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# Resolving Expectations Gaps in Financial Reporting: Issues for International Financial Reporting Standards

## ABSTRACT

*Financial statements have continued to play relevant roles to investors and in decision making despite limitations as a result of identifiable expectations gaps. Thestudy examines unresolved financial reporting gaps and how they affect public investors' confidence in financial statements in decision making. The importantrole of the International Accounting Standards Board for International Financial Accounting Standards (IFRS) cannot be over-emphasized. This is critical in theemerging accounting knowledge base and globalization dispensation.*

**Key Words ::** Financial Reporting Expectations Gap, Recognition, Measurement of Financial Information.

## INTRODUCTION

The custodianship and stewardship functions required of earlier financial accounting statements formed the process of development of the subject. Thesefunctions constitute the basis of corporate responsibility in modern business. It is in fulfilment of these essential requirements that financial accountingstatements were expected to provide two basic functions as to measurement and communication of information. Focusing on the above functions,financial accounting statements as measurement tools assert period performance outcome and financial position. Financial accounting statements also ascommunicating tools are reporting statements which are communicated to end-users.

These statements further serve as data and information for decisionmaking by users and management to initiate further actions as the statements serve as persuader statements. Statutory audit certified financial reports are regarded as credible and reliable, although events such as Enron, Parmalat, AP, and Xerox among others have castdoubts and non-credibility on statutory audit and financial reporting. Financial Statements' credibility and other audit issues have further triggered issues offinancial statements' gaps. (Benston,2006). While focus on audit issues have been the trend, not so much attention has been focused on expectations gaps infinancial accounting reporting and related issues and the resolving of the issues.

In financial accounting statements, underlying conventions of measuringeconomic transactions are largely historical based and at best revalued on occasions. The bases for preparing accounting information have come underincreasing criticisms in recent times.

## THE ISSUES ::

Although audit practice is an assurance practice, an extension of the subject is financial reporting which is highly judgmental. Financial Reporting principles andpractice encompass multitude of assumptions and judgments. Hence, it is possible for audit report on an entity to have been clean and unqualified and yet thecompany collapses soon after such reports. The issues become those of credibility which either hinge on management representations in financial reports or theunderstanding of financial reporting in their own contexts. This study is a lens focus on the multitude of assumptions and judgments in the context of financialreporting. The study attempts at resolving of these issues.

**EXTANT LITERATURE REVIEW ::**

Unresolved issues of financial statements expectations gaps are varied. Higson (2005) observed conceptual framework of the Financial Accounting StandardsBoard (FASB) and the International Accounting Standards Board (IASB) which were expected to be addressed. Notable issues of financial statementsexpectations gaps among others are: issues of recognition and measurement, the communication theory cause of financial statements expectations gap, users'decision perspective and lack of comprehension of some fundamental aspects of accounting.

**EXPECTATIONS GAP OF RECOGNITION AND MEASUREMENT IN FINANCIAL REPORTING ::**

In an Australian study (ASCPA and ICAA, 1994), the recognition and measurement expectation gap has drawn great concern. It is considered vital to 'clear anymisconceptions to ensure both preparers and users of financial reports fully understand the reporting and auditing process.' It is considered that issue ofexpectations gap should be used to describe the difference between the expectations of users of financial reports and the perceived quality of financialreporting and auditing services (Higson, 2005). Differences in financial data and information are considered unreasonable; also, expectations gap about theinadequate performance in accounting practice.

