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Gunther Gebhardt

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The Evolution of Global Standards in Accounting

GÜNTHER GEBHARDT

FOR SEVERAL DECADES companies in many key industries have confronted increasingly more worldwide competition. They have responded to this challenge with strategies of globalization. As a result, not only the leading companies now operate on a global basis with subsidiaries in all important countries or regions. The pressure to globalize is also felt by many small and medium-size enterprises that supply components or specialized services to the giant multinational companies.

Most of the leading companies still have a strong national home base. However, for many companies, especially from smaller countries like Switzerland or Scandinavia, the importance of the home market is almost negligible. For example, the 1998 net sales of Nokia in Finland, its home market, constituted only 3.5 percent of total sales.¹ In addition, in the past few years, increasing cross-border merger activities have resulted in companies that are viewed as global players (for example, ABB, Daimler-Chrysler, and Adventis). Although no longer national in character, such companies are still subject to national regulation—last but not least in the areas of accounting and financial reporting.

Globalization strategies are not restricted to operating and investing activities but increasingly also involve financing. Foreign listings are not new to U.S. multinationals or many of the large European companies being

1. See Nokia (1998), p.12.

traded at home as well as on other major European and Asian stock exchanges (such as London, Frankfurt, Paris, Hong Kong, Tokyo). Recently, a growing number of European companies have been applying for listing on U.S. stock exchanges, notwithstanding the burden that complying with Securities and Exchange Commission (SEC) requirements puts on them. These developments coincide with the emergence of investors who follow global investment strategies in order to gain the benefits from international portfolio diversification. The home base of most important global investors is the United States. Those investors increasingly focus not only on the global players, but also on small and medium-size enterprises that may not be quoted on a stock exchange.

Accounting information plays a crucial role in these processes. For globalizing companies, accounting reports are a vital means of internal communication between managers and employees from different national backgrounds. Even though the core concepts of accounting are not very different internationally, differences in rules and in the application of those rules hamper internal communication. This problem traditionally was overcome by internal accounting guidelines based mainly on the national accounting rules of the parent companies.

For companies focusing their financing strategies on the international investment community, accounting reports serve as means of external communication. The use of national accounting rules is increasingly regarded as impairing effective communication.

It seems obvious that the use of only one set of global accounting principles would facilitate internal and external communication. Promoting the harmonization of accounting rules has been the mission of regional bodies (such as the European Union [EU] and Nordic countries) and of international bodies (such as the International Accounting Standards Committee [IASC]) for more than twenty-five years. National (for example, the U.S. Financial Accounting Standards Board [FASB]) or regional (for example, EU) standard setters have designed strategies to have their accounting rules applied beyond their respective jurisdictions. However, we are far from an agreement on a single set of global accounting standards that are accepted and applied consistently worldwide.

The second section explores the background of accounting regulation in select country settings and highlights distinguishing features that explain the persistence of different national accounting rules. This is followed by a section highlighting major differences between national and international

accounting rules and their impact on accounting numbers and by a section discussing the difficulty of evaluating alternative accounting rules theoretically or empirically. The final section discusses the structure and process of a global accounting standard-setting body designed to overcome the national and international differences in accounting regulation.

Institutional Characteristics of Accounting Regulation

The growing body of international accounting literature unanimously agrees that one of the major reasons for differences in national accounting rules is that accounting performs different functions in different socioeconomic environments. In the United States, the prime objective of financial reporting is to provide information for participants in capital markets (investors, creditors) and for the general public. This is also a prime objective according to the IASC framework, which suggests that such information will also meet the common needs of other stakeholders.² In the United Kingdom, the Accounting Standards Board (ASB) focuses more narrowly on the providers of risk capital as the primary users of financial information, thereby implicitly acknowledging the different needs of equity investors and creditors.³

Providing information to capital market participants and to the general public is a common objective in other jurisdictions as well. However, it is not necessarily the prime objective. In continental European countries (for example, France and Germany) accounting serves primarily as a verifiable basis for contractual arrangements and especially as a mechanism for determining distributions to equity investors and tax authorities. Beyond that, the French government uses accounting to make macroeconomic policy decisions.⁴

Such differences in the socioeconomic functions of accounting induce differences in the processes of accounting regulation. Table 1 provides an overview of the institutional features of these processes in four selected countries (United States, United Kingdom, Germany, and France) and at the international level. In all four countries, accounting regulation is at

2. See FASB (1999b), par. 1.1, 1.5, 1.6; IASC (1995), par. 1.

3. See Institute of Chartered Accountants in England and Wales (1993), par. 1.1–1.6.

4. See Colasse and Standish (1998), p. 115.

Table 1. Systems of Accounting Regulations

<i>Jurisdiction</i>	<i>Legal basis of accounting regulation</i>	<i>Accounting standard-setting bodies</i>	<i>Enforcement of accounting standards</i>
United States	Securities Act (1933) and Securities Exchange Act (1934)	Securities and Exchange Commission, Financial Accounting Standards Board (1978, comprehensive delegated authority), and Emerging Issues Task Force	Securities and Exchange Commission, statutory audits by a certified public accountant
United Kingdom	Companies Act	U.K. Parliament, Accounting Standards Board (1990), and Urgent Issues Task Force	Statutory audits by a certified public accountant and Financial Reporting Review Panel (1989)
International accounting standards		International Accounting Standards Committee (1973) and Standing Interpretations Committee (1996)	Recommended audits (with International Federation of Accountants support)
Germany	Commercial Code and Tax Code	German Parliament, Federal Ministry of Justice, and German Accounting Standards Committee (1998, delegated authority for group accounts of listed companies subject to approval by the Federal Ministry of Justice)	Tax authorities, tax and civil courts, and statutory audits by a certified public accountant
France	Commercial Code, Tax Code, and Plan Comptable General	French Parliament, Council National de la Comptable (state-dominated), and Comité de Réglementation Comptable (1998)	Statutory audits by a certified public accountant

the outset governed by law enacted by Parliament, which accords it democratic legitimacy. It should be noted that there is no comparable legitimacy at the international level.

