No. 2000/05

The Evolution of Global Standards of Accounting

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CFS Working Paper No. 2000/05

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December 1999

Abstract: The globalization of markets and companies has increased the demand for internationally comparable high quality accounting information resulting from a common set of accounting rules. Despite remarkable efforts of international harmonization for more than 25 years, accounting regulation is still the domain of national legislators or delegated standard setters. The paper starts by outlining the reasons for this state of affairs and by characterizing the different institutional backgrounds of accounting standard setting in four selected countries as well as on the international level. This is followed by a summary of important international differences in accounting rules and a summary of the empirical evidence of the impact of different rules on the resulting numbers and their relevance to users. It is argued that neither a priori theoretical reasoning nor the evidence from empirical studies provides a convincing basis for choices between accounting regimes and even less so between specific accounting rules. As there is a broad consensus that there is a need for one set of global accounting standards the final sections of the paper discuss currently existing and proposed structures of international accounting standard setting. The evolving new IASC structure is critically evaluated.

Keywords: Standard Setting, Global Accounting Standards, Accounting regulation, IASC New Structure

JEL classification: G 10, G 15, G 18

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1. Introduction

For several decades we observe that in many key industries companies increasingly are confronted with worldwide competition. They have responded to this challenge with strategies of globalisation. 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 globalise is also felt by many focussed small and medium sized enterprises that are suppliers of components or specialised 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 its Finland home market have been only 3.5 percent of total sales.[1] In addition, in the past few years, we observe increasing cross border merger activities that have resulted in companies (e.g. ABB, DaimlerChrysler, Aventis) that no longer can be regarded as national groups. But those companies are still subject to national regulation – last but not least in the areas of accounting and financial reporting.

Globalisation strategies are not restricted to operating and investing activities but increasingly also involve financing. Foreign listings are not new to US multinationals or many of the large European companies being traded at home as well as on other major European and Asian stock exchanges (such as London, Frankfurt, Paris; Hong Kong, Tokyo). New in recent years is that an increasing number of European companies are applying for listing on US stock exchanges notwithstanding the fact that complying with Securities and Exchange Commission (SEC) requirements puts quite a burden 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 focus not only on the global players, but increasingly on small and medium sized enterprises that may not to be quoted on a stock exchange.

Accounting information plays a crucial role in those 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

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[1] See Annual Report Nokia 1998, p.12.

different internationally, we observe differences in rules and differences in the application of those rules that hamper internal communication. This problem traditionally was overcome by internal accounting guidelines that were mainly based on the national accounting rules of the parent companies.

For companies focussing 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.

From the above, it seems to be obvious that the use of only one set of global accounting principles would facilitate internal and external communication. Promoting the harmonisation of accounting rules has been the mission of regional bodies (e.g. European Union (EU), Nordic Countries) and international bodies (e.g. IASC) for over more than 25 years. National (e.g. FASB) or regional (e.g. EU) standard setters have designed strategies to have their accounting rules applied beyond their respective jurisdictions. However, we still are far from an agreement on only one set of global accounting standards that is accepted and consistently applied worldwide.

The next section will explore the background of accounting regulation in selected country settings and highlight distinguishing features that explain the persistence of different national accounting rules. Section 3 points to major differences between national and international accounting rules and to their impact on accounting numbers. It further discusses the difficulties of evaluating alternative accounting rules theoretically or empirically. A discussion of structures and processes of a Global Accounting Standard Setting Body designed to overcome the national and international differences in accounting regulation is the theme of section 4.

2. Institutional characteristics of accounting regulation

The growing body of international accounting literature stresses as one of the major reasons for differences in national accounting rules the different functions of accounting in its respective socio-economic environments. The provision of information for participants in capital markets (investors, creditors) and for the general public is the prime objective of financial reporting in the US and also according to the IASC Framework which suggests that such information will meet the common needs of other stakeholders.[2] Interestingly, the UK Accounting Standards Board (ASB) more narrowly focuses on the providers of risk capital as the primary user group thus 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 (e.g. France, Germany) accounting serves primarily as a verifiable basis for contractual arrangements and especially as mechanism for determining distributions to equity investors and to tax authorities. Beyond that, accounting is used by the French government in macroeconomic policy decisions.[4]

Such differences in the socio-economic functions of accounting induce differences in the processes of accounting regulation. Table 2-1 provides an overview of important institutional features of these processes in four selected countries (USA, UK, Germany, France) and at the international level. In all four countries accounting regulation is at the outset governed by law enacted by parliament thus having 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 (e.g. USA, Australia) details of accounting regulation are delegated to governmental agencies (e.g. SEC) which in turn might delegate their authority to a private accounting standard setting body (e.g. FASB). In countries with a tradition of code law (e.g. France, Germany) commercial law 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 in France and Germany. Both, the French Comité de Reglementation Comptable (CRC) and the German Accounting Standards Committee (GASC) do not have the ultimate power to issue accounting rules but have to ask for governmental approval.[6] Thus, legislators and governments in those countries are determined to retain control of the process of accounting regulation.

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[2] See FASB (1999a), Statement of Financial Accounting Concepts No. 1: Objectives of Financial Reporting by Business Enterprises, par. 1.1, 1.5, 1.6; IASC (1995), Framework, par. 1.

[3] See ASB (1993), Statements of Principles for Financial Reporting, par. 1.1-1.6.

[4] See Colasse, Standish (1998), p. 115.

[5] The UK as a common law country had to introduce many detailed accounting rules in company law due to the transformation of EU Directives.