In September 2006, the FASB issued FASB No. 157, Fair Value Measurements (SFAS No. 157). This provides guidance for using fair value to measure assets andliabilities. In February 2007, the FASB issued FASB No. 159, the Fair Value Option of Financial Assets and Financial liabilities. These provisions permit entities tochoose to measure eligible financial assets and liabilities at fair value.Applying fair value for financial instruments is a means of reducing recognition and measurement inconsistencies that occur under the current mixed attributereporting regime. In CFA Institute (2008), findings of CFA Institute 2007 Financial Reporting and Measurement survey showed that 58% of respondents preferfair value as the single measurement basis for financial assets and liabilities with amortized cost information provided as a note disclosure item, 72% ofrespondents indicated that companies should not have recognition and measurement options for similar items. This is predicated on the belief that a singlemeasurement basis can allow greater comparability between reporting entities and within items reported by the entity. Another survey (CFA Institute, 2008)conducted by the European Federation of Financial Analysts Society (EFFAS) corroborates the findings as it showed that 61% of their respondents were generallysupportive of fair value as the single measurement basis.The need for reducing recognition and measurement inconsistencies cannot be overemphasized. While that objective is paramount in financial reporting,balances must be struck among nations' diversity challenge and accounting practices. The critical need for accounting comparability within industry, nations andglobal contests cannot be overemphasized. The IFRS has the responsibility to facilitate this objective thereby, assisting to close the expectation gap.

**THE COMMUNICATION THEORY CAUSE OF FINANCIAL STATEMENTS EXPECTATIONS GAP ::**

Accounting terminologies and financial statements may truly be technical jargons as far as the layman and majority of the general public accounting informationusers are concerned. Those with basic accounting knowledge may not even understand as much as the professionals and the accounting preparers. It is wellknown in communication theory that effective communication is achieved only when the object of a message is successfully passed across to the receiver. Whenthere is a misunderstanding or a distortion in the facts being received, then communication is not achieved. This communication cause could therefore be saidto contribute to financial statements expectations gap. There is conscious effort by financial statement preparers to express these statements in narrations andin graphical forms as understandable as possible.

Modern Accounting Information Systems also serve as aid to effectively communicating accountinginformation.This expectations gap is prevalent. Skilled accounting practices require continuous update not only of emerging accounting issues at local levels, but also atglobal levels. Besides, emerging accounting issues and gaps are critically challenging as to the exactness and comprehension of the issues concerned. The resultof emerging accounting issues and challenges are the issuance of accounting standards, pronouncements on statutory audits and from the Security ExchangeCommissions (SEC).

Accounting standards evolve and debated over a timeframe before adoption. They are also not static as they are amended, and withdrawnand replaced as the case may be. While the complexities

experienced in standards setting and their comprehension exist on one hand, being conversant withthese standards and evolving standards also exist on the other hand. These are extant challenges in professional accounting practices. The other challenge isthe understandability of accounting information by the layman. Astute financial analysts will continue to be relevant for good communication of the informationconveyed through financial statements.

**EXPECTATIONS GAP OF USERS' DECISION PERSPECTIVE OF FINANCIAL STATEMENTS ::**

The basic objective of financial statements is to provide information useful for making economic decisions (Trueblood Reports in AICPA, 1973). This assertion hasbeen controversial as several authorities such as Armstrong (1977), Drury (2000), and Edmonds, Edmonds and Tsay (2003) have queried the conceptualframework which admits that Annual Financial Statements are to provide useful information to users for economic decision making. Essentially from relevantcost accounting perspective, financial accounting costs which are historical costs (past costs information) are classified as sunk costs and these cannot beexpected to serve as basis for decision making.

Costs and management accounting reporting will normally emphasise costs and benefits in decision making.Backward-looking financial statements cannot directly provide the future estimates which decision making processes require. Besides, financial accountingstatements may have been published 'too late' to be of relevant use to shareholders' decision making.Financial accounting statements were originally meant to serve stewardship accounting purpose and to acknowledge managements' performance. Even whenpast financial accounting information may be relevant for one purpose, it is not true that one set of accounting information will be useful for all decisionpurposes.

It is noted that if the objective of financial statements is for stewardship, then the whole conceptual framework for wholesome users' decision makingwould have been unwarranted. It is observed by Laughlin and Puxty (1981) that this assumed object of financial statements for decision making, thoughunspoken, is questionable.

