or principles-based standard. PRC GAAP does consider mergers, or entities that are operated under joint control, in its definition of business combinations. The accounting treatment for classes of business combinations is the same as that of Japanese GAAP, where acquisitions are recorded under the purchase accounting method and mergers are recorded under the pooling of interests method or a similar method in practice. US GAAP does not designate a difference between acquisitions and uniting of interests, or mergers, and hence, all business combinations are to be recorded under the purchase accounting method. The justification for universal treatment of business combinations under US GAAP is because it is in compliance with FASB’s *Objective of Financial Reporting by Business Enterprises* which states: “Financial reporting should provide information that helps in assessing the amounts, timing, and uncertainty of prospective net cash flows to an entity.... Because the purchase method records the net assets acquired in a business combination at their fair values, the information provided by that method is more useful in assess the cash-generating abilities of the net assets acquired than the information provided by the pooling method,” (*FASB: Summary of Statement 141, 2001*). IFRS regarding business combinations prescribes the same accounting treatment for acquisitions and mergers, or uniting of interests, as that of Japanese and

PRC GAAP. However, the IFRS considers all business combinations acquisitions unless they meet the criteria for an exception in which case the business combination is considered a uniting of interests under which a pooling of interests accounting method is used.

Under the purchase method of accounting for business combinations, treatment for positive and negative goodwill related to the acquisition or merging of net assets of the enterprises involved is required. Japanese GAAP amortizes both positive and negative goodwill systematically. For positive goodwill, the period of amortization should be a length of time in which goodwill is considered effective. Negative goodwill's amortization period should use a length of time that is appropriately in accordance with the reality of the acquisition. Hong Kong FRS also systematically amortizes goodwill, although no distinction is made between positive or negative goodwill related to business combinations, over a useful life which is a period that "should reflect the best estimate of the period during which future economic benefits are expected to flow to the enterprise," but should generally not exceed 20 years. PRC GAAP also follows the same systematic of goodwill related to business combinations as that used by Japanese GAAP and Hong Kong FRS, although the amortization period generally should not exceed 10 years. US GAAP has a different approach use to reduce positive and negative goodwill. Impairment testing is performed at least annually or when impairment possibilities are increased by events or circumstantial changes for positive goodwill under the US GAAP purchase accounting method. Negative goodwill, however, is deducted from the acquired assets (with certain expenses) on a pro rata basis. If any negative goodwill remains then the balance is immediately recognized as an

extraordinary gain. Positive goodwill according to the IFRS requires the exact treatment as that in US GAAP. Negative goodwill is not recognized; however, if negative goodwill exists, all acquired assets and liabilities are reassessed to ensure complete identification and recognition. If the reassessment deems that negative goodwill exists then the balance is immediately recognized as a gain.

Universal accounting treatment of all classifications of business combinations eliminates or at least minimizes exceptions and, consequently, reduces loopholes left to exploit by management in accounting standards. With a single accounting method, the purchase method, in use a principles-based standard objective can be accomplished. This is what qualifies the US GAAP standard on business combinations as a principles-based standard. The objective supporting this standard not only prescribes an accounting method for business combinations but helps in assessing potential future cash flows by reporting the business combination at fair value whereas requiring a pooling of interests method gives a less accurate depiction of the potential future cash flows generated by the assets acquired or merged.

Segment Reporting

Due to the globalization of business operations and the trend of mergers and acquisitions, the lines of operations or segments of a business have become blurred and consequently created difficulties in determining the main focus of an enterprise.

Businesses report their financial information based upon segments that are grouped in various ways. This method of reporting financial information helps investors focus on areas of operation of a business that generate a majority of its revenues and related

expenses. Therefore identifying appropriate and realistic reporting segments and disclosing relevant information related to those segments is paramount to fulfilling the needs of users of a company's financial statements.

Segment classification can be difficult to determine based upon the circumstances surrounding a company's existence and source(s) of its revenues and related expenses. Japanese GAAP reports company segment information based on two classifications: the line of business and the geographical location. Companies are allowed to report revenues and related expenses together if they are generated from products of similar type and characteristics. They are also allowed to group together revenues and expenses generated from similar manufacturing methods, sales markets, etc. The segment is then divided further into segments of similar geographical proximity, economic activities, and interrelationships of business activities. The Hong Kong FRS for segment reporting requires that financial information be reported by a business segment and by geographical segment. A business segment is defined as "a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments," (*HKICPA: SSAP 26, 2001*). Criterion used to identify whether a product or service is related include:

- The nature of products or services,
- the nature of processes used for the products or services,
- the classification of customers targeted for the products or services,
- the distribution methods used for the products or services, and
- the nature of the regulatory environment, if applicable.