Table 2: Differences in Accounting Regulation

	USA	UK	IAS	Germany	France
Legal Basis of Accounting Regulation	Securities Act (1933) Securities Exchange Act (1934)	Companies Act		Commercial Code Tax Code	Commercial Code Tax Code Plan Comptable General
Accounting Standard Setting Bodies	Securities and Exchange Comission	UK Parliament		German Parliament Federal Ministry of Justice	French Parliament Council National de la Compatible (State dominated)
	Financial Accounting Standards Board (1978) (comprehensive delegated authority)	Accounting Standards Board (1990)	International Accounting Standards Comittee (1973)	German Accounting Standards Comittee (1998) (delegated authority for group accounts of listed companies subject to approval bv BMJ)	Comité de Réglementation Comptable (1998)
	Emerging Issues Task Force	Urgent Issues Task Force	Standing Interpretations Comittee (1996)		
Enforcement of Accounting Standards	Securities and Exchange Comission			Tax authorities Tax and Civil Courts	
	Statutory Audits by CPA	Statutory Audits by CPA	Recommended Audits (IFAC support)	Statutory Audits by CPA	Statutory Audits by CPA
		Financial Reporting Review Panel (1989)			

State control of accounting regulation 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 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 of 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 purely the purpose to provide information. The GASC has authority to issue accounting standards applicable to group financial statements of listed companies only and therefore should - in principle - not be able to impact profit distribution or taxation.

In Germany, compliance with state controlled accounting regulation is secured by the tax authorities and by tax courts rulings because there is a close link between tax financial statements

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[6] See Federal Ministry of Justice (1998); Colasse, Standish (1998), pp. 139-140.

and commercial financial statements.[7] For commercial financial statements enforcement is the domain of the civil courts which deal primarily with accounting issues relevant to the level of taxable or distributable income which is based on the individual financial statements. There are only a few civil court decisions on accounting issues relating 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 when 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 Mio. for audits of non-listed companies and of only DM 8 Mio. for listed companies.

The threat of sanctions is further eased by the difficulties in identifying noncompliance as 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 which should be followed by the auditors. However, neither the IDW has a delegated authority of interpreting accounting rules nor are those interpretations formally approved by the legislator or by government. Also, there is no authorized interpreting body such as the Emerging Issues Task Force (EITF) in the US or the Standing Interpretation Committee (SIC) at the international level.

Enforcement of accounting rules in the US is dominated by the SEC having set up a special enforcement division concentrating on the review of 10-Q and 10-K-filings. The SEC Division of Corporate Finance is concerned with accounting reports in filings for security registration. The

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7 See Ballwieser (1995), pp. 1428-1432; Working Group on External Financial Reporting of the Schmalenbach-Gesellschaft/Deutsche Gesellschaft für Betriebswirtschaftslehre (1995), pp. 92-99.

8 See § 322 par. 1 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/the 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

SEC Enforcement Division undertakes reviews not only based 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 to testify. Even though the SEC requires all filings of financial statements to be audited by a certified public accountant, it does not fully rely on the auditors who face much stronger sanctions when failing on their duties than their Continental European colleagues.

In the interpretation of accounting rules and in the identification of noncompliance the SEC Chief Accountant plays a decisive role drafting Financial Reporting Releases for approval by the SEC Commission and issuing interpretations in a variety of ways (e.g. Staff Accounting Bulletins, speeches, articles). He also influences the standard setting process by asking the FASB to be specific on different variations,[9] by providing examples, and increasingly by developing training materials.

The SEC commands an effective armory of sanctions against non-complying registrants ranging from stops 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 at the time of announcement of a SEC investigation.[10]

Reliance on the auditors and on adverse publicity by a Financial Reporting Review Panel (FRRP) is an important characteristics of the UK enforcement process. The FRRP (re)acts only upon 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 statements by quoted companies, but which does not take direct actions on non-complying companies.[11] The FRRP can take companies to court but would do so only as a last resort.

The differences between the enforcement processes in the US and in the UK are striking.[12] Even more striking is the lack of any genuine enforcement on the international level. The IASC relies

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financial statements/consolidated financial statements."

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

10 See Feroz et. al. (1991); Dechow et. al. (1996).

11 See Jack (1994), p. 48.

on the enforcement of its accounting rules at the national level and on the support of the International Federation of Accountants (IFAC). Ultimately, it seems that there is currently no effective threat of sanctions to noncompliance with IAS by companies or by auditors other than loss of reputation if detected and made public.

3. Current status of differences between national and international accounting rules

There exists an impressing body of literature comparing the accounting rules of individual countries (e.g. US/UK comparison) or, more recently, comparing the national accounting rules with international accounting standards (IAS) issued by the IASC.[13] The German GASC has devoted its first German Accounting Standard DRS1 to an analysis of the compliance of IAS and US SFAS with EU Directives.[14] 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, 133 require all derivative instruments and all securities available for sale or held for trading to be fair valued through net income or other comprehensive income. Current EU rules and German rules in particular prohibit fair valuation exceeding cost values.
- *Accounting for long term construction contracts*: German rules still require the use of the completed contract method whereas IAS 11.22 and US GAAP (ARB 45.4 ff.) require an 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 US GAAP (APB 16.66 ff.) it is compulsory to recognize the goodwill on the acquisition and to amortize it over its useful live.

A list of further differences typically will comprise the areas of recognition of deferred taxes on

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[12] Böckem (1999) provides a detailled discussion of the enforcement arrangements in those two countries.