**ACCOUNTING CONCEPTS ::**

Accounting concepts and generally accepted accounting principles (GAAP) requirements notwithstanding, accounting practices in nations differ one fromanother since accounting in individual countries have been a product of several factors. Notable environmental factors that shape accounting development inspecific countries are:

1. Each country's legal requirement, tax and Security Exchange Commission requirement. Accounting principles and practice have therefore, beendesigned to meet each country's need;
2. Adherence to particular financial accounting model. Most former colonies of developed countries had their accounting system by choice andhistorical antecedent, patterned after their colonial masters;
3. Process for setting national financial accounting standards. Most developing countries thereafter established nation's accounting standards board;such as the Indian Accounting Standards Board , as well as other nations' accounting setting standards bodies; and
4. Conservatism relative to uncertainties, which businesses have to cope with and there are diversities from one set of national GAAP to another. Thishas developed alongside national demands and pace of development of accounting standards.

Accounting diversities in the nations of the world is common knowledge and has been subject of discussions. Initially these have featured more frequentlybecause of need for accounting practices harmonization, and more recently the trend calling for worldwide complete convergence or adoption of theInternational Financial Reporting Standards (IFRS). The benefits for international accounting harmonization through the instrumentality of the IFRS cannot beoveremphasized. Benefits specifically accrue to corporate organizations, the Securities Exchange Commission (SEC), and the Indian Accounting Standard Board

**EXISTING PRACTICE DIFFERENCES ::**

National differences in accounting practices are observed specifically in two dimensions; namely, measurement and disclosure of economic events and financialtransactions. Certain difficult items for measurement include investment in technology, human resources, and effect of environmental

protection orcomparisons with countries' GAAP. Difficult items also include effect of industrial action of workers, mergers and acquisitions and product development.Specific areas of international accounting diversities are measurement and treatment of goodwill, income smoothing and asset valuation. Readers of accountingand financial information would wish to know which measurement methods are used and if there are items of interest which could not be measured directly.Issues are further aggravated with differential nations' taxation policies. From the foregoing, and for other nations' economic requirements, there exists enoughevidence to conclude that GAAP differs from one country to another to the satisfaction or otherwise of the interest groups.

**MERITS OF INTERNATIONAL ACCOUNTING CONVERGENCE ::**

Much has been said about the need for harmonizing and now outright convergence of accounting diversities of nations and the merits for this is beingconversed. Critical issues advocated as merits for convergence and the adoption of the IFRS are that:

1. There will be comprehensiveness and comparability of cross-national reporting of financial statements. This is probably the leading reason for the callfor convergence of standards and adoption of the IFRS. Corporate managements, investors and stock exchange regulators will find standard financialreporting statements most welcome and a rewarding development.
2. Corporate organizations and the multi-nationals will succeed in curtailing huge expenditures which are usually made to accounting professionals tobring up accounting statements in local standards in line with International Standards.
3. There will be high quality accounting standards and practice internationally.

**CHALLENGES OF INTERNATIONAL ACCOUNTING CONVERGENCE ::**

There are some merits for diversity of financial reporting if local environments and culture have indeed influenced meaningful developments in their uniquesituations. Accounting diversities in nations may be logical and justified if nations' financial reporting is in line with their tax laws and company laws.National accounting standards setting bodies such as the Financial Accounting Standards Board (FASB), IASB, and Ind AS have over the years succeeded inreducing diversities at national levels and have made continuous review of their standards and GAAPs.

**SEC ISSUES PROPOSED ROADMAP FOR USE OF IFRS BY U.S. ISSUERS ::**

Commencing from 2005, the European Union Communities has mandated all its companies on adoption of the IFRS and compliance. Also, the US and SEC areactive on the convergence issues.On November 14, 2008, the SEC issued a proposed Roadmap on potential use of IFRS by U.S. issuers in preparation of their financial statements.The Roadmap sets forth several milestones that could lead to the required use of IFRS by U.S. issuers in 2014. In the roadmap, the Commission has proposedamendments to various regulations, rules and forms that would permit early use of IFRS by a limited number of U.S. issuers where this would enhance thecomparability of financial information to investors.Source: Deloitte (2005), Issues of News-Global IFRS

**ISSUES ON CONVERGENCE OR THE ADOPTION OF THE IFRS IN INDIA ::** In order for the convergence in accounting standards to work effectively, two other related convergences have to take place.