The Hong Kong FRS defines a geographical segment as: “a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments,” (*HKICPA: SSAP 26, 2001*).

Criteria used to identify geographical segments include:

- Economic and political environment similarities,
- Operational relationships in different geographic areas,
- Operational proximities,
- Specific operational risks within an area,
- Control regulations surrounding exchange, and
- Any potential currency risks.

PRC GAAP does not have any specific requirements regarding segment reporting; however, it is important to mention that PRC GAAP focuses on the consolidation of subsidiaries, associates, and jointly controlled entities, when presenting financial statements. US GAAP uses a different approach for segment reporting- the management approach. Under the management approach, operating segments are identified and reported on. Operating segments are defined based upon a corporation’s organizational structure and its system for internal financial reporting. US GAAP also allows for segmentation to be reported by alternative methods, however, business or geographic-based segmentation is not permitted. The IFRS on segment reporting identifies segments based upon profitability, or the differences in risks and returns. An alternative method for reporting segments is the management approach used by US GAAP, as well as reporting based upon line of business and geographic location. Each of the segment

reporting standards appear consistent in that they each individually establish principles for reporting financial information by segment.

In determining which standard is a more qualified candidate for a principles-based accounting standard, the disclosure requirements for segment reporting is an important aspect to compare. Japanese GAAP has different disclosure requirements for the different reporting segments. For line of business segments the reporting company must disclose: sales, operating income or ordinary income, the method of business segment identification, and the names of products that play a major role in the segment. For geographical location segments the following items must be disclosed: sales, operating income, the method of country or regional segment identification, and the names of the major countries or regions included in each segment. Additionally, any overseas sales that occurred in countries or regions other than Japan are required to be disclosed. Japanese GAAP, although there are restrictions to the forms of segments permitted, requires a firm to provide an explanation as to how particular segments are identified. This piece of information can be valuable to investors because it allows users to better evaluate the risks and returns associated with a multi-operational enterprise. Hong Kong FRS for segment reporting requires the same disclosures for both the line of business and the geographical location segments. These disclosures include segment revenue, segment results which is the result of segment expenses deducted from segment revenue before any adjustments are made for minority interests, the total carrying amount of segment assets, segment liabilities, the total costs incurred during the period to acquire segment assets that are to be used for longer than 1 period, the total amount of expenses included in the segment result relating to depreciation and amortization, the total amount of

significant non-cash expenses, and the total amount of the enterprise's share of the net profit or loss of associates, joint ventures, or other entity investments included in the reporting segment. Also, the enterprise is required to make a disclosure of the reconciliation between the information presented in the reconciliation between the information disclosed in the reportable segment and the total information presented in the consolidated or individual financial statements. Because Hong Kong FRS restricts the forms of segmentation allowable for reporting, it does not require explanations for the segment identification. This does not help meet investors' needs in regards to understanding the main functions of an enterprise. US GAAP requires a much greater amount of disclosure for segment reporting. First, general information regarding the specifics used for segmentation (i.e. types of products, processes, and/or services, etc.) are required for disclosure. Then information regarding segment income or loss, segment assets, and measurement standards for each segment are also required for disclosure. This information includes details such as income from external customers, other segment income, etc. Similar to Hong Kong FRS, a reconciliation of segment information with consolidated or individual enterprise financial statements is disclosed. The reconciliation must specify items such as total segment revenues and incomes and losses. Lastly, information about the corporation must be disclosed as a requirement under US GAAP. This information must include items such as: sales by product group, external sales by geographical areas, balances of long-term assets, as well as information regarding major customer dependency. Disclosed information required under US GAAP, although greater in amount than the other compared regions, allows the user of the financial statements a greater amount of insight as to the information management uses to make certain

significant decisions within the enterprise. IFRS segmentation requires basic and supplementary requirements for disclosure. The basic reporting requirements include: revenues, income/loss, and reconciliation with the consolidated or individual enterprise financial statements. Supplementary disclosures include items such as external sales, total assets, and capital expenditures. The IFRS does not require as much detail in their segment disclosure as that of US GAAP and consequently, gives less insight as to the method of management of operations to the users of the financial statements.