[13] See for example FASB (1996); IDW (1995). Revised editions of these comparative studies incorporating the changes in IAS after completion of the IASC/IOSCO Comparability Improvement Project have been announced.

prior period losses, of recognition of research and development expenses, of revaluations of non-current assets, of recognition of liabilities, of provisions for restructuring, of provisions for pensions and post retirement benefits, and of accounting for foreign currency transactions. There are also 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. As this evaluation should be related to the objectives of accounting, we face the non-trivial problem that agreement on the objectives should be the first step. Fortunately, it appears that a consensus is developing that published financial statements of listed companies should be aiming at the provision of information to providers of capital that is useful in making investment decision. 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 primarily interested 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 a priori evaluate specific accounting rules (e.g. capitalisation 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 (i.e. relevance, reliability, neutrality, comparability, consistency) that should make accounting data useful. However, the application of these qualitative characteristics does not result in unambiguous choices as 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 as probability estimates require judgements that will lack verifiability in many instances. The key problem with the choice of accounting rules is reaching an agreement on balancing different characteristics.

Differences between national and international accounting rules would be of small importance to users if they do not 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-US 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

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[14] See GASC (1999), DRS 1.

the published financial statements (i.e. national accounting rules or IAS) to US 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 US GAAP and home country or international accounting standards.

Table 3-1 displays the effects of first time adopting US GAAP on the financial statements of the German based BASF as of January 1, 1998. Differences between German commercial accounting and US GAAP accounting could in part be overcome by changes in the choice of accounting alternatives available under German rules and preferring the US GAAP alternatives that are compatible with German rules. The first panel of Table 3-1 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.

Table 3-1: BASF Annual Report 1998 - Changes in accouting methods

Panel 1:

	Million DM
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 as of January 1, 1998 after adjustment	**23,497**

Reconciliation

Additional required adjustments to comply with U.S. GAAP which could not be recorded in accordance with the german Commercial Code are included in the following reconciliation:

Panel 2:

Reconciliation of shareholders` equity as of January 1, 1998	Million DM
Equity excluding minority interests as of January 1, 1998 after adjustment	23,497
Capitalization of construction period interest	812
Valuation of securities at market values	91
Adjustments for pension funds	1,297
Other adjustments	354
Recognition of deferred tax assets for U.S. GAAP adjustments and for tax loss carryforwards	- 785
Minority interests	- 52
Equity according to U.S. GAAP as of January 1, 1998t	**25,214**

Panel 3:

Reconciliation of net income and shareholders` equity as of December 31, 1998	Net income after taxes and minority interests Million DM	Equity excluding minority interests Million DM
BASF Group´s Financial Statements	3,324	25,268
Capitalization of construction period interest	69	881
Valuation of securities at market values	- 3	173
Adjustments for pension funds	- 66	1,231
Other adjustments	109	457
Recognition of deferred tax assets for U.S. GAAP adjustments and for tax loss carryforwards	55	-738
Minority interests	-24	-76
Net income and shareholders` equity according to U.S. GAAP	**3,464**	**27,196**
Earnings per share according to U.S. GAAP (in DM)	**5,56**	
Diluted earnings per share according to U.S. GAAP (in DM)	**5,45**	

Further changes in equity result from applying US GAAP rules that are not compatible with German accounting rules (Table 3-1, Panel 2). Important areas here are the capitalisation of borrowing costs, fair valuation of securities, and a large reduction in provisions for employee benefits. The compensating effect of deferred taxes on those accounting differences is reduced by recognizing tax benefits on prior period losses which is not considered an accepted accounting practice in Germany.[15] The net change of equity is DM 2813 Mio. or 10.6 percent for BASF. This might be an understatement of the total effect as companies prefer a series of minor accounting changes over several years.[16] Panel 3 of Table 3-1 displays the BASF reconciliation at fiscal year end 1998. The difference between US GAAP and German commercial accounting net income is DM +140 Mio. or 4.2 percent, the equity difference is DM +1928 Mio. or 7.6 percent.

Table 3-2 presents the reconciliation from IAS to US GAAP by 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 back to IAS not requiring period adjustments which have to be made under US GAAP.[17]

The anectdotical evidence in Tables 3-1 and 3-2 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 US GAAP net income for about one third or more of the companies studied.[18] 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 but might also be due to technical one-time effects such as the Hoechst prior period adjustments. The notorious Daimler case - a gain of DM 602 Mio. under German accounting was reconciled to a DM 1839 Mio. loss under US GAAP - also had such a technical explanation fully understood by at least some analysts.[19] Consequently, reconciliation data should be analyzed carefully before being used to evaluate of companies or accounting regimes.

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[15] See Adler, Düring, Schmaltz (1997), § 274 HGB, par. 26-30.

[16] See Radebaugh, Gebhardt, Gray (1995), pp. 176-181.

[17] See Hoechst (1998), pp. 67-68 for details.

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

[19] See Harris (1993), p. 5; Radebaugh, Gebhardt, Gray (1995), pp. 178-180.

Table 3-2: Hoechst Annual Report 1998

42 Significant differences between IAS and United States Generally Accepted Accounting Principles

The Group´s consolidated financial statements have been prepared in accordance with IAS, which, as applied by the Group, differs in certain significant respects from U.S. GAAP. The following information is intended to give an overview of the differences between IAS and U.S. GAAP only. The reconciliation does not constitute a complete set of financial statements in accordance with U.S. GAAP. Certain additional disclosures that are required under U.S. GAAP are not included in this footnote. For a more comprehensive presentation of the significant differences between IAS and U.S. GAAP refer to Form 20-F, which is filed with the SEC.

