The Evolution of Generally Accepted Accounting Principles: A Focused Look into the International Financial Reporting Standards

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Abstract: Financial reporting has long been an essential lens through which shareholders assess the management's operation of companies and through which external users such as potential investors evaluate how companies are structured and perform financially for economic decision-making. For this reason, the truth and fairness of financial statements is emphasized in financial accounting to reflect the economic substance over the legal form. As cross-border trades and investments grew by leaps and bounds after the World War II, a call for a globally uniform and consistent set of accounting standards thrived in full swing. Hence, the genesis of IAS and subsequently IFRS for better quality, comparability, understandability, and transparency of financial statements. Over recent years, the trend in accounting harmonization with gradual convergence between IFRS and US GAAP has also become prominent. However, accounting standards are never perfect in presenting economic reality upon their inception. Blatant financial scandals play an indispensable role in shaping accounting standards for improvements. This paper takes a focused look into IFRS to examine how the generally accepted accounting principles evolve in reaction to scandals and loopholes criticized, with a detailed analysis of the standards for leases and revenue recognition. A generic discussion on the difference and convergence between IFRS and US GAAP concludes this paper.

Keywords: International Financial Reporting Standards (IFRS), leases, revenue recognition, accounting harmonization

1. Introduction

Throughout the evolution of financial accounting and the economy, financial reporting by companies has consistently been of great significance in the accountability of management and the demonstration of useful information for economic decision-making by stakeholders. In accordance with the agency theory, ownership of companies is possessed by the shareholders while control over the entities resides with the management appointed by the shareholders, resulting in a potential conflict of interest between the two parties. Therefore, financial reporting firstly plays as an important instrument for the shareholders to hold the management to account for its utilization of the companies' resources entrusted. Also, financial reporting serves as a lens through which the stakeholders view companies

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for decision-making. Specifically, investors in the capital markets pursuing capital gains are the major users of financial information for the purposes of predicting the future performance, position, and cash flows of companies. Hence, the fundamental and enhancing qualitative characteristics are established in the conceptual framework to ensure the usefulness of information for sound decision-making. For example, the relevance of the information for decision-making is enhanced with an alternative revaluation model in financial reporting to reflect the market value.

However, the usefulness of financial reporting cannot achieve on its own. In the absence of uniform accounting principles, chances are that financial statements can be manipulated to best depict companies' financial position and performance to the extent that truth and fairness of information is impaired. Thereby, the need arises for universally accepted standards applicable in each jurisdiction. Of all standards, the International Financial Reporting Standards (IFRS) and the US Generally Accepted Accounting Principles (US GAAP) are the most prevailing and renowned due to their quality. Between the two, IFRS is the major focus of this paper. The international adaptation of IFRS aims at ensuring consistency and uniformity in accounting practices and this in turn enhances comparability between the financial information of different firms across different nations, enabling stakeholders to make informed decisions. Transparency is also promoted by extensive disclosure requirements to uncover relevant and reliable information, thus reducing information asymmetry between management and intended users.

In reference to existing literature, the comparability stemming from IFRS adoption removes the cross-border barriers in the capital markets and expands investment opportunities, evidenced by a 4% increase in the shareholdings of the worldwide financial institutions in IFRS adopters two years after the adoption [1]. The reduced deliberate practice of aggressive accounting for a misleading view and the more opportune reporting of loss in Korea after the mandated IFRS adoption also testify to the quality of accounting information offered by IFRS [2]. This quality is further witnessed in the enhanced quality and detail of disclosure with the adoption of IFRS [3].

2. Major Developments in IFRS/IAS

2.1. Overall Review of the Evolution

Based on Camfferman and Zeff, an economic integration worldwide resulted from the booming growth after World War II in cross-border trade and investment; the boost in the multinational corporations especially from the UK and US by the late 1960s; and the removal of trading and investment barriers following the post-war establishment of international trading blocs [4]. This integration necessitated accounting harmonization. To answer the call, the International Accounting Standards Committee (IASC) was founded in 1973 with a vision to foster a globally coherent and consistent set of accounting standards. In the 1990s, the initial set of International Accounting Standards (IAS) was introduced including 31 standards. Subsequently, in 2000, the International Accounting Standards Board (IASB) succeeded the IASC, in parallel with the genesis of the IFRS Foundation. In 2001, IASC Standards were adopted as a whole by the IASB and significant modifications and additions commenced only after 2003. Currently, 17 IFRS standards have been in effect and 12 IAS standards among the total of 41 have been superseded by IFRS or withdrawn.