1. First, there has to be a convergence of auditing standards throughout the world. If the accounting standards converge, but the auditing standards do not converge companies would effectively have to prepare multiple financial statements, which defeats the purpose of a common set of accounting standards.

   Second, the regulatory authorities throughout the world (such as the SEC, the SEBI, etc.) need to get together and come to an agreement as to how the IFRS is going to be enforced. This is especially important because IFRS standards are principles-based standards so there is a lot of judgment involved in applying the standards.

   The regulatory authorities need to have a common set of enforcement standards. Otherwise the convergence of accounting standards will not work. For example, if Infosys files under IFRS with SEBI in India and SEBI approves the filing, but the SEC in the US does not agree with Infosys's

interpretation of IFRS then it will be a big problem for Infosys. Effectively they would have to end up preparing two sets of financial statements. There are significant costs of convergence. Each country's accountants have to learn IFRS. The auditors have to learn IFRS. The regulators have to learn IFRS. The university faculty in each country have to learn IFRS and teach it to students and the textbooks in each country have to be rewritten. There will be costs to dismantling the standard setting infrastructure in each country. All this has to be done in a short period of time if the announced deadlines are to be met.

2. In certain cases, the legal and regulatory requirements are at variance from IFRSs. ICAI has to consider these while formulating IFRSs.

   **To illustrate:**

   As per IAS 32, Financial Instruments: Presentation, preference shares that provide for mandatory redemption by the issuer are considered as liability, based on the substance, whereas as per the Companies Act, 1956, these are a part of equity.

   IAS 27, Consolidated and Separate Financial Statements, defines the terms'control' in a manner which is different from that followed in the definitions of the 'holding' and 'subsidiary' companies under section 4 of the Companies Act, 1956

3. Level of preparedness of various interest groups involved in implementing the accounting standards. In a few stray cases, practical difficulties are perceived in implementation of certain IFRSs, considering the level of preparedness in the country. ICAI has to make changes in the corresponding IFRS for the time being till preparedness is achieved.

   **To illustrate :** Considering practical difficulties, the ASB has decided not to require mandatory adoption of the component approach prescribed in IAS 16, Property, Plant and Equipment.Under the 'components approach', fixed assets are segregated into various significant components for the purpose of accounting, for example, for depreciation

   - Financial Instruments: Presentation (corresponding to IAS 32)
   - Financial Instruments: Recognition and Measurement (corresponding to IAS 39)
   - Financial Instruments: Disclosures (corresponding to IFRS 7)
   - Agriculture (corresponding to IAS 41)
   - Insurance Contracts (corresponding to IFRS 4)

   As compared to formal classroom-type training, a preferred approach in the Indian context would be for management to spend sufficient time in advance with audit committee members on key changes to accounting policies of the company and their implementation upon adoption of IFRS. This process should commence sufficiently in advance of the actual transition to enable audit committee members to familiarize themselves with IFRS accounting concepts and their implementation. Similarly, auditors would need to spend relatively more time with members of the audit committee educating them on IFRS interpretation and judgmental matters as they affect the company. A customized and company-specific approach is likely to be a good way to educate audit committees.

   In the initial period, audit committees will likely rely more on both management and the external auditors to understand concepts and accounting models that are unique to IFRS and that represent a change from current accounting practice. During this initial period, audit committees will likely focus on sufficient debate between management and the external auditors on key judgment and interpretation issues and would focus on these areas as they evaluate the financial reporting process adopted by the company. Audit committees may question the manner in which such matters have been resolved, with a focus on whether the external auditor is satisfied in relation to the position adopted by management.

4. Indian management and audit committees are also not familiar with managing the volatility that arises out of applying fair value concepts to financial instruments such as derivatives. The committees would need to devise and implement appropriate hedge accounting principles and policies to address such volatility or familiarize themselves with communicating such volatility to external stakeholders.
5. It not true that IFRS necessarily imposes any additional short-term, quarterly results-oriented views of corporate strategy. Indian corporations have been publishing quarterly results for quite some time now and adopting IFRS will not result in a change in financial reporting strategies.

What will be needed is a will to change mindsets to get a better understanding of the financial results, along with a strategy to manage and communicate volatility that arises from applying the fair value principles.