In countries with a tradition of common or case law (such as the United States and Australia), details of accounting regulation are delegated to governmental agencies (such as the SEC), which in turn might delegate their authority to a private accounting standard-setting body (such as the FASB). In countries with a tradition of code law (such as France and Germany), both commercial and tax law contain detailed accounting rules.⁵ The legislative bodies in those countries have been very reluctant to delegate authority to the private standard-setting bodies that were set up only recently. Neither the French Comité de Réglementation Comptable (CRC) nor the German Accounting Standards Committee (GASC) has the ultimate power to issue accounting rules; rather, each must seek government approval.⁶ Obviously, legislators and governments in those countries are determined to retain control of the process of accounting regulation.

State control is essential in those environments because of the tax implications of accounting regulation and the fundamental principle of equality, especially the principle of equality of taxation. Accounting rules have to be followed not only by the subgroup of listed companies but also by all companies as well as by sole traders and private partnerships. Accounting entities are primarily the legal entities that are the subjects of contracts and taxation. In addition, economic entities (groups) have to provide consolidated financial statements that are not relevant in the determination of distributable or taxable profits but have the sole purpose of providing information. The GASC has authority to issue accounting standards applicable to group financial statements of listed companies only and therefore should—in principle—not affect profit distribution or taxation.

In Germany, compliance with state-controlled accounting regulation is secured by the tax authorities and by tax court rulings because there is a close link between tax financial statements and commercial financial statements.⁷ For commercial financial statements, enforcement is the domain of

5. The United Kingdom as a common law country had to introduce many detailed accounting rules in company law due to the transformation of EU directives.

6. See Federal Ministry of Justice (1998); Colasse and Standish (1998), pp. 139–40.

7. See Ballwieser (1995), pp. 1428–32; Working Group on External Financial Reporting of the Schmalenbach-Gesellschaft/Deutsche Gesellschaft für Betriebswirtschaft (1995), pp. 92–99.

the civil courts that deal primarily with accounting issues relevant to the level of taxable or distributable income, which is based on individual financial statements. Only a few civil court decisions on accounting issues relate to group financial statements.

The statutory audit is another important enforcement mechanism for published financial statements. The scope of the statutory audit is rather narrowly defined in German law, where the auditor only has to attest compliance with legal regulations.⁸ Not irrelevant to the efficiency of the enforcement mechanism are the sanctions that can be imposed on companies or auditors failing to comply with accounting or auditing rules. However, the threat of sanctions appears to be rather weak. Most comfortable for the auditing profession is a maximum liability of DM 2 million for audits of nonlisted companies and of only DM 8 million for audits of listed companies.

The threat of sanctions is further eased by the difficulties in identifying noncompliance, because many accounting rules in the law lack specificity and thus are open to interpretation. In fact, there is an ongoing discourse of interpretation about the applicability of accounting practices in specific circumstances. Diverse interpretations in the accounting literature, whose authors are mainly from the auditing profession and from academia, serve as arguments for the acceptance of diverse accounting practices until ruled on by a higher court decision. The Institute of Chartered Accountants (Institut der Wirtschaftsprüfer—IDW) issues recommendations that auditors should follow.⁹ However, the IDW does not have a delegated authority to interpret accounting rules, and those interpretations are not formally approved by the legislator or the government. Also, Germany does not have an authorized interpreting body such as the

8 . See § 322, par. 1 of the German commercial code: "If no objections are found upon completion of the examination the auditor must confirm this by appending the following opinion to the financial statements: 'Based on an audit performed in accordance with my/our professional duties, the accounting records and the financial statements/consolidated financial statements comply with the legal regulations. The financial statements/consolidated financial statements present, in compliance with required accounting principles, a true and fair view of the net worth, financial position, and results of the company/group. The management report/group management report is in agreement with the financial statements/consolidated financial statements.'"

9. Institut der Wirtschaftsprüfer (1995); Institute of Chartered Accountants in England and Wales (1993).

Emerging Issues Task Force (EITF) in the United States or the Standing Interpretation Committee (SIC) at the international level.

Enforcement of accounting rules in the United States is dominated by the SEC, which has set up a special enforcement division concentrating on the review of 10-Q and 10-K filings. The SEC Division of Corporation Finance is concerned with accounting reports in filings for security registration. The SEC Enforcement Division undertakes reviews based not only on indications of noncompliance but also on a systematic basis. The SEC has the authority to enter into court-like administrative proceedings in which companies can be required to provide internal documents and individuals can be required to testify. Even though the SEC requires all filings of financial statements to be audited by a certified public accountant, it does not rely fully on the auditors, who face much stronger sanctions than their continental European colleagues if they fail to execute their duties properly.

In the interpretation of accounting rules and in the identification of non-compliance, the SEC chief accountant plays a decisive role by drafting financial reporting releases for approval by the SEC and by issuing interpretations in a variety of ways (such as staff accounting bulletins, speeches, and articles). He also influences the standard-setting process by asking the FASB to be specific on different variations, by providing examples, and increasingly by developing training materials.¹⁰

The SEC commands an effective armory of sanctions against noncomplying registrants, ranging from halts of trading registered securities to fines that are set in relation to the damage caused by noncompliance. It can further initiate court proceedings. Another effective sanctioning mechanism is the adverse publicity that accompanies SEC actions. Several empirical studies demonstrate significant negative abnormal returns when an SEC investigation is announced.¹¹

Reliance on the auditors and on adverse publicity by a Financial Reporting Review Panel (FRRP) is an important characteristic of the U.K. enforcement process. The FRRP reacts only on information about possible noncompliance and does not survey published financial statements on a regular basis. One major source of such information is the London Stock Exchange, which undertakes examinations of all published financial

10. See Zeff (1998), pp. 92f.

11. See Feroz, Park, and Pastena (1991); Dechow, Sloan, and Sweeney (1996).

statements by quoted companies but does not take direct actions against noncomplying companies.¹² The FRRP can take companies to court, but would do so only as a last resort.

The differences between the enforcement processes in the United States and in the United Kingdom are striking.¹³ Even more striking is the lack of any genuine enforcement on the international level. The IASC relies on the enforcement of its accounting rules at the national level and on the support of the International Federation of Accountants (IFAC). Ultimately, there is no effective threat of sanction for failure of either companies or auditors to comply with international accounting standards other than loss of reputation if the failure is detected and made public.

Differences between National and International Accounting Rules

An impressive body of literature compares the accounting rules of individual countries (for example, the United States with the United Kingdom) or, more recently, the national accounting rules with international accounting standards (IAS) issued by the IASC.¹⁴ The German GASC has devoted its first German Accounting Standard DRS1 to an analysis of compliance of IAS and U.S. Statements of Financial Accounting Standards (SFAS) with EU directives.¹⁵ Examples of major differences in accounting rules are to be found in the following areas:

—*Capitalization of borrowing costs.* IAS 23.11 and SFAS 34.8 require capitalization, whereas under EU rules capitalization is optional only for self-constructed assets.