The effects of the application of U.S. GAAP to net income and stockholders` equity are set out in the tables below:

Reconciliation of net income to U.S. GAAP

(in DM millions, except per share data)	Note	**1998**	1997
Net income under IAS		1 895	1 343
U.S. GAAP adjustments:			
Business Combinations: Goodwill	a	- 83	- 249
Business Combinations: Research-in-process	a	174	- 287
Tangible fixed assets	b	- 187	20
Inventories	c	53	- 17
Equity accounting: Investments	d	- 88	- 416
Pension provisions and similar obligations	f	58	- 12
Restructuring provisions	g	- 28	- 188
Other	h	12	- 5
Tax effect of U.S. GAAP adjustments		57	189
Minority interests	i	- 3	- 1
Net income under U.S. GAAP		1 860	377
Net income per share under U.S. GAAP		3.16	0.64

Reconciliation of stockholders` equity to U.S. GAAP

(in DM millions)	Note	**1998**	1997
Stockholders` equity as reported in the consolidated balance sheets under IAS		19 179	19 109
Less: minority interests under IAS	i	2 580	3 097
Equity of Hoechst AG stockholders		16 599	16 012
U.S. GAAP adjustments:			
Business Combinations: Goodwill	a	1 654	2 113
Business Combinations: Research-in-process	a	- 2 218	- 2 449
Tangible fixed assets	b	367	554
Inventories	c	- 2	- 70
Equity accounting: Investments	d	- 311	- 222
Available-for-sale investments	e	155	174
Pension provisions and similar obligations	f	- 97	172
Restructuring provisions	g	-	28
Other	h	136	38
Tax effect of U.S. GAAP adjustments		- 121	- 317
Minority interests	i	- 26	- 4
Stockholders` equity under U.S. GAAP		16 136	16 029

Form 20-F reconciliation data are used in a series of value relevance studies in which market returns[20] over different periods (the dependent variable) are regressed in different specifications on levels and changes of non-US GAAP net income, levels and changes of non-US GAAP equity and levels and changes of reconciliation amounts. Table 3-3 displays as a representative example the results of the returns regression in the Harris/Lang/Moeller (1994) study.

Table 3-3: Regression Harris/Lang/Moeller (1994)

Test of relations between returns and reported earnings:

$$\frac{P_{jt} + d_{jt} - P_{jt-1}}{P_{jt-1}} = \alpha_{0t} + \alpha_{1t} \frac{A_{jt} - A_{jt-1}}{P_{jt-1}} + \alpha_{2t} \frac{A_{jt}}{P_{jt-1}} + \eta_{jt}$$

Full Sample :	α_{0t}	α_{1t}	α_{2t}	R^2	*N*	***Z*-Statistic**
Germany	0.25	0.23	1.28	0.07	1084	-0.06
	(14.7)	(1.1)	(5.6)			
United States	0.17	0.24	0.28	0.07	914	
	(10.5)	(6.1)	(4.6)			

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 date t.
Z-statistics	is for comparisons of R^2 from German vs. U.S. regressions.

If the regression coefficients of the reconciliation variables are significant and if R2 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.[21] However, this evidence should not be naively used as an argument for a perceived superiority of US accounting rules. Using this methodology, one would also expect incremental value relevance for reconciliation data of US companies from US GAAP to foreign or

[20] 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.

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

international accounting rules.[22] The inclusion of additional variables has always 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 amounts of goodwill depreciation, the difference between book value and fair value of financial instruments, etc., these same amounts will show up as reconciliation items to US GAAP that may have incremental explanatory power. It would clearly be inadequate to argue for the superiority of US GAAP in such a situation because the potential of 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 (1994) in their careful study chose to use matched samples of German and US companies in order to control for other factors such as size and industry. However, the study could not identify significant differences in the value relevance of German earnings as compared to US GAAP earnings (see Table 3-3). This result is surprising as the primary objective of German accounting is not to provide information to the providers of risk capital but to determine of distributable profits. This demonstrates the difficulties of empirical approaches to the evaluation of accounting regimes

To sum up, there still exist many differences between national and international accounting rules. These differences potentially result in different accounting numbers as 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.

[22] As stock exchanges in other countries do not require reconciliations, no such data is available for foreign listed US companies.

A discussion of a tentative process designed for the development of a set of global accounting standards will be the theme of the next section.

4. Setting up a system of global accounting regulation

Currently we face a historically unprecedented favorable situation of a general consensus in the business community as well as among standard setters and legislators

- we need one set of global accounting standards
- those global accounting standards should be of high quality and
- they should be oriented towards 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 standard are equally interpreted and applied worldwide. High quality standards are a necessary prerequisite of high quality accounting reports, but not sufficient. The importance of effective enforcement cannot be overemphasized.

Accounting standards are the product of a due process conducted by a standard setter (i.e. legislative body, private standard setting body). Again there exists a broad consensus on the essential characteristics of a due process aiming at high quality accounting standards:[23]

- The standard setter should address accounting issues brought to his attention by external parties (e.g. users, preparers, regulators, 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 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 (e.g. three months);
- the standard setter should consider all comments carefully in redrafting proposed rules or issuing final standards;

[23] See FASB (1999b); IASC Strategy Working Party (1998); comment letters at http://www.iasc.org.uk/frame/ce4_66.htm.

- the decisions on issuing exposure drafts or final standards should be taken in meetings open to the public and give dissenting opinions the chance to be heard;

- if necessary, the standard setter should support the implementation of standards by providing guidance (e.g. illustrative examples, training courses);

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

a) Discussion of the structures of currently competing standard setters

Controversial is the structure of the standard setting body. To some - not necessarily only from the US - an approach of "follow the leading standard setter" would be appealing. The FASB pursues standard setting in the spirit outlined for more than 25 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-US 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 different reasons.

