

THE EFFECT OF GLOBALIZATION ON FRAMEWORKS AND CONCEPTS IN ACCOUNTING

Kornél Tóth, Adrienn Herczeg

Institute of Accounting and Finance, Faculty of Economics and Business, University of Debrecen, Debrecen, Hungary

toth.kornel@econ.unideb.hu

herczeg.adrienn@econ.unideb.hu

Abstract: *In today's fast changing economic environment the accounting data of business organizations have to provide relevant information about the income and financial conditions of firms in order to show a faithful picture. Over the past few decades global markets have gone through significant changes, nevertheless social and economic transformation, the development of information technology, and the expanding variety of financial transactions have created new challenges in financial reporting. Because of these quick changes in the economic environment and the more unpredictable and uncertain competition in the case of some balance sheet items, fair valuation of these items has arisen beside the historical cost-based measurement – especially in the case of financial instruments. Growing international trade has resulted in increased import and export activities, and the horizons of investors and borrowers have become global, which has increased the level of their risks. Practices and markets have developed which help firms manage the added risks of doing business abroad. The importance of financial instruments has increased considerably in line with the dynamic development of capital markets. Financial instruments used by not only financial institutions but other organizations as well have become more and more sophisticated, thus enhancing the role of related regulation. Financial instruments, including derivatives, are the most uncertain elements in the global financial system, affecting its stability the most. The latest financial crisis has raised the question of whether the current accounting concepts brought about the crisis or not. Answering this is difficult, since the crisis encouraged the re-thinking of several accounting issues. The research question focuses on attesting that more and more current practice of fair valuation does not decrease the usefulness of the information in financial statements. The main finding of this paper is that measuring certain financial instruments at their fair values corresponds to the concepts of the accounting paradigm of the information economy.*

Keywords: usefulness of financial information; financial instruments; relevance; faithful representation; fair value; IFRS

JEL classification: M40; M41

1. Introduction

Nowadays, significant changes in the global economy, among other impacts, have increased the importance of financial instruments, which can be found in every business entity's balance sheet, but in the case of some corporations (for example banks and investment companies) the business activities might be presented faithfully only through these items. Nevertheless, the recognition based on the traditional accounting concepts and framework cannot be faithfully represented. Loss of information is basically concerned with the over the counter (OTC) transactions, as these deals are exposed to higher level of risk. Measuring certain financial instruments at historical cost decreases the usefulness of the reported information, since the requirement of relevance is biased because of the

increased level of uncertainty affecting negatively the decisions made by investors. For this reason it is very important to develop a uniformised accounting regulation system, but according to Crawford et al. (1997) in the case of these types of financial instruments it is a fundamental problem for the main standard setter bodies (Financial Accounting Standards Board – FASB, International Accounting Standards Board – IASB) to develop standards by which they are faithfully measured and represented. Nevertheless, financial instruments play an important role in analysing the financial position of business entities. The main purpose of regulation is to help increase their understandability by setting rules regarding the disclosures and measurement of financial instruments (Balázs et al., 2006; Fenyves, 2013).

In the past few decades one of the major signs of globalization could be indicated by the increasing role of banks and other financial institutions too (Máté, 2010). According to Irvine (2008) and King (2006) the effect of globalization could be experienced in accounting and in accounting standard setting as well confirmed by factors such as the increased use of derivatives, restructuring the existing accounting concepts and frameworks. These alterations are clear evidence of the changes in accounting thought and paradigm shift, the main purpose is to adjust the accounting concepts and measurement methods to the needs of the business environment.