—*Fair valuation of derivative and financial instruments.* IAS 39 and SFAS 115 and 133 require fair valuation of all derivative instruments and all securities available for sale or held for trading through net income or other comprehensive income. Current EU rules, and German rules in particular, prohibit fair valuation exceeding cost values.

12. See Jack (1994), p. 48.

13. Böckem (1999) provides a detailed discussion of the enforcement arrangements in those two countries.

14. See for example FASB (1999c); Institut der Wirtschaftsprüfer (1995). Revised editions of these comparative studies incorporating the changes in IAS after completion of the IASC/IOSCO Comparability Improvement Project have been announced.

15. See GASC (1999).

—*Accounting for long-term construction contracts.* German rules still require use of the completed contract method, whereas IAS 11.22 and U.S. generally accepted accounting principles (GAAP; Accounting Research Bulletin no. 45.4 ff.) require accelerated realization of profits under the percentage of completion method.

—*Business combinations.* Under EU and German rules, there is a choice between recognizing and expensing goodwill or writing it off directly against reserves in a share deal transaction. Under IAS 22.18 ff. and U.S. GAAP (Accounting Principles Board Opinion no. 16.66 ff.), it is compulsory to recognize the goodwill on the acquisition and to amortize it over its useful life.

A list of further differences typically will comprise the areas of recognition of deferred taxes on prior-period losses, recognition of research and development expenses, revaluations of noncurrent assets, recognition of liabilities, provisions for restructuring, provisions for pensions and post-retirement benefits, and accounting for foreign currency transactions. There also are differences in the scope of full consolidations, of partial consolidations of joint ventures, and of the equity method as well as differences in the procedures of consolidation.

When there are differences between national or international rules, the key question arises as to which rules should be included in a set of global accounting standards. This evaluation should be related to the objectives of accounting, so that we face the nontrivial problem of obtaining agreement on the objectives. Fortunately, a consensus seems to be developing that published financial statements of listed companies should provide information to the providers of capital that is useful in making investment decisions. As the information needs of providers of equity and providers of debt financing will differ, a more narrow focus on the providers of risk capital would be preferable. Equity investors are interested primarily in the prediction of the amounts, timing, and risks of the residual cash flows they will receive from their investments.

Unfortunately, it is very difficult (if not impossible) to evaluate specific accounting rules a priori (such as capitalization of research and development costs versus direct expensing) relative to such a guiding objective. Standard setters try to overcome this problem by defining a list of qualitative characteristics (that is, relevance, reliability, neutrality, comparability, consistency) that should make accounting data useful. However, the application of these qualitative characteristics does not result in clear

choices because conflicts may arise. For example, in order to anticipate all relevant future cash flows, provisions should reflect all future charges that have a positive probability. This clearly is in conflict with the reliability characteristic because probability estimates require judgments that lack verifiability in many instances. The key problem with the choice of accounting rules is reaching an agreement on how to balance different characteristics.

Differences between national and international accounting rules would be of importance to users only if they result in major differences of relevant accounting numbers. The magnitude of the impact of different accounting rules on financial statements can be demonstrated for the small group of large non-U.S. companies that register their securities with the SEC. Form 20-F requires a reconciliation of net income and of stockholders' equity from the basis of accounting used in the published financial statements (that is, national accounting rules or international accounting standards) to U.S. GAAP. As different sets of accounting rules are applied to identical events and transactions of the same accounting periods, Form 20-F reconciliations are a unique source for identifying material differences between U.S. GAAP and home-country or international accounting standards.

Table 2 displays the effects of first-time adoption of U.S. GAAP on the financial statements of the German-based BASF Group as of January 1, 1998. Differences between German commercial accounting and U.S. GAAP accounting could be overcome in part by changing the choice of accounting alternatives available under German rules and choosing the U.S. GAAP alternatives that are compatible with German rules. The first panel of table 2 displays the effect of changes within the range of German rules on equity of the BASF Group as of the beginning of fiscal year 1998. Significant negative effects result from an upward valuation of provisions for pensions because BASF formerly applied restrictive German tax valuations. Positive effects result from the removal of tax-based valuations on the asset side and from deferred taxation arising from increasing differences between commercial and tax accounting.

Further changes in equity result from applying U.S. GAAP rules that are not compatible with German accounting rules (table 2, panel 2). Important areas here are the capitalization of borrowing costs, fair valuation of securities, and large reduction in provisions for employee benefits. The compensating effect of deferred taxes on those accounting

Table 2. Reconciliation of the BASF Group's Annual Report to U.S. GAAP, 1997 and 1998

Millions of Deutsche marks unless otherwise noted

Accounting method and indicator	Reconciliation of shareholders' equity as of December 31, 1997/January 1, 1998	Reconciliation as of December 31, 1998	
		Net income after taxes and minority interests	Shareholders' equity excluding minority interests
Application of U.S. GAAP rules within the range of German accounting rules			
Equity excluding minority interests as of December 31, 1997/January 1, 1998	23,031		
Valuation of pension obligations in accordance with the projected unit credit method (FAS 87)	-1,881		
Elimination of special tax valuation measures	412		
Other adjustments	-210		
Recognition of deferred tax assets for the above adjustments and temporary differences	2,060		
Minority interests	85		
Equity excluding minority interests after adjustment	23,497		
Application of U.S. GAAP rules that are not compatible with German accounting rules			
Capitalization of construction period interest	812	69	881
Valuation of securities at market values	91	-3	173
Adjustments for pension funds	1,297	-66	1,231
Other adjustments	354	109	457
Recognition of deferred tax assets for U.S. GAAP adjustments and for tax loss carry forwards	-785	55	-738
Minority interests	-52	-24	-76
Equity according to U.S. GAAP	25,214		
BASP Group's financial statements		3,324	25,268
Reconciliation according to U.S. GAAP rules			
Net income and shareholders' equity		3,464	27,196
Earnings per share (Deutsche marks)		5.56	
Diluted earnings per share (Deutsche marks)		5.45	

Source: Adapted from BASF Group (1998).

differences is reduced by recognizing tax benefits on prior-period losses, which is not considered an accepted accounting practice in Germany.¹⁶ The net change in equity is DM 2.2 billion or 9.5 percent. This might understate the total effect because companies prefer to make a series of minor accounting changes over several years.¹⁷ Panel 3 of table 2 displays the BASF reconciliation at fiscal year-end 1998. The difference between U.S. GAAP and German commercial accounting net income is a gain of DM 140 million or 4.2 percent, the equity difference is a gain of DM 1.9 billion or 7.6 percent.