First, it is difficult to imagine that legislators or standard setters of other countries will delegate authority to a body dominated by another country. The slogan of 1776 "no taxation without representation" does not only apply to the thinking of US citizens and officials.

Second, even though the FASB deserves praise for the overall achievement, this does not imply that US GAAP rules provide always 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) set an end to the abuse of not consolidating finance subsidiaries that was – at least not to the same extent - a problem in European accounting. Currently in the project on consolidations the FASB is considering to move to the control concept that was the only basis of German consolidated financial statements before 1985.[24] The discussion on asset retirement obligations also brings US GAAP closer to German and EU rules.

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[24] See FASB (1999c), 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 US rules was developed as a response to accounting issues emerging in the US environment. Foreign users of US GAAP experience problems as they have to deal with accounting problems that do not show up in the US in the same way, for example in the areas of provisions for restructuring or deferred taxation. In Europe, participation of workers and labor unions implies that binding commitments by management have to be made at a time when US rules would not allow to set up 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 specifics of international taxation.[25] As on a worldwide basis there are many of such special situations, the "cook book" - approach of US standard setting will be difficult to be maintained.

An alternative to an internationalized FASB could be the IASC. The IASC Board in its current structure has 13 part-time country members and three co-opted institutional members. The broader country representation is deliberately biased towards the developed countries (nine members). Founded by the national accountancy profession bodies cooperating in IFAC, the IASC Board membership is still dominated by the accountancy profession even though meanwhile many country delegations (normally two Board Representatives and one Technical Advisor) include representatives of preparers, users, or national standard setters. With about 70 persons (including observers, guests, IASC staff) sitting at the table of IASC Board meetings, this is not an efficient group 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 which are charged to prepare drafts to be submitted to the IASC Board. However, membership is not balanced neither within nor across Steering Committees. There is a clear dominance of members from the Anglo-Saxon G4 countries (i.e. Australia and New Zealand, Canada, UK, US).

Despite these structural deficits, the work of the IASC Board has gained the support from a considerable number of national legislators and standard setters including the EU.[26] On most of the major stock exchanges financial statements prepared under IAS are accepted for cross border listings with the US being the most prominent exception. In many of the developing countries IAS may form or even have to be the basis of the primary financial statements. Currently, the

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25 See Bruns (1999), pp. 5-9.

26 See for the use of IAS in countries around the world: http://www.iasc.org.uk/frame/cen1_12.htm and for

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 US 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, there is an intense discussion of a major IASC restructuring in order to gain wider acceptance.

b) Discussion of the 1998 proposal by the IASC Strategy Working Party

In December 1998 an IASC Strategy Working Party proposed a new structure for standard setting at the international level (Figure 4-1).

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 (i.e. legislative bodies; private standard setting bodies) for the relevant accounting area (i.e. primarily for listed companies). The 1998 proposal of the IASC Strategy Working Party calls for a larger IASC Board of 20 unpaid country delegations representing national professional accountancy bodies and of five co-opted institutional members having the final right of approval on Exposure Drafts, Interpretations, and on Final Standards. This structure is bound to fail as country representation is improved only marginally and there is no shift from the accountancy profession to the legitimate national standard setters.

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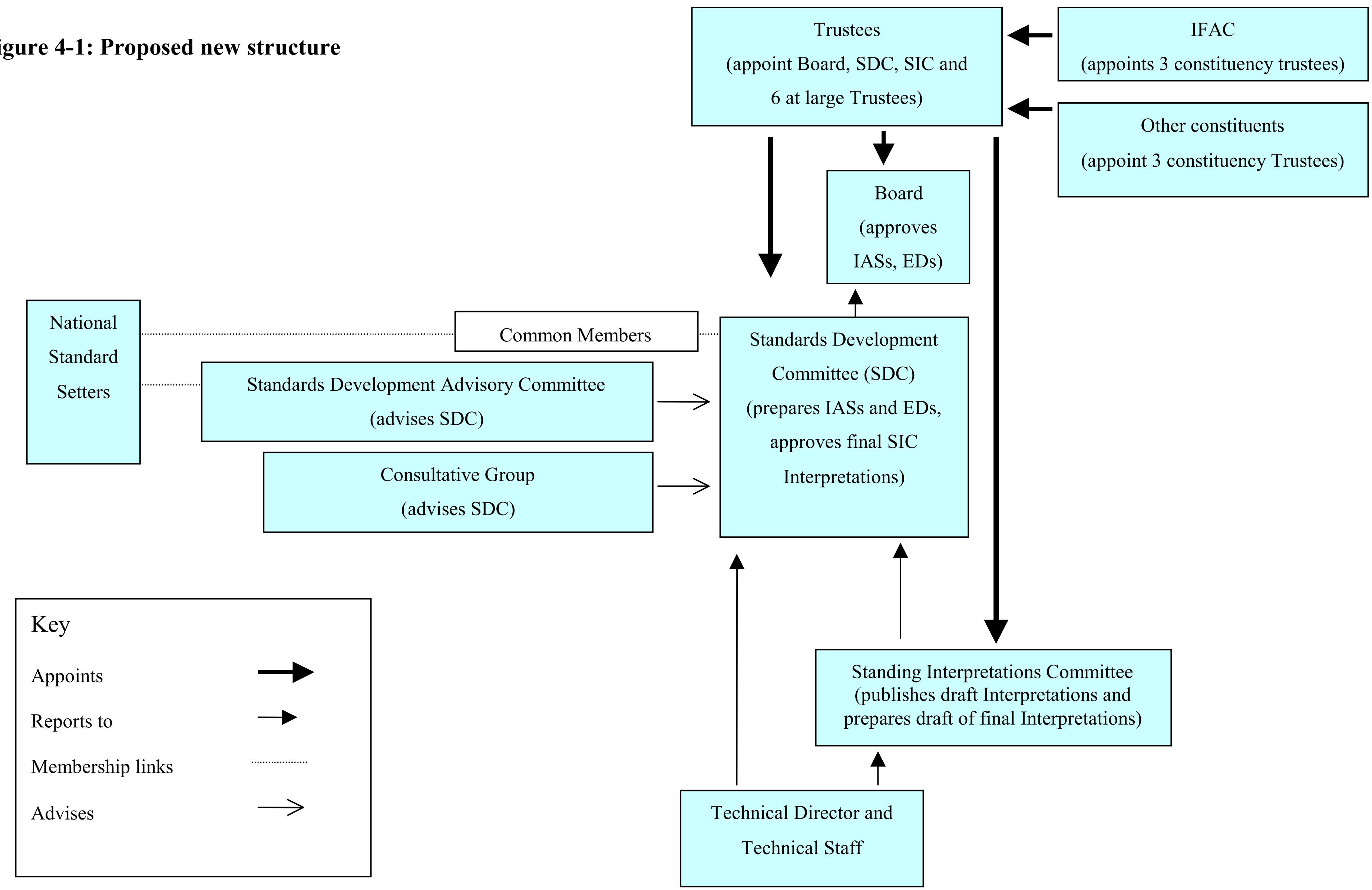
companies referring to their use of IAS: http://www.iasc.org.uk.frame/cen1_7.htm.