Besides the need for accounting harmonization and uniformity, the dramatic accounting frauds are another force in shaping the continuing evolution of accounting standards for better transparency and quality. Take for example the Enron scandal, one of the severest frauds historically. Succinctly speaking, billions of debts in US dollars, which Enron was actually obliged for, were concealed from the investors by off-balance-sheet transactions and the utilization of special purpose entities (SPEs) to misrepresent low leverage and financial risk. In reaction, the Financial Accounting Standards Board (FASB) and IASB were urged to collaboratively revise the then standards for leases, which were FAS 13 and IAS 17. Previously, it was unsatisfactory that these standards allowed most lease agreements to be excluded from the balance sheets of the lessees, which was then resolved in the succeeding IFRS 16. Furthermore, the off-balance-sheet treatment of SPEs by Enron stimulated IASB to review the topic of consolidation of SPEs, and the IASB eventually in 2011 issued IFRS 10, 11, and 12 to govern the consolidation of financial statements [5]. However, as reported by Camfferman and Wielhouwer, the response to accounting scandals by the standard-setters and regulatory bodies oftentimes suffers long time lags, in which case when the amendments are effective there can be new scandals erupting to make the standards less relevant [5].

After a brief review of the overall evolution of IFRS, the following sections focus on the major developments in two selected standards on the topics of revenue recognition and leases.

2.2. Revenue Recognition: From IAS 11 & 18 to IFRS 15

Before the enforcement of the new standard for revenue recognition, IAS 11 and IAS 18 were effective for revenue recognition since their issuance in 1979 and 1981 respectively. The year 2014 witnessed the publication of IFRS 15, whose application has been required from 1 January 2017 onwards and has replaced the outdated IAS 11 and 18. The weaknesses and inconsistencies observed in IAS 11 and 18 warrant the emergence of IFRS 15. The previous standards give rise to the great variety in the practices of recognizing revenue since the guidance on important application issues, for example, the treatment for contracts containing various obligations is fairly limited. In terms of complicated package contracts including both selling and providing of goods and services, difficulty arises in applying the preceding standards to untangle the bundle. Before the adoption of IFRS 15, not rare was the scene of IFRS-adopting companies referring to the standards and interpretations of US GAAP for guidance to apply IAS 18 [6]. Additionally, without consideration of and guidance on the uncertainties such as sales returns and prospective obligations of customer warranties, the provisions in IAS 18 can lead to inconsistent treatments for the acceptance timing and the corresponding deferral when recording revenue. The recognition criteria, particularly the risks and rewards of ownership, may also result in sold goods not being recognized as revenue but still as inventory after the control has been transferred upon delivery. This is possible if companies retain an obligation for undesirable performance beyond the normal provision for warranties.

To deal with the inconsistencies and weaknesses, IFRS 15 invents an explicit five-step approach to revenue recognition. The recognition scope is extended from mainly the sale and provision of goods and services to any contracts with customers excluding exceptional transactions such as lease and insurance contracts. In Step 2 to identify performance obligations in a contract, more detailed provisions are given for when unbundling distinct performance obligations and separating revenue recognition are required. For example, the standard specifically stipulates that goods or services used as input for yielding an integrated output, which is expected to be received en bloc, are non-separable. As for Step 3, the transaction is priced at the amount, including variable consideration, for which the company is qualified in return for the fulfillment of promises in the contract. Unlike IAS 18, IFRS 15 specifies the accounting for variable consideration by the aggregate of the probability-weighted amounts or the single most probable amount on the ground that the settlement of the associated uncertainties will not result in a significant reversal in the revenue recognized. Further provisions also offer instructions on when the material reversal is probable and variable consideration should be constrained. Additionally, IFRS 15 covers specific guidance on previously overlooked matters such as treatment for warranties. The accounting for warranties is now dependent on the purchase option and the nature of warranties as to whether they provide services beyond guaranteeing the agreed-upon stipulations. Concerning the timing of revenue recognition, it is recorded as or when the performance obligations are satisfied. Accordingly, instructive conditions of when revenue should be recognized over a period of time are stated in IFRS 15. The transfer of performance obligation is now marked in

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IFRS 15 by the control principle, unlike in IAS 18 by the handover of risks and rewards to the contracted party. Given this improved detail in IFRS 15, more consistent accounting practice is anticipated by IASB.