2. Literature Review

The continuous and growing changes in the world economy affect every area of business activities. Because of the recent financial crisis the level of confidence of many participants in various markets has decreased, and in order to maintain the stability of the financial system, the harmonization of financial reporting is needed. Due to various problems of global capital markets, the trading volume of certain financial instruments has decreased, and the markets of several financial instruments have turned inactive, thus the suitability of accounting regulations has become questionable. When the financial crisis broke out, fair valuation of new financial products became a major issue due to losing confidence in them. Fair values of many financial instruments were available immediately, but as a consequence of the crisis quite often these markets did not exist anymore, which ceased the availability of fair values; examples are CDOs (Collateralized Debt Obligations) and corporate bonds. The issues of fair valuation, CDOs and the financial crisis of 2007 and 2008 are described by Deventer (2008). All these factors revealed that in order to improve decision-making it is essential to ensure transparency in financial reporting, to reduce asymmetric information, and to share and manage risks (Fekete, 2009; Deventer, 2008). Insights in auditing related to the financial crisis are discussed by Sikka (2009). Nour et al. (2013) examining the role of derivative instruments in the financial crisis, highlight the lack of control and poor transparency. Because of the strengthening level of globalization, its consequences and effects cannot be evaded, and this has been greatly affected by recent the financial crisis, thus a harmonized accounting system is a need of globalization (Barlev and Haddad, 2007). The fall of financial stability and the accumulated risks drew attention to the importance of information obtained from financial reports (Apostolou and Apostolou, 2008). The financial crisis has also raised the question of whether the current accounting concepts brought about the crisis or not. Answering this question is difficult, since the crisis encouraged the re-thinking of several accounting issues, among which two areas are emphasised: fair valuation and loan loss reserves (Tardos, 2009; Wallace, 2009).

In the case of prevailing relevance many authors argue one disadvantage of fair value, i.e. it is not immediately realizable, and it only provides useful information when the business entity manages its portfolio based on fair value. Concerning reliability it can be problematic that market information is not always available, and thus it does not reflect the risks associated with cash flows (Kovács, 2012; Balázs et al., 2006). Benston (2008) underlines the costs of producing fair value information and the possibility of manipulating them. The

analyses of Cantrell et al. (2014) indicated that the predictive ability of loans measured at historical cost is better than when they are measured at fair value. Consequently, in this case relevance, faithful representation, and the usefulness of information could prevail at a limited level.

Since fair valuation is mainly associated with accounting for financial instruments, it is essential to examine and understand the background to this area. Considering the recent related literature the value-relevance of financial instruments has been verified, especially the value-relevance of securities and derivatives. This is proved by authors such as Petroni and Wahlen (1995), Barth et al. (1999), Eccher et al. (1996), Nelson (1996), Venkatachalam (1996), Park et al. (1999), Beaver and Venkatachalam (2000), Barth and Clinch (1998) and Power (2010). In sum, during the last decade the growing use of derivative financial instruments and the increasing instability of the global financial system have intensified and sharpened debates about whether various securities and derivative instruments increase or decrease the risk of business organizations, affecting faithful representation based on their financial statements and decision usefulness, relevance and faithfulness of the reported information.

3. Transformation of Frameworks and Concepts in Accounting

Over the past few decades accounting has gone through significant changes along with financial globalization, and according to Irvine (2008) it affects standard setting in accounting as well. The author identifies four reasons why “national standard setters operate in an increasingly globalized environment:

1. there is a recognized and growing need for international accounting standards;
2. no individual standard setter has a monopoly on the best solutions to accounting problems;
3. no national standard setter is in a position to set accounting standards that can gain acceptance around the world; and
4. there are many areas of financial reporting in which a national standard setter finds it difficult to act alone” (Irvine, 2008:15).

As a result of globalization accounting concepts appear to be transforming. The increased emphasis on fair valuation, the reappraisal of the conceptual framework, the evolution of the principle-based accounting, and the change in the application of relevance and reliability are the evidences of these developments. The lack of relevant accounting information led to reporting inconsistencies and caused revolutionary shift in accounting paradigms. The tendency is about to move to an accounting paradigm that fits the economy in an information age. Revolutionary change occurs when a crisis or anomaly result in a movement of fundamental accounting thought. This movement is represented by transformation from an industrial economy to an information economy, increased globalization, improvements in data accessibility, and higher level of information processing capabilities. These fundamental changes in accounting can be viewed as a paradigm shift. The older, industrial paradigm was mainly based on historical cost and rules, and focused on transactions and allocations. The new, information paradigm is principle-based, emphasises fair value, and highlights economic events (Shortridge and Smith, 2009). Table 1 illustrates the main elements of each accounting paradigm.

Accounting paradigm in industrial economy	Accounting paradigm in information economy
Reliability	Globalization, faithful representation replaces reliability
Allocation of costs	Fair values
Transaction focused	Economic event focused
Rules based	Principle based

Table 1: Accounting paradigms

Source: edited by the authors based on Shortridge and Smith, 2009:12

It is very difficult to identify the beginning of these revolutionary changes in accounting, but it can be suggested that greater demand for financial derivative instruments over the last few decades contributed to this process as a result of increased risk from foreign currency transactions. As the use of derivatives grew, it became obvious that different information is needed to be reported in the information economy which also resulted in modifications in the conceptual framework (Shortridge and Smith, 2009). Nevertheless Penno (2008) notes that these significant changes, such as shift to fair value measurement, more information technology, more sophisticated valuation methods have enlarged the level of vagueness (uncertainty) in conceptual frameworks. This inconsistency also causes problems in accounting for derivatives and hedging because of the intensive financial engineering that has created previously unexpected products (Penno, 2008).