Table 3 presents the reconciliation from IAS to U.S. GAAP in the financial statements of Hoechst for the first two fiscal years of filing Form 20-F. The aggregate differences are almost negligible for 1998. In 1997 the significant difference in net income can be traced to the failure of IAS to require period adjustments that have to be made under U.S. GAAP.¹⁸

The anecdotal evidence in tables 2 and 3 is in line with the results of empirical studies of Form 20-F reconciliations. They report no material differences between home-country net income and U.S. GAAP net income for about one-third or more of the companies studied.¹⁹ A small net effect is often the result of both positive and negative effects, with deferred taxation as a built-in compensating effect. When there are significant differences, they need not necessarily reflect important differences in accounting rules; they might be due to technical one-time effects such as the Hoechst prior-period adjustments. The notorious Daimler case—a gain of DM 602 million under German accounting was reconciled to a DM 1.8 billion loss under U.S. GAAP—also had such a technical explanation that it was fully understood by only some analysts.²⁰ Consequently, reconciliation data should be analyzed carefully before being used to evaluate companies or accounting regimes.

Form 20-F reconciliation data are used in a series of value relevance studies in which market returns over different periods (the dependent variable) are regressed in different specifications on levels and changes of

16. See Adler, Düring, and Schmaltz (1997), § 274, par. 26–30.

17. See Radebaugh, Gebhardt, and Gray (1995), pp. 176–81.

18. See Hoechst (1998), pp. 67–68 for details.

19. See Amir, Harris, and Venuti (1993); Frost and Pownall (1996); Barth and Clinch (1996); and the recent survey by Pownall and Schipper (1999).

20. See Harris (1993), p. 5; Radebaugh, Gebhardt, and Gray (1995), pp. 178–80.

Table 3. Reconciliation of the Hoechst Annual Report to U.S. GAAP, 1997 and 1998

Millions of Deutsche marks unless otherwise noted

<i>Reconciliation to U.S. GAAP</i>	<i>1997</i>	<i>1998</i>
Net income		
Net income under IAS	1,343	1,895
U.S. GAAP adjustments		
Business combinations: Goodwill	-249	-83
Business combinations: Research-in-process	-287	174
Tangible fixed assets	20	-187
Inventories	-17	53
Equity accounting: Investments	-416	-88
Pension provisions and similar obligations	-12	58
Restructuring provisions	-188	-28
Other	-5	12
Tax effect of U.S. GAAP adjustments	189	57
Minority interests	-1	-3
Net income under U.S. GAAP	377	1,860
Net income per share under U.S. GAAP (Deutsche marks)	0.64	3.16
<i>Stockholders' equity</i>		
Stockholders' equity as reported in the consolidated balance sheets under IAS	19,109	19,179
Less minority interests under IAS	3,097	2,580
Equity of Hoechst stockholders	16,012	16,599
U.S. GAAP adjustments		
Business combinations: Goodwill	2,113	1,654
Business combinations: Research-in-process	-2,449	-2,218
Tangible fixed assets	554	367
Inventories	-70	-2
Equity accounting: Investments	-222	-311
Available-for-sale investments	174	155
Pension provisions and similar obligations	172	-97
Restructuring provisions	28	n.a.
Other	38	136
Tax effect of U.S. GAAP adjustments	-317	-21
Minority interests	-4	-26
Stockholders' equity under U.S. GAAP	16,029	16,136

Source: Adapted from Hoechst (1998).

n.a. Not available.

non-U.S. GAAP net income, levels and changes of non-U.S. GAAP equity, and levels and changes of reconciliation amounts.²¹ Table 4 displays the results of the returns regression in the study by Harris, Lang, and Moeller.²²

If the regression coefficients of the reconciliation variables are significant and if R^2 is raised by including those variables, this is interpreted as value relevance incremental to home-country or international accounting. The studies report rather weak evidence of incremental value relevance.²³ However, this evidence should not be naively used as an argument for the perceived superiority of U.S. accounting rules. Using this methodology, one would also expect incremental value relevance for reconciliation data of U.S. companies from U.S. GAAP to foreign or international accounting rules.²⁴ The inclusion of additional variables always has the potential to increase the explanatory power of a regression.

A conceptual criticism of the value relevance approach questions its relevance to the functions of accounting. To be useful to investors or creditors in making investment decisions, accounting data should improve predictions of the amount, timing, and risk of future cash flows to the entity and ultimately to the investor. The association between contemporaneous or lagged stock market returns over different intervals and accounting variables does not provide such predictions.

If one on principle accepts the approach of the value relevance studies, other criticisms can be raised. The approach incorporates the explanatory power of a restricted number of variables out of a much larger data pool. For example, if home-country financial reports only disclose in the notes the amount of goodwill depreciation and the difference between book value and fair value of financial instruments, for example, these same amounts will show up as reconciliation items to U.S. GAAP that may have incremental explanatory power. It would clearly be inadequate to argue for the superiority of U.S. GAAP in such a situation because the potential

21. Empirical studies also use market values or share prices as dependent variables. As Brown, Lo, and Lys (1998) convincingly demonstrate the existence of a scale effect in price regressions, only the results of return regressions are considered in the following review of value relevance studies.

22. Harris, Lang, and Moeller (1994).

23. See, for example, Amir, Harris, and Venuti (1993); Barth and Clinch (1996); Harris and Muller (1999).

24. As stock exchanges in other countries do not require reconciliations, no such data are available for foreign listed U.S. companies.