Figure 4-1: Proposed new structure



The key to gaining quality is to secure the input of the best technical experts in the accounting problem areas 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 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, up to four members from other groups (e.g. preparers, users, public accountants, and academics). SDC membership further should be balanced between developed and developing countries as well as geographically. The SDC would be charged with developing exposure drafts and standards and may 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 (e.g. internet reporting). The IASC Board would need a majority of 15 out of 25 voting members for approval of a standard or exposure draft submitted by the SDC on a qualified majority vote of 7 out of 11. Thus, a minority of 11 votes would be sufficient to reject proposals by the SDC to the Board. If the proposal were resubmitted by the SDC on a 9 out of 11 vote the Board decision to accept or reject would require a simple majority (of 13 out of 25).

The proposed SDC closely follows the model of an independent expert standard setter that has proved to be successful in the US environment and has been copied elsewhere (e.g. Australia, Germany, UK). 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 as they derive their support from the national legislators.

The 1998 proposals of the IASC Strategy Working Party elicitated more than 80 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 pleads for a strengthening of the SDC and recommends the role of the IASC Board as an advisory board to the SDC with 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.[27] 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

[27] See for example the comment letters by the FASB/FAF, the UK ASB or the SEC at

at the IASC Board level.[28]

To perform the responsibility of a decision making body efficiently, the number of delegates on a Global Accounting Standard Setting Body obviously needs to be restricted. However, the legislators and standard setters delegating some of their authority will request to have influence on the nominations and on the processes at the Global Board. This could be effected by representation of national legislators and/or standard setters 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 to be submitted to the Global Board. The Joint Working Group of Standard Setters on Financial Instruments could serve as a model for a Global Accounting Task Force: In 1998 the IASC Board has established an international working group with a number of national accounting standard setters that assumed the charge to develop an integrated and harmonised standard on financial instruments. In addition to delegations from the G4 countries there are representatives of France, Germany, Japan, and the Nordic Countries. Thus, membership of the Joint Working Group is heavily biased towards the developed countries and in particular to the anglo-saxon countries. However, on principle standard setters from the developing or emerging countries with expertise and interest in the subject area (e.g. Singapur) could easily be integrated. Such a concept of project related working groups would allow more national standard setters to actively participate in the development of Global Accounting Standards and thus create an incentive to support consistent application and enforcement of the standards.