In the IFRS (International Financial Reporting Standards) Framework relevance and faithful representation are the fundamental qualitative characteristics of financial information. Relevance helps users make a difference in their decisions, however to be useful, financial information must also represent the economic phenomena faithfully. Comparability, verifiability, timeliness and understandability are qualitative characteristics that enhance the usefulness of information as well. Comparability enables users to identify and understand similarities in, and differences between items. Verifiability assures users that information represents faithfully the economic phenomena. Timeliness means that information is available to decision-makers in time in order to influence their decisions. Classifying, characterising and presenting information clearly makes financial information understandable. According to the Framework, the going concern assumption is an underlying assumption, which presumes that an entity will continue in operation. An item is recognized in the financial statements, when it is probable that any future economic benefit associated with the item will flow to or from the entity; and the item's cost or value can be measured with reliability (IFRS Framework, 2010). Formerly faithful representation was a part of reliability, and nowadays it stands alone and replaces the term reliability, however it is included within the recognition criteria of the conceptual framework.

Nowadays the information economy is characteristic of an increasing number of developed countries; and according to DeLong and Summers (2001) in the information economy technological development and the ease of access to information helps in the globalisation of the business elite. These changes, together with an increased role for the service sector, have resulted in more space being created for intangible assets, and as a consequence the relationship between the book- and market value of the different elements of property owned by owners. On this basis it can be established that the accounting data characteristic of the industrial society do not meet the demands of decision-makers.

One of the main features of the information economy is that it requires resources for business activities other than physical ones, which implies that the information produced by the industrial paradigm in the information economy does not comply with the needs of business entities thus resulting in anomalies and inconsistencies.

Although estimating fair value often encounters difficulties, the use of processes involving consistent estimates can be considered an important advance in departing from historical cost measurement. Change and the acceptance of the new paradigm take time, and additionally certain standards can contradict each other. The overlaps in the temporary transition period can be among the problems encountered, which in part can be solved with the new and old paradigms, although the method used for the solution can be fundamentally different. Since accounting is classified as a social science, the consequent changes are accompanied by a behavioural dimension as well, which also has an effect on the accounting paradigm. Although accounting must react to changes in the economic

environment, at the same time it cannot influence the behaviour of those who use accounting. The task of the paradigm is thus to adjust accounting theories and methods of analysis to the continually changing environment (Shortridge and Smith, 2009).

Despite the fact that fair value measurement of some financial instruments has become dominant, there is no clear evidence regarding the valuation and disclosure of these items, as they are totally different from items such as inventory or tangible assets. The losses of derivative financial instruments in 1990s highlighted the importance of measuring these kinds of balance sheet items at fair values, although at that time it was only one of the basic requirements for management information systems, it affected financial reporting systems a decade later. Regarding the financial statements prepared under International Financial Reporting Standards it is essential to measure nearly all financial instruments, and all of the derivatives at their fair values. By using this method, the transparency of financial statements can be enhanced, and the investors can also obtain a clearer view on the financial position of the firm (Balázs et al., 2006; Orbán, 2013).

The most relevant economic value of an asset can be defined as the current value of the cash flow income which derives from it, which in itself includes any secondary offer price of the asset for which there is an active market. When an asset has no active market, the income must be defined according to another substitute valuation process. For those assets which have no market, an internal information system is necessary to support the values presented in the balance sheet. In relation to accounting information systems, it can be stated that their primary focus is responsibility, the effectiveness of decisions, particularly financial risks and profit, and maintaining professional integrity, since the market value and certain asset values can be questioned if they are characterised by uncertainty and by behaviour which lacks integrity. Basically, the intentions of investors and creditors give legitimacy to an economic entity by providing resources for its activities.