Table 4. Regression Testing the Relations between Returns and Reported Earnings^a

$$(P_{jt} + d_{jt} - P_{jt-1}) / P_{jt-1} = (\alpha_{0t} + \alpha_{1t}) [(A_{jt} - A_{jt-1}) / P_{jt-1}] + \alpha_{2t} (A_{jt} / P_{jt-1}) + \eta_{jt}$$

Full sample	α_{0t}	α_{1t}	α_{2t}	R^2	N	Z-statistic
Germany	0.25 (14.7)	0.23 (1.1)	1.28 (5.6)	0.07	1,084	-0.06
United States	0.17 (10.5)	0.24 (6.1)	0.28 (4.6)	0.07	914	

Source: Harris, Lang, and Moeller (1994).

a. N is the number of observations; P_{jt} is the price per share of common stock of firm j at time t ; A_{jt} is accounting earnings per share for firm j at time t ; d_{jt} is dividends per share for firm j at time t ; Z-statistics are given to compare R^2 from German and U.S. regressions. Numbers in parentheses are t -statistics.

value relevance of the disclosed amounts is not reflected. Thus value relevance studies by design can only capture a small part of the full explanatory potential of accounting reports.

Harris, Lang, and Moeller in their careful study used matched samples of German and U.S. companies in order to control for factors such as size and industry.²⁵ However, the study could not identify significant differences in the value relevance of German earnings as compared to U.S. GAAP earnings (see table 4). This result is surprising because the primary objective of German accounting is not to provide information to the providers of risk capital but to determine distributable profits. This demonstrates the difficulties of empirical approaches to the evaluation of accounting regimes.

To sum up, many differences still exist between national and international accounting rules. These differences potentially result in different accounting numbers, as is evident from Form 20-F reconciliations. However, neither a priori theoretical reasoning nor the evidence from empirical studies appears to be convincingly useful in discriminating between different accounting regimes and even less so between specific accounting rules. National standard setters base their choices on secondary criteria and on an extensive process of deliberations on specific accounting issues. A discussion of a tentative process for developing a set of global accounting standards is the theme of the next section.

25. Harris, Lang, and Moeller (1994).

Setting up a System of Global Accounting Regulation

Currently, we are facing a historically unprecedented favorable situation of a general consensus in the business community as well as among standard setters and legislators on the following:

- We need one set of global accounting standards.
- Those global accounting standards should be of high quality.
- They should be oriented toward the needs of providers of finance in capital markets.

Two questions have yet to be resolved: (1) How do we arrive at an agreement on this one set of standards? And (2) how can we be sure that those standards are equally interpreted and applied worldwide? High-quality standards are a necessary prerequisite of high-quality accounting reports, but they are not sufficient. The importance of effective enforcement cannot be overemphasized.

Accounting standards are the product of a due process conducted by a standard setter (for example, a legislative body or a private standard-setting body). Again there exists a broad consensus on the essential characteristics of a due process aimed at establishing high-quality accounting standards:²⁶

—The standard setter should address accounting issues brought to his attention by external parties (users, preparers, regulators, and the general public, including academics) in a responsive and timely manner.

—The standard setter should actively seek communications with external experts about the accounting problems and all relevant accounting alternatives on his agenda, for example, through meetings, public hearings, invitations to comment on discussion papers, and field hearings.

—The standard setters should publish exposure drafts of proposed rules together with an outline of the basis of conclusions and ask for comments from all interested parties within a reasonably long comment period (for example, three months).

—The standard setter should consider all comments carefully in redrafting proposed rules or issuing final standards.

—The decisions on issuing exposure drafts or final standards should be taken in meetings open to the public that give dissenting opinions the chance to be heard.

26. See FASB (1998); IASC (1998); comment letters are available at www.iasc.org.uk/frame/ce4_66.htm.

—If necessary, the standard setter should support the implementation of standards by providing guidance (for example, illustrative examples and training courses).

—The standard setter should evaluate the success of the standard with regard to the objectives.

The Structure of Competing Standard Setters

The structure of the standard-setting body is the most important and controversial issue. To some—not necessarily only from the United States—an approach of “follow the leading standard setter” is appealing. The FASB pursues standard setting in the spirit outlined for more than twenty-five years, and its achievements are regarded highly worldwide. The board is structured as a group of seven independent, full-time experts in accounting with differing backgrounds reflecting the experience of users, preparers, auditors, and academics. The idea of restructuring to include non-U.S. members and establish an internationalized FASB as the global accounting standard setter has been discussed. However, this model does not appear to be a viable alternative for various reasons.

First, it is difficult to imagine that legislators or standard setters of one country will delegate authority to a body dominated by another country. The slogan of 1776—“no taxation without representation”—does not apply only to the thinking of U.S. citizens and officials.

Second, even though the FASB deserves praise for its achievements, U.S. GAAP rules do not always provide the most advanced solution to accounting issues. For example, providing for post-retirement benefits was required by German and EU accounting rules well before the issuance of SFAS 106 (1990). SFAS 94 (1987) put an end to the abuse of not consolidating finance subsidiaries, which was not—at least to the same extent—a problem in European accounting. Currently, in the project on consolidations, the FASB is considering a move to the control concept, which was the only basis of German consolidated financial statements before 1985.²⁷ The discussion on asset retirement obligations also brings U.S. GAAP closer to German and EU rules.

27. See FASB (1999a), par. 198: “The Board concluded that the relevance and representational faithfulness of the information provided by consolidated financial statements will be increased by reporting all of the assets a parent controls.”

Third, the current set of U.S. rules was developed as a response to accounting issues emerging in the U.S. environment. Foreign users of U.S. GAAP experience problems because they have to deal with accounting issues that do not show up in the United States in the same way, for example, the provisions for restructuring or deferred taxation. In Europe, the participation of workers and labor unions implies that binding commitments by management have to be made at a time when U.S. rules do not allow such a provision. The rules of SFAS 96 (1987) on deferred taxation are based on a classical system of income taxes and are not easily applied to tax systems with different rates for distributed and undistributed earnings—not to speak of the specifics of international taxation.²⁸ Because there are many special situations on a worldwide basis, the “cook book” approach of U.S. standard setting will be difficult to maintain.

An alternative to an internationalized FASB could be the IASC. The IASC board in its current structure has thirteen part-time country members and three co-opted institutional members. The broader country representation is deliberately biased toward the developed countries (nine members). Founded by the national accountancy bodies cooperating in the International Federation of Accountants, membership of the IASC board is still dominated by the accountancy profession, even though many country delegations (normally two board representatives and one technical adviser) include representatives of preparers, users, or national standard setters. With about seventy persons (including observers, guests, and IASC staff) sitting at the table, IASC board meetings are not an efficient forum for detailed technical discussions.