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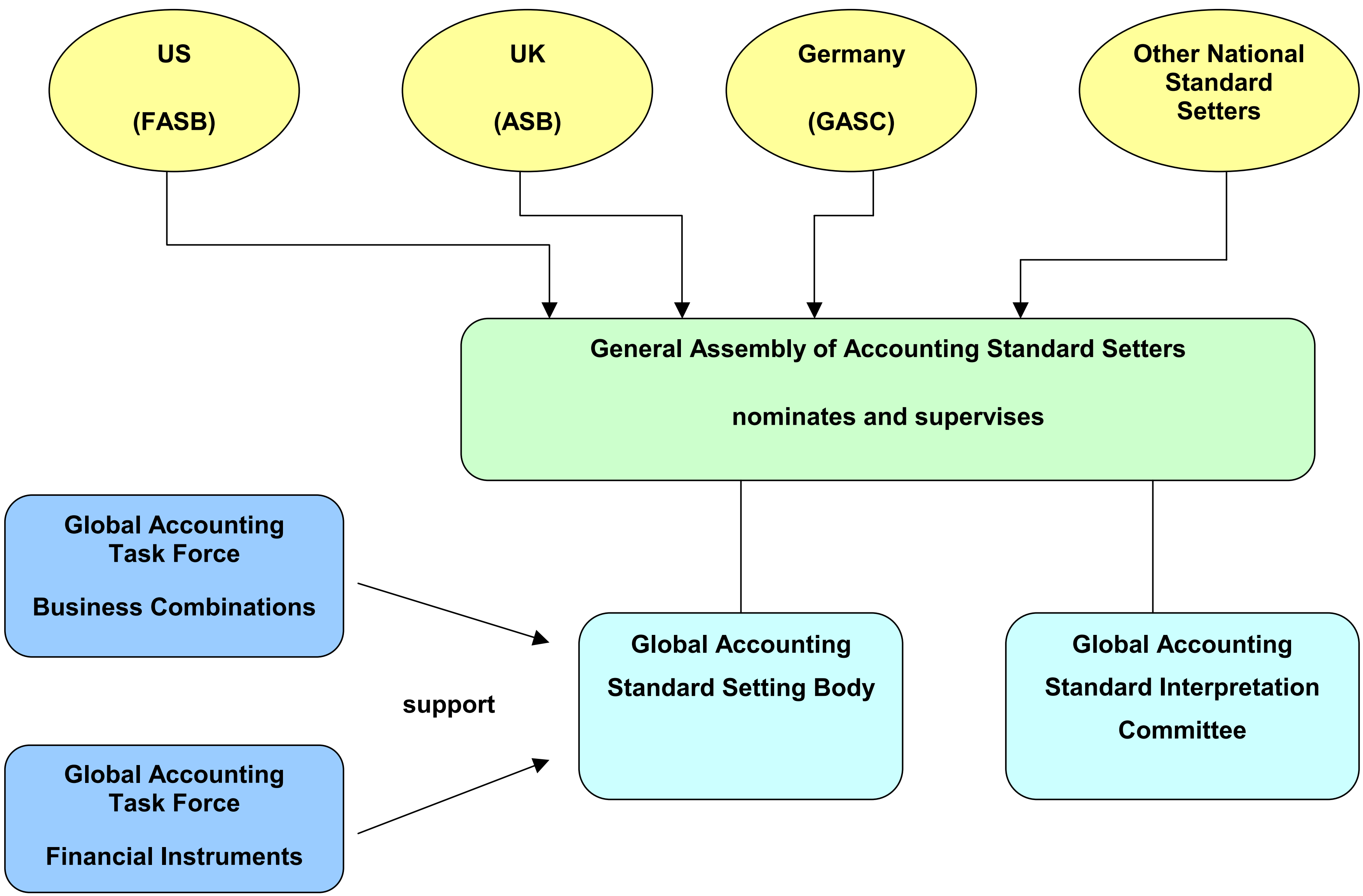
http://www.IASC.org.uk/frame/cen4_66.htm.

28 See especially the comment letter of the EU at http://www.iasc.org.uk/frame/cen4_66.htm.

Figure 4-2: Model of a recommended structure for Global Accounting Standard Setting



The national legislators or standard setters would play an important role in lending legitimacy to the Global Accounting Standard Setting Body, contributing to the development of Global Accounting Standards, and – last but not least – enforcing the consistent application. The legal structures of enforcement will differ as application of GAS might be required by specific types of corporations only in the different jurisdictions (e.g. 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 exert pressure on the Global Board to address accounting problem in a timely manner and strive for high quality standards. Thus we would envisage a contest of "accounting beauty".

c) Discussion of the evolving new structure of the IASC[29]

At the November 1999 meeting the IASC Board unanimously approved a new structure proposed by the IASC Strategy Working Party after having considered the comments to the 1998 proposal and after extensive background negotiations.[30] It is expected that the new structure will be approved at the March 2000 IASC Board Meeting and come into effect by January 1, 2001.

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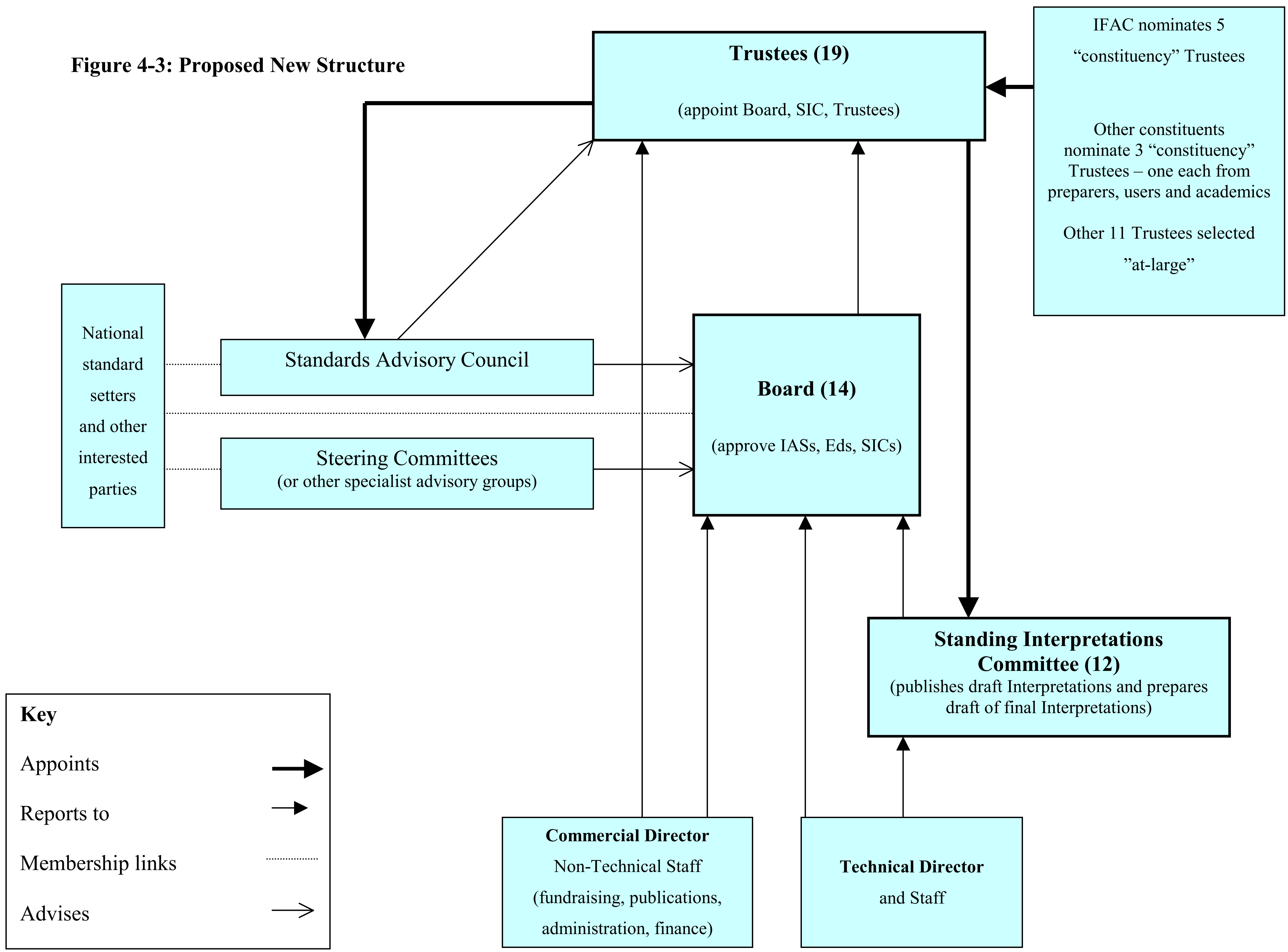
[29] This section has been added to the paper presented at the conference in order to incorporate the new developments in the process of IASC restructuring.