In certain cases applying the principle of prudence can distort market information; this can also mean a return to a kind of natural conservatism and a cash turnover perspective which can maximise utility and minimise financial risk. However, the majority of decisions taken by those using accounting information are related to financial risk. In order to ensure that users receive the necessary information, historical and replacement costs and heterogeneous market valuations are required, although they do not need to show all the possible elements of content. From the point of view of creditability and commonality of accounting concepts, the fine tuning of the content of financial statements is essential in today's changing world economy (Raar, 2008).

Working capital is used to produce goods and services, the traditional accounting concepts are connected to these activities, but in the case of financial instruments the value is created by their ultimate user. The valuation of these items must be based on the discounted expected cash-flows related with them. Because of this valuing these instruments the traditional accounting concepts and framework could be problematic, and this explains why an alternative accounting framework is needed in order to achieve usefulness of the reported financial information.

Financial instruments measured at fair value on the basis of relevant information and market prices create the possibility for the management to follow investments on a clearer path and so achieve greater profit with them. The risks of the assets set in operation are basically determined by the predicted costs and the demand of the given market, but given that the yield and risks of financial assets are affected by market expectations and macroeconomic trends, these assets are more susceptible to changes in the environment and to the moral risks of market actors. Consequently, the values must be determined as the expected current value of future cash flow with the use of the appropriate discount rate of the risk. So, within the traditional accounting framework and concepts it can be problematic in many cases to determine the value and income, and this explains why a new, alternative, accounting approach is necessary. The determination of income based on historical cost and the realisation principle basically serves to measure income from

production and the provision of services, and it is not realistic to assume that it can be adapted to measuring the complex nature of the income deriving from the financial markets characteristic of today's economy and from products developed through financial engineering. In the case of measurement of financial instruments such as held for sale shares or derivatives (options, futures, forward and swaps), accounting concepts must be applied which make it is easier to satisfy the fundamental requirement of presenting useful information, and thus showing the real content of the economic activity in a more comprehensive way (Ishikawa, 2005). Thus, the accounting data have potential information content; the aim being that they provide represented information that is relevant and faithful for investors, to increase market effectiveness and to help decision-makers. Changes in the accounting regulations can have a market-distorting effect, since the profit structure and the elements that affect the entries in the balance distort the investors' judgements of value (Krumweide, 2008; IASB, 2013).

On the basis of King (2006), one of the signs of the paradigm shift in accounting is that both the FASB and the IASB are gradually changing from historical cost to measurement made at fair values. In addition the paradigm change is also driven by the fact that the demand for derivative instruments has increased significantly in the past decades, in an attempt to manage the increased risk of transactions related to stocks and foreign currencies. The increased use of financial instruments has given rise to contradictions in terms of what must be shown according to the industrial society paradigm, and what kind of information is necessary in the new information economy (Shortridge and Smith, 2009). In our opinion the appearance and spread of measurement based on fair values brings with it a new interpretation of relevance and faithful representation. Considering the aims of financial reporting, measurement based on fair values helps to increase the usefulness of financial information, and at the same time there is still a demand for the appearance of historical cost measurement.

4. Conclusion

Taking the above factors into account we can conclude that in the further development of the international regulation of accounting concepts, frameworks, and financial instruments, it is essential to reduce the uncertainties associated with them in order to allow the balance sheet to show the most current values. This idea is also supported by the fact that nowadays many areas can be found in IASB's Conceptual Framework where there is less guidance on measurement and recognition, and considering assets and liabilities, useful information can be achieved when the flow of economic resource is not probable.

We also draw the conclusion that measuring held for trading, available for sale financial instruments, as well as derivatives at their fair values and recognizing them as assets or liabilities in the financial statements – satisfying the information demands of stakeholders – reduces inconsistency and increases transparency and the effectiveness of investments. As a consequence of this, there is an increase in the usefulness of reported information, especially in the case of financial instruments which have an active market. In the case of financial instruments developed through financial engineering, especially in the case of derivatives, traditional accounting framework and concepts are not an appropriate method of measuring value and income. The main finding of this paper is that measuring certain financial instruments at their fair values corresponds to the concepts of the accounting paradigm of the information economy, emphasizing a principle-based view, shifting towards fair valuation, and focusing on economic events in financial reporting.