Most of the technical work is carried out by steering committees composed of six to eight volunteers from different countries and backgrounds, who are charged with preparing drafts to be submitted to the IASC board. However, membership is not balanced either within or across steering committees. Members from the Anglo-Saxon G-4 countries (Australia and New Zealand, Canada, United Kingdom, and United States) clearly dominate in the steering committees.

Despite these structural deficits, the work of the IASC board has gained support from a considerable number of national legislators and standard

28. See Bruns (1999), pp. 5–9.

setters, including the EU.²⁹ On most of the major stock exchanges, financial statements prepared under IAS are accepted for cross-border listings, with the United States being the most prominent exception. In many of the developing countries, IAS may form, or even have to form, the basis of the primary financial statements. Currently, the IASC is seeking the endorsement of IOSCO that the core set of IAS finalized by the end of 1998 will be accepted for cross-border listing by all stock exchanges cooperating in IOSCO (including the U.S. stock exchanges under the regime of the SEC).

The IASC board in its current structure is not a viable alternative to serve as the global standard-setting body either. Currently, a major restructuring is being discussed as a way for the IASC to gain wider acceptance.

The 1998 Proposal by the IASC Strategy Working Party

In December 1998 an IASC Strategy Working Party proposed a new structure for setting standards at the international level (figure 1).

The key to gaining legitimacy will be a stronger involvement in the body deciding on global accounting standards of those institutions that have legitimacy and authority on the national level (for example, legislative bodies, private standard-setting bodies). The 1998 proposal of the IASC Strategy Working Party calls for increasing the IASC board to twenty unpaid country delegations representing national professional accountancy bodies and five co-opted institutional members having the final right to approve exposure drafts, interpretations, and final standards. This structure is bound to fail because it improves country representation only marginally and does not shift from the accountancy profession to the legitimate national standard setters.

The key to gaining quality is to secure the input of the best technical experts from all over the world. The IASC Strategy Working Party proposes a new Standards Development Committee (SDC) of eleven members appointed for a five-year term and renewable once (with all members working at least half time and a majority working full time). Six to eight members should be delegated by national standard setters, with up to four members from other groups (such as preparers, users, public accountants,

29. For the use of IAS in countries around the world, see www.iasc.org.uk/frame/cen1_12.htm [May 19, 2000]; for companies referring to their use of IAS, see www.iasc.org.uk/frame/cen1_7.htm [May 19, 2000].

Figure 1. Proposed New Structure

and academics). SDC membership further should be balanced between developed and developing countries as well as geographically. The SDC would develop exposure drafts and standards and set its own agenda. It would set up subcommittees or advisory groups for accounting problems in special industries or regions as well as in new problem areas (for example, Internet reporting). The IASC board would need a majority of fifteen out of twenty-five voting members for approval of a standard or exposure draft submitted by the SDC on a qualified majority vote of seven out of eleven. Thus a minority of eleven votes would be sufficient to reject proposals by the SDC to the board. If the proposal were resubmitted by the SDC on a nine out of eleven vote, the board decision to accept or reject would require a simple majority (thirteen out of twenty-five).

The proposed SDC closely follows the model of an independent expert standard setter that has proved successful in the U.S. environment and been copied elsewhere (Australia, Germany, United Kingdom). Due to the small number of SDC members, the problems of representation and legitimacy will continue to arise at the international level. The national standard setters do not face the same problem of legitimacy and authorization because they derive their support from the national legislators.

The 1998 proposals of the IASC Strategy Working Party elicited more than eighty comment letters. Many respondents criticized the sharing of authority to vote on exposure drafts and final standards between the SDC and the IASC board. One group of comments asked for a stronger SDC and recommended that the IASC board be an advisory board to the SDC with a broader representation of countries. In order to be more responsive to the problem of legitimacy, it was suggested that the number of SDC members should be increased.³⁰ Again, a marginal increase would not solve the problem of inadequate representation and thus would not result in a substantial gain of support. Other comments suggested concentrating the voting power at the IASC board level.³¹

Figure 2 presents a model of a structure of a global accounting standard-setting body designed to overcome the above criticisms. To perform efficiently, a global accounting standard-setting body obviously

30. See, for example, the comment letters by the FASB/FAF, the U.K. ASB, or the SEC at www.IASC.org.uk/frame/cen4_66.htm [May 19, 2000].

31. See, especially, the comment letter of the EU at www.iasc.org.uk/frame/cen4_66.htm [May 19, 2000].

Figure 2. Model of a Recommended Structure for Global Accounting Standard Setting

needs to have a restricted number of delegates. However, the legislators and standard setters delegating some of their authority will want to influence the nominations and the processes of the global board. This could be effected by having national legislators and standard setters be represented in a general assembly of accounting standard setters that nominates and supervises the global board.

On the technical projects the global board should be supported by global accounting task forces staffed by experts from national standard setters and their constituencies. Membership should, in principle, be open but restricted to highly qualified persons having the resources and time to contribute effectively to the drafting of proposed and final standards for submission to the global board. The Joint Working Group of Standard Setters on Financial Instruments (JWG) could serve as a model for such global accounting task forces. In 1998 the IASC board established an international working group consisting of representatives of ten national accounting standard setters. The JWG is charged with developing an integrated and harmonized standard on financial instruments. In addition to delegations from the G-4 countries, the group includes representatives of France, Germany, Japan, and the Nordic countries. Thus membership of the Joint Working Group is heavily biased toward the developed countries and in particular the Anglo-Saxon countries. However, in principle, standard setters from the developing or emerging countries with expertise and interest in the subject area (for example, from Singapore) could easily be integrated. The creation of project-related working groups would allow more national standard setters to participate in the development of global accounting standards and thus create an incentive to support consistent application and enforcement of the standards.

The national legislators or standard setters would play an important role in lending legitimacy to a global body, contributing to the development of global accounting standards, and—last but not least—enforcing their consistent application. The legal structures of enforcement will differ as application of global accounting standards might be required by specific types of corporations only in certain jurisdictions (for example, listed companies, large companies).

Setting accounting standards in such a structure will not be monopolized by the global board. The national standard setters, most notably those of the most developed countries, will be forceful competitors and will exert pressure on the global board to address accounting problems in a

timely manner and to strive for high standards. Thus one would envisage a contest of “accounting beauty.”

The Evolving Structure of the IASC

At its November 1999 meeting, the IASC board unanimously approved the new structure proposed by the IASC Strategy Working Party after considering the comments to the 1998 proposal and after extensive background negotiations.³² It is expected that the new structure displayed in figure 3 will be approved at the March 2000 IASC board meeting and come into effect by January 1, 2001.