2.3. Leases: From IAS 17 to IFRS 16

Dating from its initial issuance in 1982, IAS 17 Accounting for Leases has experienced rounds of alterations, of which the landmarks are the replacements by IAS 17 Leases in 1997 and by IFRS 16 Leases in 2019. In plumbing the rationale of the giant move from IAS 17 to IFRS 16 in recent years, the criticisms and accounting scandals relating to IAS 17 are noteworthy. Concerns are prolonged that IAS 17 results in manifold operating leases with material financing components left out in the financial statements, which reduces reporting transparency and jeopardizes the true and fair representation of economic substance.

With reference to the US Security and Exchange Commission, the off-balance-sheet operating leases in the US publicly listed companies are estimated at $1.25 trillion [7]. The off-balance-sheet leases are more intensified in such industries as airlines, transportation, and retailing. Specifically, the off-balance-sheet leases equal 22.7% of the total assets of airlines [8]. This lack of transparency adds to the difficulty in understanding the financial position of companies and drawing comparisons between counterpart companies. Moreover, companies may take advantage of off-balance-sheet financing to present an enlarged debt capacity and favorable financial ratios for lower costs of capital.

Table 1: Different financial positions with finance leases considered [9].

Financial statements of Walgreens		
	Finance leases considered alone ($)	Operating leases considered together ($)
Gross profit	16,643	16,643
Depreciation	(840)	(1,197)
Other expenses	(12,362)	(10,565)
PBIT	3,441	4,881
Interest	(11)	(1,451)
Tax	(1,273)	(1,273)
Net profit	2,157	2,157
Total assets	22,410	40,053
Total debts	1,420	19,063
Total equity	12,869	12,869
Financial ratio analysis		
Interest coverage	312.8	3.4
Debt to equity	9.90%	59.70%
Return on assets	9.60%	5.40%

Table 1 above exemplifies why companies are motivated to avoid accounting for finance leases. With the assets of Walgreens under off-balance-sheet operating leases included, the financial statements for the fiscal year 2008 show a surge in leverage and a slump in interest coverage, denoting a higher financial risk. The return on assets is also overstated without accounting for finance leases, suggesting a less efficient position to generate profits from assets de facto. These financial ratios are referred to when financial institutions consider whether to finance companies with debt. Seeing a seemingly low leverage, credit risk is rated low and the interest rate charged is thus reduced. Furthermore, the growing accounting scandals concerning abusive off-balance-sheet transactions,

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especially Encon's, emphasize the tightening of the standards. Under IAS 17 great space is left to the accountants for personal interpretation and judgment of the substance of the contracts to distinguish between operating and finance leases. This in turn makes even more possible abusive off-balance-sheet transactions.

In response to these loopholes, IFRS 15 came into existence. IFRS 15 eliminates the requirement to distinguish operating and finance leases, which means each leased asset with two exceptions must be reported in the financial statements so long as there is an identified lease contract. In IFRS 15, assets of low value or under a lease term within one accounting period can be accounted for off-balance sheet. This eradicates the room for off-balance-sheet transactions and inconsistent interpretation and treatment for leases. Previously in IAS 17, the classification of leases relies on the concept of risks and rewards of the leased assets. However, IFRS 16 bases the classification on the right to use the identified assets, which is related to the control principle. And all leases once identified amount to the capitalization of right-of-use assets alongside the recognition of associated lease liabilities in the financial statements. This ensures more transparent and comparable financial information for external users to understand the business and financial position of an entity.

3. IFRS vs. US GAAP: Difference & Convergence

3.1. Overall Differences in the Frameworks

When comparing the two different sets of standards, IFRS is commonly regarded as principle-based while US GAAP is deemed rule-based. It is estimated that the printed version of US GAAP would encompass approximately 25,000 pages, whereas IFRS only around 2,000 pages [10]. This significant disparity in size reflects the detail in guidance and specifications within US GAAP. For the lack of in-depth guidance on accounting practices, IFRS often requires individual judgment and estimates otherwise. Under a principle-based environment, interpretations and treatments can be diversified for like-kind transactions, which entails more considerable disclosure requirements for the purpose of transparency and understandability.