[30] See IASC Strategy Working Party (1999).

Figure 4-3: Proposed New Structure



The new IASC structure will consist of only one body - the new IASC Board - having the authority to vote on the issuance of exposure drafts and of final standards and 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 19 Trustees. The composition of the Board follows the independent expert model emphasizing technical expertise as the prime qualification of Board members. 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 a background as practicing auditors - thus retaining much of the IFAC influence; at least three Board member should come each from the groups of preparers and of 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 employers.[31]

The critical selection of Board members is the prime responsibility of the Trustees of which six should be from North America, six from Europe, four from the Asian Pacific region and another three from any area including the aforementioned ones. Five Trustee seats should be reserved to IFAC nominees and one Trustee should have the background from each of the group of preparers, users, and academics. For the remaining eleven "at large" seats there are no special requirements of belonging to a constituency group. The Trustees will be appointed ad personam and serve for a three year term renewable once and also be renumerated by IASC. They should show a firm commitment to the IASC and have an understanding of the issues involved.[32]

The Trustees would further be responsible for selecting replacements in their group. This may result in the perpetuance of the power structure of the original nominations. This underlines the importance of the task of the Nominating Committee of seven outstanding individuals that have been appointed at the extra December 1999 meeting of the current IASC Board.

The group of Trustees will not bring legitimacy to the structure in the sense that this is a representation of standard setters or legislators. Thus, the new IASC structure may find it hard to

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[31] See IASC Strategy Working Party (1999), par. 52-55, Appendix A.

[32] See IASC Strategy Working Party (1999), par. 21 f., 59.

gain the support by important regional or national standard setters that strive to retain their influence. The proposed new 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 that have no direct influence on the Trustees or on the new IASC Board.[33]

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

5. Concluding remarks

Currently there exists a “window of opportunity” that we arrive at a structure of global accounting standard setting that will produce a comprehensive set of high quality accounting standards that are consistently applied and properly enforced worldwide. National legislators and standard setters have expressed their readiness to cooperate and compromise. European countries (e.g. France, Germany) accept for a restricted period of time financial statements prepared under IAS or US GAAP in order to facilitate convergence on an international level. The UK ASB has publicly announced not to insist on having a seat on an international accounting standard setting body that promises to meet the almost non-controversial goals.

It would however be naive to assume that all parties with vested interests are really ready to compromise on a new structure. The professional accounting bodies would have to give up much of their influence on the international standard setting process they now control through IFAC and IASC. National legislators and standard setters would have to accept rules of standard setting defined outside their domain. The European countries are more used to give up authority in this area where it had been delegated to the European level long ago. This appears to be much more

[33] It should be noted that for example the EU was not represented in the Strategy Working Party.

difficult for the FASB and the SEC who in a way feel and are respected as the world leaders in standard setting and enforcement.

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 by SEC officials the process of change at the SEC has been outlined with indications that this process will be time consuming and thorough.[34] Nobody really can object to a thorough analysis of this set of IAS that 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 of IAS and US GAAP. The remaining differences in rules should be judged with regard to their contribution to the objective of accounting regulation. The anecdotical evidence of the Hoechst reconciliation in Table 3-2 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 US perspective especially as more and more European companies are applying for listing even under current SEC rules. It would preserve the perceived current predominance of US GAAP with large multinational companies and result in an at least temporary competitive advantage of US based companies in the huge market for accounting and auditing services. However, such a strategy is not without risk to the SEC and the FASB as they would leave the iniative to others. From their contributions to the debate it becomes evident that 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 SEC and the FASB have immediately announced their support for the new IASC Board.[35] 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 area of legitimacy has not conceptually been resolved by leaving the nomination and supervision of the Board members to a group of however

[34] See for example Turner (1999).

[35] Statement of SEC Chief Accountant Lynn E. Turner: http://www.iasc.org.uk/news/cen8_156.html

carefully selected Trustees.

Ultimately, global companies and global investors will not accept national regulations that are not responsive to their needs. Markets demand and market forces will achieve globally accepted accounting standards. Currently, US 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 US institutions.

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