The new IASC structure will consist of only one body—the new IASC board—with authority to vote on the issuance of exposure drafts and final standards and to approve final interpretations by an unchanged Standards Interpretation Committee. The board will consist of twelve full-time and two part-time members to be selected by a group of nineteen trustees. The composition of the board follows the independent expert model, emphasizing technical expertise as the prime qualification of board membership. There are no quotas for geographic representation. However, the trustees should ensure that the composition of the board is not dominated by a particular group or regional interest. At least five board members serving for a five-year term (renewable once) should have experience as practicing auditors—thus retaining much of the IFAC influence; at least three board members should have experience as preparers and three as users; at least one board member should be an academic. Seven full-time board members should have formal liaisons with national accounting standard setters. All full-time board members are to be compensated exclusively by IASC and are to sever all employment relationships with their current employer.³³

The selection of board members is the prime responsibility of the trustees, of whom six should be from North America, six from Europe, four from the Asian Pacific region, and three from any area, including the aforementioned ones. Five trustee seats should be reserved for IFAC nominees, and one trustee should come from one of the following groups: preparers, users, or academics. Trustees holding one of the remaining eleven

32. This section has been added to the paper presented at the conference in order to incorporate new developments in the process of IASC restructuring. See IASC (1999).

33. See IASC (1999), par. 52–55, app. A.

Figure 3. Proposed New Structure

at-large seats do not have to belong to a particular constituency group. The trustees will be appointed *ad personam* and serve for a three-year term, renewable once; they will be remunerated by IASC. They should show a firm commitment to IASC and have an understanding of the issues involved.³⁴

The trustees will also select replacements in their same group. This may perpetuate the power structure of the original nominations, which underlines the importance of the task put before the seven outstanding individuals appointed to the Nominating Committee in December 1999.

The group of trustees will not bring legitimacy to the structure in the sense that they represent standard setters or legislators. Thus the new IASC structure may find it hard to gain the support of important regional or national standard setters who will strive to retain their influence. The proposed structure features a Standards Advisory Council that shall provide accountancy bodies, regulators, national standard setters, and organizations of constituent groups a “forum in which to debate technical and other issues with the Board.” This Standard Advisory Council probably will not be accepted as an adequate representation by those standard setters and legislators who have no direct influence on the trustees or on the new IASC board.³⁵

The unanimous preliminary vote on the new structure is a good start. However, approval of the structure by the current IASC board will not be sufficient for its success. Acceptance will have to go beyond the standard setters represented on the new board. This is essential for a process of global harmonization of accounting standards that are to be consistently applied and properly enforced on a national level.

Concluding Remarks

Currently, there exists a window of opportunity for creating a structure capable of producing a comprehensive set of high-quality global accounting standards that are consistently applied and properly enforced worldwide. National legislators and standard setters have expressed their

34. See IASC (1999), par. 21ff., 59.

35. It should be noted that, for example, the EU was not represented in the Strategy Working Party.

readiness to cooperate and compromise. European countries (such as France and Germany) have agreed to accept, for a restricted period of time, financial statements prepared under IAS or U.S. GAAP in order to facilitate convergence on an international level. The U.K. ASB has publicly announced that it will not insist on having a seat on an international accounting standard-setting body that promises to meet the generally accepted goals.

However, it would be naive to assume that all parties with vested interests are ready to compromise on a new structure. The professional accounting bodies will have to give up much of the influence that they now exercise through IFAC and IASC. National legislators and standard setters will have to accept rules defined outside their domain. The European countries are used to ceding authority in this area where rule making was delegated to the European level. This appears to be much more difficult for the FASB and the SEC, whose members in a way feel and are respected as the world leaders in setting and enforcing accounting standards.

The rather restrictive approach of the SEC to the endorsement of the IAS core set of standards resulting from the IASC/IOSCO Comparability Improvement Project is not encouraging. In several speeches, SEC officials have outlined the process of change at the SEC and indicated that this process will be time-consuming and thorough.³⁶ Nobody really can object to a thorough analysis of this set of IAS as it might serve as a starting point for developing a comprehensive set of global accounting standards. It is the spirit of the analysis that matters. Without doubt, the analysis will identify areas of close similarities as well as areas of divergence between IAS and U.S. GAAP. The remaining differences in rules should be judged with regard to their contribution to the objective of accounting regulation. The anecdotal evidence of the Hoechst reconciliation presented in table 3 questions the empirical relevance of the differences in rules.

A strategy of delaying the process of global accounting standard setting might appear attractive from a U.S. perspective, especially as more and more European companies are applying for listing under current SEC rules. It would preserve the current predominance of U.S. GAAP with large multinational companies and result in at least a temporary competitive advantage for U.S.-based companies in the huge market for accounting and auditing services. However, such a strategy is not without risk to

36. See, for example, Turner (1999a).

the SEC and the FASB, as they would leave the initiative to others. Judging by their contributions to the debate, the SEC and the FASB are aware of the risks of not supporting the establishment of a global accounting board.

The new IASC structure evolved as a result of intense background discussions and negotiations. The outcome has been especially responsive to the critical arguments put forward by the FASB and the SEC. Both the SEC and the FASB have announced their support for the new IASC board.³⁷ We will have to wait and see whether this new structure will also gain the crucial support of other regional or national standard setters, who feel that their suggestions have not been implemented adequately. The key problem of legitimacy has not been resolved, however, because the nomination and supervision of board members have been left to a group of trustees, however carefully selected.

Ultimately, global companies and global investors will not accept national regulations that do not address their needs. Market demand and market forces will achieve globally accepted accounting standards. Currently, U.S. financial markets are unrivaled in liquidity and depth. But a cooperation of stock exchanges in Euro-land probably will result in markets that are attractive to issuers and investors from all over the world. With a set of high-quality global accounting standards in place, this would create a challenge for U.S. institutions.

37. Turner (1999b).

Comment and Discussion

Comment by Robert H. Herz: This paper is very much a linchpin, and the author is very deliberative in his process. I agree wholeheartedly that this is because the Securities and Exchange Commission (SEC) can boast that we have 60 percent of the world's trade equity here. Everything that relates to our system by definition must be the right model, at least until proven otherwise.