Generally, IFRS differs from US GAAP in appearance and in substance. The difference in appearance merely lies in how information is displayed in financial statements. For example, the format of statements of financial position is prescribed under US GAAP as 'Assets = Liabilities + Equity', while the prevailing format among IFRS-adopters is 'Assets – Liabilities = Equity' despite not being particularly stipulated [10]. On the other hand, substantive differences are material ones in the recognition and measurement basis of items in financial statements. Several disparities frequently seen in the financial statements are selected for discussion. Firstly, in terms of inventory, systems of perpetual and periodic inventory records are allowed in both IFRS and US GAAP. However, the measurement bases are different. Apart from First In First Out (FIFO) and weighted average, Last In First Out (LIFO) is applicable in US GAAP for the purposes of income tax but not in IFRS [9]. Moreover, the reversal of inventory write-downs is forbidden under US GAAP. As for intangible assets, both research and development costs are expensed in US GAAP, whereas development costs must be capitalized in IFRS if companies can prove the fulfillment of all the criteria such as probable economic benefit, feasibility and intention to complete the intangibles, and adequate resources to complete the intangibles [11]. With regards to non-current assets, IFRS permits the subsequent measurement of these assets by revaluation model, which is disallowed in US GAAP with exclusive use of cost model to measure long-lived assets save certain financial instruments. Besides, many discrepancies in accounting also exist in areas of calculation of earnings per share, recognition of deferred tax assets, and so on.

3.2. Trends in Convergence and Accounting Harmonization

Currently, the mandatory use of IFRS has been widespread in 146 jurisdictions as of 2023 [12]. IFRS and IAS are also converging to unity in recent years. The 'Norwalk Agreement' signed in 2002 between IASB and FASB is a milestone of the start of a mutual effort to converge the accounting standards. In this agreement, IASB and FASB reached a consensus to strive for compatibility of existing standards and joint development of future programs [13]. This commitment was reinforced by the issuance of the Memorandum of Understanding in 2006, documenting guidance on the achievement of convergence and the progress to be reached by 2008. In 2007, the SEC eliminated the requirement to reconcile financial statements reported under IFRS by foreign private issuers to US GAAP, implying that the quality of IFRS is acknowledged as being commensurate to US GAAP and that the convergence has arrived at a noticeable extent. A roadmap was also issued by SEC in 2008 to declare the possibility of adopting IFRS commencing 2014 and of giving the option for voluntary adoption earliest in 2009 [14]. However, as indicated in the final report, no support was observed from investors, regulators, and audit parties, thus stranding the potential plan of compulsory adoption. The chief concern of the SEC with IFRS adoption consisted in the quality and interpretation and the investors still largely perceived US GAAP as important standards in the capital market to ensure the highest accuracy and quality of financial information [15]. Outright adoption in the US of IFRS is unlikely at least in the near future. Nevertheless, remarkable progress in convergence is witnessed in the joint effort to develop consistent new standards by IASB and FASB over the decade. For instance, a joint project was undertaken by the two boards to build a unified standard for revenue recognition, i.e., ASC 606 and IFRS 15.

4. Conclusion

To summarize, in an era of intensifying globalization, and cross-border trade and investment, accounting harmonization, particularly through IFRS, facilitates the quality, comparability, and understandability of financial statements so that external users can have a sound basis on which economic decision is made and companies can have increased access to the capital markets globally. However, financial scandals also reveal that accounting standards cannot stand in a rut after issuance. High-quality financial information is only guaranteed by ongoing review and amendment of the standards in response to the observed practices of deviations that do not result in the relevant and more reliable presentation of economic transactions. Furthermore, limitations of IFRS yet exist despite the effort for betterment. Specifically, IFRS is still criticized for the wide options of accounting methods offered and for the limited guidance provided on the interpretation and application of the standards. These weaknesses can breed inconsistencies in accounting treatments although IASB has been endeavoring to relieve inconsistency, for example by requiring all leases of different types to be recognized in the new IFRS 16.

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