In terms of identifying and disclosing segment financial information, the US GAAP standard for segment reporting appears to be the most principles-based standard. The basic objective of the segmentation standard is “that a public business enterprise report financial and descriptive information about its reporting operating segments...[where] the financial information is required to be reported on the basis that it is used internally for evaluating segment performance and deciding how to allocate resources to segments,” (*FASB: Summary of Statement No. 131, 1997*). This objective is accomplished not only by the method of segmentation identification, but by the disclosure requirements. Operating segmentation identification bases the determination of segments of an enterprise on the enterprise’s organizational structure and its system for internal financial reporting. Because the segmentation uses the same information as viewed by management, users of the financial statements better comprehend the internal working of the enterprise thereby increasing its transparency which is a benefit to users of the financial statements. Also, the segmentation will give a more accurate depiction of what an enterprise’s main focus of operations is. This also helps the users or potential investors make better informed investment decisions. The disclosure requirements under

the US GAAP standard for segment reporting also help it qualify as a principles-based, or objective-oriented, standard. Although US GAAP require a significantly greater amount of items disclosed than the other countries or region in the comparison, the disclosures create more transparent financial statements. For example, by disclosing major customer dependency, users of the financial statements are able to better assess whether a going concern issue might exist. A more transparent enterprise helps the users of the financial statements better determine the risk and return associated with an enterprise as well as allows users of the financial statements to make better informed judgments about the enterprise on a holistic basis.

Conclusion

Principles-based, or objective-oriented, accounting standards represent a great number of benefits to a number of parties that use the financial statements. The general logic behind accounting standard setting, at least in the case of the U.S. Financial Accounting Standards Board, is that “high quality accounting standards that improve the transparency of information ‘are essential to the efficient, functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, and understandable financial information,’” (*FASB: Principles-Based Approach To U.S. Standard Setting, October 2002*). A more principles-based approach to accounting standard setting, not only in the U.S., will allow for a number of benefits. Under a more principles-based standard set, comprehension and implementation of the principles will be easier since they are more broadly defined. Also, a principles-based standard set will require an increased use of professional judgment, on the parts of management and the

auditor, which will consequently present the economic substance of the transaction and/or the event the standards cover. Exceptions and the need for interpretive guidance to the principles will be minimized which will, as a direct result, reduce the possibility of transaction or event restructuring and increase relative enterprise comparability of financial statements. Lastly, broadly defined principles-based accounting standards will be more flexible and responsive to the constantly emerging issues in the ever-changing financial and economic environments in which companies operate.

The adoption of principles-based accounting standards will help expedite the goal of standard setters to develop a unified and high-quality set of accounting standards. Therefore, as a precursor to yet published studies conducted by accounting standard setting entities, this paper explores the various standards of critical concepts of countries and regions that play a significant role in today's global economy. A comparison of Japanese GAAP, Hong Kong FRS, PRC GAAP, US GAAP, and IFRS was conducted over standards regarding intangible assets, accounting for impairment, related party transactions, financial instruments- specifically focused on derivatives and hedges, stock options and share-based payments, business combinations, and segment reporting to determine which, from each concept, would qualify as a more principles-based accounting standard.

The results differed over the various concepts. US GAAP qualified as a more principles-based standard for intangible assets. The method used by US GAAP for recording and measuring intangible assets (at fair value) and its method of depreciation (impairment testing) reflected the economic substance of the transaction more accurately which is a benefit that results from a principles-based accounting standard. The IFRS for

accounting for impairment resembled a principles-based standard because it also reflected the economic substance of an event/transaction by not amortizing but periodically testing for impairment. The loss resulting from the impairment test, if any, is measured using the recoverable amount- which involves the asset's fair market value- as a basis for allocation. Also, as an alternative, IFRS allows for other rational methods to be used which is in accordance with the broad characteristic of a principles-based accounting standard. The Hong Kong FRS for related party transactions gives a more broadly defined and inclusive definition for a related party that coincides with the characteristic of a principles-based standard. However, a modification would need to be made to the standard to require the disclosure of related parties that did not result in a transaction in order to best meet the needs of the users of the financial statements. The US GAAP standard for financial instruments, specifically derivatives and hedges, provides a more principles-based approach because it provides a more comprehensive method of evaluation. In terms of stock options and share-based payments, the IFRS allows for increased flexibility in determining the fair value of the stock option because the measurement is not confined to an option pricing model, but allows for the use of valuation techniques which can be employed to estimate stock option value. The US GAAP standard prescribing the accounting treatment of business combinations qualifies as a more principles-based standard. The universal treatment of all classifications of business combinations, the purchase accounting method, minimizes exceptions and the need for interpretive guidance, another beneficial characteristic of a principles-based standard. The objective of the standard also increases its qualification because it requires the reporting of the economic substance of the transaction by reporting the business

combination at fair value. US GAAP is also a more principles-based standard in terms of segment reporting. The objective of the standard is accomplished and users of the financial statements are more easily able to comprehend management's decisions by viewing their operating segments and are consequently better informed to make significant investment decisions of their own.

This study serves as a preliminary comparison for principles-based standard setting. Taking into consideration that definitive plans for revision of current regional and national accounting standards have not been finalized, this particular study gives some insight as to the possible direction or possible revisions that will be made to implement a unified, principles-based accounting standard set.

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