That brings me to a critical point. In the United States, whether all of the elements are perfect or not, we do have all of the elements needed for a good financial reporting system. We have fairly robust accounting rules, and we have extensive disclosure rules. I like to think that we have good auditing in general. We have a fairly comprehensive system of regulatory review, oversight, and enforcement. We also have an improving environment of corporate governance over financial reporting. It is not perfect, but it is improving.

Following up on the observation that financial reporting is a product, I would say that a product has different elements that are essential for it to be a good product. My own view is that the time clearly has come for us to have a global financial reporting product or products with all of these elements. Getting there is proving to be extremely, extremely difficult, because there are so many vested interests. We have different regulators and different accounting bodies, all of which make a living out of doing what they do. They all have their own views about things.

Unless we build this product, globalization, technology, and the work of the analysts are quickly going to obviate financial reporting as we know it, and this may happen anyway. The amount of alternative information that is available for judging the performance of companies is overwhelming. Plus

the models that we have of financial reporting right now, which include the U.S. model and the international accounting standards model, raise serious questions about the relevance of some of the underlying concepts, particularly concerning the bricks and mortar concept in the information age.

And then there is the issue of timeliness. It is possible to get all of the information needed to make decisions rapidly over the Internet as opposed to through the formal financial statements that come out in the United States, on average, two months after the year end. Abroad they come out four or five months after the year end.

Unless we do something, we may be displaced in the provision of information products. There have been hopeful signs, although the efforts are not coordinated in the way that I would like. I would like to see a product development effort. Lots of different groups of regulators and constituents are looking at different parts of the system. For example, a group called the IFAC Forum, which is the International Federation of Accountants, was formed to promote accountancy and auditing development. This group is meeting periodically to discuss general concepts and the future, but it does not address product development.

The big accounting firms are coming closest to that. We can set in effect the standards for auditing in a real sense: not the actual standards themselves, but the way that auditing is done. For example, my firm uses a standard methodology for audits throughout the world. The problem arises with the way that it is applied in different cultures. It is applied very, very differently.

We probably have a decent shot at catalyzing this development and bringing the parties together. In fact, a group has been formed called the Global Steering Committee of the Big Five. This committee is seeking to uplift and harmonize both accounting and auditing. For example, in our firm, we are now—and this may seem fairly simple—identifying in our audit reports exactly which GAAP, country GAAP, or international accounting standards are being used and which set of auditing standards is being used. So if you pick up our report, and we are using Japanese standards, you know that we are using Japanese standards.

The second step would be—and we have done this in certain countries as well, particularly in Asia—to add some language to that. The pejorative term would be akin to a health warning. We would speak to the fact that these accounting standards may not be what the reader is used to in other places in the world.

These are all positive developments. I think it is very important to improve relevance, because we have to have a financial reporting product that people feel is useful in decisionmaking.

Many different efforts are under way. An effort being coordinated by the Financial Accounting Standards Board (FASB) called the business reporting research project is essentially cataloging nonfinancial disclosures across ten industries in an effort to identify the practices.

Steve Wallman is heading a group sponsored at Brookings that is looking at approved disclosures on tangibles. And the Securities and Exchange Commission (SEC) is now seeing that some momentum is beginning to build with that. Last week, Arthur Levitt announced that there also will be an SEC group, headed by Jeff Garten of Yale University, looking at this issue of intangibles and soft assets.¹

Again, those are all good, but if you really want to get somewhere, you have to approach this the way that companies do in developing a product and putting together a product development team. It may mean that some people have to fall on their sword. Without that, the development would be extremely slow. I am not optimistic that what I currently do for a living, for example, is going to continue being very much in demand in the marketplace.

General Discussion: Anthony Santomero began by asking whether it is appropriate and effective to force the global financial community to conform to a single accounting standard. He suggested that certifying different accounting standards may be sufficient, since the rate of change in the value of firms can be calculated once you understand the standards and keep to those standards over time. Robert Litan expressed his concern that such a system could be confusing to investors and politically charged, since the United States would have to make a separate mutual recognition decision for every single country-specific standard.

Trevor Harris argued that the problem with the current accounting standards in the United States is that they are not dynamic and fail to adapt quickly to market needs. Harris also explained that the difficulty in understanding and comparing different accounting standards across countries

1. SEC Chairman Arthur Levitt, "Quality Information: The Lifeblood of Our Markets," Speech to the Economic Club of New York, New York City, October 18, 1999.

also leads to inefficiencies in the allocation of capital. He added that having good auditing and proper enforcement of the standards is just as important as having common accounting rules.

Philip Mistretta pointed out that any attempt to harmonize capital regulatory standards is meaningless if the capital is denominated under a completely different accounting system. Edward Ettin responded by asserting that accounting factors are dwarfed by regulatory differences in explaining international differences in permissible levels of bank capital under the Basel Accord.

Michael Pomerleano commented that accounting consistency would be useful in facilitating not only flows of portfolio investment but also cross-border foreign direct investment, especially mergers and acquisitions. He argued that one of the impediments to the corporate restructuring process in Asia is that the due diligence process involves tremendous time and effort in translating from one accounting standard to another. As an example, he pointed to Hyundai's acquisition of Kia in which the acquirer discovered that actual liabilities were twice the reported liabilities.

Litan wondered what would be wrong with having foreign firms wishing to register on American equities exchanges account for their financial statements under either the international standards (International Accounting Standards Committee) or generally accepted accounting principles (GAAP), so long as investors are told which standard applies. One respondent noted that many large non-U.S. firms, such as Nestlé, already have Americans as a substantial percentage of their shareholders and therefore do not need to register themselves on the U.S. stock exchange to attract U.S. investors. Trevor Harris added that even if market participants know which accounting standards a foreign firm is reporting under, investors still have a problem understanding the different standards and making accurate comparisons. He cited one of his own studies, which showed that although German and U.S. accounting standards are very similar in some respects, large differences remain in the way stocks are priced in the two countries. If investors had detailed information about, say, the reserve structure of Deutsche Bank, they would be much better informed about how to price the bank's shares relative to those issued by Citigroup.

Another participant observed that a large number of U.S. fund managers access the European market through Instinet terminals, which indicates that technology is eroding the barriers between markets. Nonetheless,

there continue to be large efficiency losses because investors have a very difficult time translating from one accounting standard to another. The example was given of auto analysts who try to make global comparisons of auto company performance by taking out depreciation, an important measure in the view of some, only because they do not know how else to sort out accounting differences.

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