6. The accounting framework in India is deeply affected by laws and regulation. In India we have multiple regulators of accounting standards. For example, if there is a listed bank, it has to follow the accounting norms prescribed by SEBI, RBI, ICAI, Companies Act and the Banking Regulation Act. Some of the accounting requirements may be inconsistent with each other and some are definitely inconsistent with IFRS.
7. The success of convergence to IFRS in India will depend on how well the regulators cooperate. At the moment, if the law conflicts with any requirement of an accounting standard, the law overrides the accounting standard. For instance, the presentation of financial statements as per the Companies Act, 1956 conflicts with the requirements of IFRS, and business combinations accounting is governed by the courts, which may conflict with IFRS. Besides the Companies Act, 1956, other regulators in India like Sebi, RBI and income-tax department will need to accept IFRS in lieu of their sets of rules of accounting. So, the Companies Act and related laws would need to be amended to ensure that the law does not conflict with the accounting framework that may be prescribed by the Institute of Chartered Accountants of India.
8. These and many other strategic issues in regards to IFRS adoption/convergence are not clear at this point in time. More importantly because law overrides accounting standards, full convergence with IFRS is not possible unless those laws are amended or an ov4erriding section is enacted with regards to accounting standards. Some key examples are discussed below.

   Companies Act, 1956 prescribes statutory depreciation rates. Companies are required to provide depreciation based on useful life of an asset or statutory rates, whichever is higher. In practice most companies apply statutory rates without regard to useful life. Under IFRS, depreciation is based only on the useful life of an asset. Accounting for amalgamation is done based on treatment prescribed by the High Court under an approved scheme, even though it may not be in accordance with accounting standards. Under IFRS, accounting for amalgamation is required to be done purely based on IFRS principles and hence may conflict with directions of the High Court.
9. Definition of subsidiary under Companies Act is not consistent with definition of subsidiary under IFRS. Further, section 78 of the Companies Act, 1956, permits writing off of preliminary expenses, underwriting commission paid or discount allowed on issue of debentures, premium payable on redemption of debentures etc. to be adjusted against securities premium account. Treatment of such expenses is different in IFRS and in many cases would result in a charge to the income statement.
10. While the MCA(ministry of Corporate Affairs)notification clearly indicates that India will adopt IFRS, it does not lay down a comprehensive strategy for convergence or adoption. It would only be appropriate for the MCA to announce a strategy as soon as possible focusing on adoption rather than convergence, since if adopted Indian entities can claim that their accounts are prepared under IFRS which will give them a distinct advantage. If we converge and don't adopt IFRS, Indian entities would not be able to claim that they are IFRS compliant, which will defeat the very purpose of embracing IFRS.

    Apart from the MCA, tax authorities should consider IFRS implications on direct and indirect taxes and provide appropriate guidance from a tax perspective.

**CONCLUSION::**

The merits of a global reporting system for effective comparability are clearly evident. A global market place has need for clarity in its financial reporting withoutambiguity. This is coupled with the fact for fluidity of capital sourcing in the global market. Investment decision strategies both for corporate managements,investors and accounting standards setting bodies cannot be overemphasized. However, because of the continuously existing challenge of national culturalbackground, nature of economy and also critically, the individual countries' legal framework, the adoption of the IFRS faces serious challenges. IFRS convergenceas a global project faces the critical challenge of difference in size of economy between the developed countries and the developing nations on one hand anddifferences between the multinational companies and the Small and Medium industries on the other hand. Considering the progress and gains achieved so far inthe convergence project of the IASB, one can only expect that India will take a position, probably that of the IFRS adoption, otherwise it will engage in aprocess of rigorous standards setting development towards a conversion. The latter option may probably be extremely costly and whose standards may notalways be

comprehensive enough for changing global relevance.

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**Dr. Bhavesh A. Lakhani**
Asst. Prof. Shri K.K.Shastri Government Commerce College
Maninagar, Ahmedabad – 380008

**Dr. Gurudutta p. Japee**
Asst. Prof. S.M.Patel Institute of Commerce
Law Garden, Ahmedabad - 380006