References

- Apostolou, B. and Apostolou, N. G. (2009) "Banks Face New Disclosures about Derivatives", *Bank, Accounting & Finance* Vol. 22, No. 1, pp. 39–46.
- Balázs, Á., Boros, J., Bosnyák, J., Gyenge, M., Gyórfi, D., Hegedűs, I., Kováts, E., Lakatos, L.P., Lukács, J., Madarasiné Szirmai, A., Matukovics, G., Nagy, G., Ormos, M., Pavlik, L., Pál, T., Rózsa, I., Székács, P., Tardos, Á. and Veress, A. (2006) *Az IFRS-ek rendszere (A Nemzetközi Pénzügyi Beszámolási Standardok rendszere)*, Magyar Könyvvizsgálói Kamara Oktatási Központ Kft., Budapest
- Barlev, B. and Haddad, J. R. (2007) "Harmonization, Comparability, and Fair Value Accounting", *Journal of Accounting, Auditing & Finance*. Vol. 22, No. 3, pp. 493–509.
- Barth, M. E. and Clinch, G. (1998) "Revalued Financial, Tangible, and Intangible Assets: Associations with Share Prices and Non-Market-Based Value Estimates", *Journal of Accounting Research*, Vol. 36, No. 3 Supplement, pp. 99–233.
- Barth, M. E., Clinch, G. and Shibano, T. (1999) "International Accounting Harmonization and Global Equity Markets", *Journal of Accounting and Economics*, Vol. 26, No.1-3, pp. 201–235.
- Beaver, W. H. and Venkatachalam, M. (2000) "Differential Pricing of Components of Bank Loan Fair Values", *Journal of Accounting, Auditing and Finance*, Vol. 15, No. 1, pp. 41–67.
- Benston, G. J. (2008) "The Shortcomings of Fair-Value Accounting Described in SFAS 157", *Journal of Accounting and Public Policy*, Vol. 27, No. 2, pp. 101–114.
- Cantrell, B. W., McInnis, J. M. and Yust, C. G. (2014) "Predicting Credit Losses: Loan Fair Values versus Historical Costs", *The Accounting Review*, Vol. 89, No. 1, pp. 147–176.
- Crawford, L. E., Wilson, A. C. and Bryan, B. J. (1997) "Using and Accounting for Derivatives: An International Concern", *International Accounting, Auditing & Taxation*, Vol. 6, No. 1, pp. 111–121.
- DeLong, J. B. and Summers, L. H. (2001) "The 'New Economy': Background, historical perspective, questions, and speculations", *Economic Review (Federal Reserve Bank of Kansas City)*, Vol. 86, No. 4, pp. 29-59.
- Deventer, D. R. van (2008) "Fair-Value Accounting, CDOs and the Credit Crisis of 2007-2008", *Bank, Accounting & Finance*, Vol. 21, No. 6, pp. 3–8.
- Eccher, E. A., Ramesh, K. and Thiagarajan, S. R. (1996) "Fair Value Disclosures by Bank Holding companies", *Journal of Accounting and Economics*, Vol. 22, No. 1-3, pp. 79–117.
- Fekete, I. (2009) "A globális válság szakmai kihívásai", *Számvitel Adó Könyvvizsgálat*, Vol. 51, No. 1, pp. 20–24.
- Fenyves, V. (2013) "Problems with the application of conventional financial ratios in corporate risk measurement", *Abstract – Applied Studies in Agribusiness and Commerce*, Vol. 7, Issue 4-5, pp. 5-12.
- IASB (2013) *A Review of the Conceptual Framework for Financial Reporting – Discussion Paper*, July, [online], Available: <http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Discussion-Paper-July-2013/Documents/Discussion-Paper-Conceptual-Framework-July-2013.pdf> [19 May 2014]
- IFRS Framework (2010) *Conceptual Framework for Financial Reporting*, [online], Available: <http://www.iasplus.com/en/standards/other/framework>, [9 April 2015]
- Irvine, H. (2008) "The Global Institutionalization of Financial Reporting: The Case of the United Arab Emirates", *Accounting Forum*, Vol. 32, No. 2, pp. 125–142.
- Ishikawa, J. (2005) "A Social Science of Contemporary Value-based Accounting: Economic Foundations of Accounting for Financial Instruments", *Critical Perspective on Accounting*, Vol. 16, No. 2, pp. 115–136.
- King, A. M. (2006) *Fair Value for Financial Reporting: Meeting the New FASB Requirements*, John Wiley & Sons, Hoboken, New Jersey
- Kovács, D. M. (2012) "A valós értékelés új keretrendszere a nemzetközi pénzügyi beszámolásban", *Hitelintézet Szemle*, