THE IMPACT OF GLOBALIZATION: THE CONVERGENCE OF FINANCIAL REPORTING SYSTEMS AND HARMONIZATION REQUIREMENTS

UČINAK GLOBALIZACIJE:PRIBLIŽAVANJE SUSTAVA FINANCIJSKOG S IZVJEŠĆIVANJA I UJEDNAČAVANJE ZAHTJEVA

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Abstract: *Global convergence of financial reporting systems has accelerated as national accounting standards converge with one another, strengthening IASB as a global standard setter. This paper addresses major developments regarding international convergence of financial reporting systems, fostered by accounting standards harmonization. It is driven by the widespread idea that markets' globalization presupposes high quality accounting standards and accounting basis' consistency in financial reporting, to gather the confidence of accounting information users, in both, private and public sector. The question we pose is how far the convergence in terms of information equivalence has proceeded and whether further reporting systems' harmonization is required?*

Key words: *accounting standards, financial reporting systems, international convergence, information equivalence, market globalization*

Sažetak: *Globalno približavanje sustava financijskog izvješćivanja je ubrzano kako se računovodstveni standardi povezuju jedan s drugim,ojačavajući IASB kao globalni standard. Ovaj rad bavi se glavnim smjernicama razvoja koje se odnose na približavanje sustava financijskog izvješćivanja nastalih na osnovi usklađivanja računovodstvenih standarda. Opće prihvaćena ideja je da globalizacija tržišta pretpostavlja računovodstvene standarde visoke kvalitete i dosljednost računovodstvenih osnova u financijskom izvješćivanju,kako bi osigurali povjerenje korisnika računovodstvenih informacija u privatnom i društvenom sektoru. Pitanje koje postavljamo je koliko je napredovalo približavanje u odnosu na usklađenost informacija i je li potrebno daljnje usklađivanje sustava izvješćivanja.*

Ključne riječi: *računovodstveni standardi, sustav financijskog izvješćivanja, međunarodno usklađivanje, usklađenost informacija, globalizacija tržišta*

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1. Introduction

The process of adopting a uniform set of accounting standards, as a part of the international convergence of financial reporting systems, is perceived as a very important aspect of the globalization of the world economy (Australian Accounting Standards Board - AASB, 2002, Herz, 2007). According to The International Accounting Standards Board (IASB), "a single set of high quality, uniform, globally-applied, and enforced accounting standards is essential for both domestic and cross-border investment and financing decisions. It is desirable to have a uniform set of accounting standards because inconsistency in accounting standards is causing confusion in the investor community"(Asia Focus, 2008). In addition, rapid globalization of capital markets, cross-border investing, costs and complexity of multiple accounting and reporting regimes, the fact that supervisors and auditors had to spend much time analyzing the key accounting differences between jurisdictions, has resulted in further acceleration of the global convergence of accounting standards, as national accounting standards are being converged with one another in becoming more consistent with the International Financial Reporting Standards (IFRS). For many years, accounting professionals, regulators, financial analysts and investors have called for efforts to harmonize accounting standards across countries. As more countries around the world adopt and implement IFRS, many accounting experts examine the following: assessment of the progress of national accounting standards setting bodies in converging their standards with IFRS, variations from/similarities of national financial reporting standards with the IFRS, practical implications of a reliance on IFRS rather then on existing national standards, the purported costs and benefits of adopting IFRS, and effects of convergence on the financial reporting and accounting systems of domestic and multinational companies, and audit firms (Gray, et al., 2008, Fontes, et al., 2005, Lindahl & Schadéwitz, 2008).
In this paper we aim to address and capture recent developments in international convergence of financial reporting systems, encouraged by accounting standards harmonization. We examine the degree of convergence/harmonization process achieved so far. The existing research shows that in some cases the requirements of IFRS are very similar to existing national standards (e.g. the UK), so changes to existing approaches are generally small. However, in other areas adoption of IFRS may have more significant implications. Australian experience, for example, indicates the uncertainty regarding interpretation of the standards, because of their greater complexity in comparison to the national reporting standards used prior to IFRS adoption (Gray, et al., 2008). Besides discussing the reliance of national accounting/financial reporting standards on IFRS, we discuss two, in our opinion, most interesting convergence processes: the convergence of the two main financial reporting systems – US GAAP (United States Generally Accepted Accounting Principles) and IFRS, and the convergence of International Public Sector Accounting Standards (IPSASs) towards IFRS. Even though the US GAAP accounting has been used by the largest part of the global capital market, the use of IFRS has in recent years been expanding globally. Even though the consistency in their application remains to be confirmed, to date approximately 100 countries worldwide have, either

mandatory or optionally, adopted IFRS (Gray, et al., 2008). According to Grossi (2006), besides those countries that have been currently adopting the accruals in reporting and budgeting, and complying to almost all of the IPSASs requirements, a wide range of national governments, with the intention to change to the accruals, has expressed the will to consult IPSASs. Even the United Nations announced the adoption of IPSASs by 2010 (Accountancy age, 2007).
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2. The movement towards global private sector financial reporting – IFRS

As aforementioned, the use of IFRS is truly becoming global. IFRS are considered as "principles-based" set of standards and to date approximately 100 countries have adopted IFRS on a mandatory or a permissive basis. Prior to 2005, there were around 350 publicly listed companies that used IFRS. Since 2005 all listed EU companies (including banks and insurance companies) have been required to use IFRS. In the UK, for example, where the convergence to IFRS is planned to be achieved by a gradual replacement of existing UK Financial Reporting Standards – UK FRSs (The Chartered Institute of Public Finance and Accountancy - CIPFA, 2006), the UK government has announced that it will allow entities to choose to adopt IFRS, with some exceptions (i.e. charitable companies). Finnish public companies have been obligated to present consolidated financial statements in compliance with the International Accounting Standards (IAS)/IFRS, since 2005. Interestingly, Canada, India, and Japan have announced that they will adopt or converge with IFRS in 2011 (Gray et al., 2008). The government of Russia has been implementing a program to harmonize its national accounting standards with IFRS since 1998, while full transition is expected to take place from 2011. In certain countries where accounting framework has been set up as a law – based system (e.g. Croatia), national financial reporting standards had not been developed, whereas the appliance of IFRS had been enacted as obligatory for big companies listed on the Stock Exchange, and optionally for all the others. After a few years of IFRS in practice, several countries decided to develop national financial reporting standards mostly for the purpose of regulating the reporting for Small and Medium Enterprises (SMEs) who found it complex to follow the IFRS, while big companies listed on the Stock Exchange continued to mandatory follow the IFRS. In Croatia, for example, SMEs are obliged to follow

Croatian Financial Reporting Standards that were developed in the beginning of 2008. In Singapore, National Financial Reporting Standards have been modelled closely according to the IFRS, while SMEs have their own set of accounting standards. The UK Accounting Standards Board (UK ASB), as it is addressed later in the paper, has also found IFRS as too complex for SMEs' financial reporting.

When discussing the reliance of national accounting/financial reporting standards on IFRS, one can not argue that the convergence of US GAAP and IFRS, has gained much attention worldwide. Even though there has been controversy about whether the time and effort put into convergence of these two financial reporting standards, is worth it, the US FASB (Financial Accounting Standards Board) and the IASB have been pursuing the convergence discussion (FASB/IASB Convergence Program). Memorandum of Understandings, brought in 2006, specified a set of items for which either the convergence or measurable progress would be achieved in the upcoming years. The progress in convergence has further led towards the negotiations for the mutual recognition of accounting standards among securities regulators of major capital markets. In fact, following the mandatory application of IFRS to listed companies in the EU markets, the US Securities and Exchange Commission (SEC) issued a proposal that non - US companies which use IFRS would be able to access the U.S. capital markets without having to provide US GAAP reconciliations. Finally, in 2007 the SEC requested information on whether US companies should be allowed the choice of using US GAAP or IFRS, taking into account the expected progress in the convergence process by 2009. Once the decision to adopt IFRS has been made, these organizations start facing the implementation issues.

As for the recent research on IFRS – the literature has started providing polemics about the benefits of allowing different accounting systems to compete (e.g. Schmidt, 2002), about the challenges/ difficulties of applying IFRS in different countries and about the compliance among companies who have chosen to adopt IFRS (e.g. Glaum &Street, 2003). We notice that while certain countries decided on developing and improving their existing national standards to keep pace with international equivalents and to achieve convergence by a gradual replacement of existing national standards with those based on IFRS (e.g. UK), in Australia, for example, the implementation of IFRS has already occurred in all companies, regardless of their size and no matter whether they are listed on the Stock Exchange or not. The UK ASB approach and starting point to convergence was that there can be no case, in the medium term (three to five years) for the use of two sets of different accounting standards in the UK, and that UK accounting standards should be brought into line with IFRS (CIPFA, 2006). Due to the fact that the vast majority of UK companies are likely to continue to use UK GAAP (Generally Accepted Accounting Principles) for a considerable time, UK standards will need to be developed and improved to keep pace with international equivalents. In addition, in accordance with its view that there is no medium term case for divergent standards, the UK ASB would not develop new standards which are inconsistent with IFRS. Rather, convergence will be achieved by a gradual replacement of existing UK Standards with those based on IFRS. It is the ASB's intention that separate UK Standards should be no more demanding or restrictive than IFRS, since IFRS will be used by the entities important for the capital markets. In accordance with mentioned convergence strategy, in 2004 the UK ASB issued UK FRSs that are based on international equivalents. These include FRS 25 and FRS 26 on financial instruments. However, there are two important areas where UK approaches had no international equivalent: financial reporting for smaller entities and Statements of Recommended Practice. As we already mentioned, it is precisely the issue of IFRS as being too complex for smaller entities, that has recently been articulated and discussed much, and that urged certain countries to develop their own national financial reporting standards (e.g. in Croatia). In that respect, IASB is currently consulting on a project to reduce the burden of applying IFRS on smaller entities. In the meantime UK ASB intends to retain the Financial Reporting Standards for Smaller Entities. In Australia, however, IFRS are adopted as obligatory for all entities and, according to Gray et al. (2008) there are no differences regarding the size of the companies when costs/benefits' measurement of IFRS implementation is concerned. Gray et al. (2008) project documented the views of preparers of financial reports on the costs and benefits of making the transition from Australian GAAP to Australian Equivalents of International Financial Reporting Standards. According to their study findings, the financial statements' preparers perceived the uncertainty regarding interpretation of the standards and the complexity of the standards themselves as major difficulties of implementation. It resulted in the increased time and cost spent in discussions with auditors. Specific areas such as accounting for financial instruments, accounting for income taxes, and accounting for the impairment of assets were reported as difficult (and costly) to obtain the necessary information to present the transactions or balances in accordance with IFRS. This in fact confirms the thesis that adopting IFRS is more costly in the short-run, while benefits of implementing IFRS are rather expected to be achieved in the long-run.

3. Public and private sector reporting systems - how close is close enough?

The aforementioned trend of international convergence and harmonisation policy of private sector accounting and financial reporting standards has also made the influence on the process of entire public sector reform that has been progressing worldwide. In addition, the changes in public sector (governmental) accounting were central to the public sector reform. Accounting and management challenges for general government and its component entities have implicated a continuous introduction of innovations and reforms in accordance with new international trends, techniques and experiences, already adopted within the private sector. In fact, the International Public Sector Accounting Standards Board (IPSASB) launched its Standards Programme in 1996. It was then decided to focus on the full accrual accounting and also to address the needs of constituents on the cash basis, which was yet the reporting basis for the large majority of governments globally. The first phase of the Standards Programme was completed in 2002. It comprised the publication of 20 accrual-basis IPSASs and allied guidance on the migration from the cash basis to the accruals basis. To date IPSASB has issued 26 accrual-basis IPSAS reflecting an array of international trends and views concerning governmental accounting development. These trends refer to the convergence of public and private sector financial reporting systems that results in transparent, standardized and internationally comparable accounting information, which consequently decreases diversifications of accounting systems and improves the quality of government reports, especially regarding public expenditures. They comprise the following:

- the convergence of IPSAS towards IAS/IFRS (the accruals implementation) and the harmonization of national and international public sector accounting (mostly referring to the accounting basis' consistency in financial reporting and budgeting),
- the harmonization of information systems - accounting and statistics reporting systems (the identification of differences in approach between financial reporting and statistical forms of reporting such as the System of National Accounts and the Government Financial Statistics system that is accruals based),
- the development of cost and managerial accounting instruments within the public sector to enhance the harmonization of internal and external reporting.

So far, IPSASs have been adopted by some international bodies, such as the North Atlantic Treaty Organisation and the Organisation for Economic Co-operation and Development. Although they have not been directly and mandatory adopted by many national governments, they have been influential in other ways. Some countries and supranational organisations have used them to inform their own standard-setting processes as they move to the full accruals basis of reporting. For example the European Commission has used IPSASs as the basis for the development of its accounting policies for its daunting objective of migrating to the full accruals basis in 2005. Jurisdictions which have been on the full accruals basis for some time have used the approaches on public sector specific issues to inform their accounting policies in these areas, because neither IFRS nor national accounting standards give firm steers as to the appropriate approaches. In the UK, The Financial Reporting Advisory Board has been particularly keen to follow the emerging approaches to the treatment of tax revenues and the state pension and has highlighted the work of the IPSASB on these issues in its reports to the Parliament.

Even though there has been controversy in the literature about whether the introduction of private sector management and accounting techniques into the public sector is appropriate, taking into account the specific non-for profit nature of general government sector, precisely a non-financial nature of public sector resources, the move to the accruals in government financial reporting and budgeting has gained universal acceptance. As emphasised, certain countries have been adopting the accruals in, both, financial reporting and budgeting, complying almost to all of the IPSASs requirements -Australia, Canada, Sweden, and New Zealand (Roje, 2007), while a range of national governments with the intention to change to the accrual basis have expressed the will to consult IPSASs -United Arab Emirates, The Netherlands, Malta, Israel, etc. (Grossi, 2006). In certain countries where neither national public sector accounting standards have been developed, nor IPSASs appliance required (e.g. Croatia), the implementation of certain accounting solutions defined by IPSASs has been recommended by regulations (Vašiček, 2004, Vašiček, 2007). Interestingly, the UN also announced that all of its "agencies, departments,

comities and headquarters must adopt IPSASs no later than 1 January 2010" (Accountancy Age, 2007). In a number of developed countries, the introduction of private sector management techniques in public sector, which has led to the full adoption of the accruals in both reporting and budgeting, shifted the emphasis of the budgetary process away from cash inputs and towards outputs and outcomes measurement practise (Roje, 2007). In particular, a study by Ellwood and Newberry (2007) compares the development and use of accrual accounting in public sector financial management reforms in two countries that are among those who made the largest progress as far as public sector financial reform is concerned - the UK and New Zealand. Their findings show that the adoption of accruals in the public sector is intended to improve transparency and accountability. In addition, as we understand it, accrual accounting provides a means to encourage efficient public assets utilisation and to reduce the government's role to that of procurer of services and enforcer of rules set by others, thus, enhancing greater competition in the public sector.
The concept of so-called "modern government" has led to governmental accounting information system being regarded as a managerial and not just purely administrative–oriented one, and the need for further harmonization of internal and external financial reporting in general government sector emerged. In fact it is our understanding that precisely in order to encourage international transparency of national economies as for public finances are concerned and to continue with their adjustment towards the future trends concerning upgrading public sector accounting standards, many national and international accounting boards and associations have been intensively working on preparing and perfecting public sector accounting standards. To date IPSASB has issued 26 accrual-basis IPSASs, reflecting an array of accounting and management challenges for general government and its component entities. Introducing accruals in governmental financial reporting has enhanced the development of cost and managerial accounting instruments in public sector. Consequently, a large portion of the literature has been devoted to the managerial impact of implementing accruals in public sector, stating that accruals would improve decision making by providing managers with a new set of information that was not available to them under cash- based accounting. Naturally, the need for efficient budget planning and costs' control enhanced the internal and external reporting harmonization process and the introduction of performance measurement practice in the general government sector. (Vašiček, 2006).

4. Conclusion

Globalization of financial reporting information systems is much encouraged by the accounting/financial reporting standards harmonization requirements under the lead of the IASB whose IFRS are truly becoming a common/global set of regulations. Over 100 countries worldwide use IFRS/IAS on either compulsory or permitted basis and according to our findings more countries are expected to follow this trend in the near future. The need for high quality global standards to enhance sound and consistent financial reporting, and the fact that the inefficiency and ineffectiveness of public sector in its actions, extended to a belief that public and private sectors did not have to be managed in fundamentally different ways, fostered the already started harmonization of national and international public sector accounting systems and their convergence towards the private sector financial reporting standards.

As the convergence of public and private sector financial reporting systems progresses and a complex changes regarding financial reporting rapidly take place worldwide, there is a constant need for more review papers to provide the audience with the updated information regarding the latest changes in this field. This paper is precisely an attempt to contribute to the existing literature with a review of a portion of most recent changes, but also to emphasize some issues we find important to be more empirically examined in the literature, as more countries adopt global reporting standards, such as: how difficult was the transition to and implementation of IFRS and IPSASs; whether preparers expect the benefits of using IFRS/accrual based IPSASs to outweigh the costs and if further reporting systems harmonisation is expected. Thus, in this paper we address major developments in international convergence of private and public sector accounting standards and financial reporting systems, and the developments regarding the convergence of national towards the global financial reporting systems. Even though the paper articulates the idea that the globalization of markets presupposes a set of a high quality accounting standards and globally consistent accounting basis in financial reporting to gather the confidence of accounting information users, in both, private and public sector, we do not imply that different capital markets or different sets of reporting on public expenditures need identical standards on each and every case. What we, instead, find as important is that reporting in either private or public sector has been done to a high standard and that a certain degree of equivalence among different systems ensures more comprehensive and more comparable information that would further encourage international transparency of national economies. Our analysis of different countries' experiences shows that there has been a huge progress of national accounting standards setting bodies in converging national standards with IFRS/IPSASs and that further progress in harmonizing different financial reporting systems is to be expected. We find that for jurisdictions with pre-existing domestic regulations, the requirement to converge with IFRS/IPSASs involves changes in national financial reporting practices. Yet, the level of differences/similarities of different national financial reporting standards with the IFRS/IPSASs and the degree of the convergence progress differ across countries.

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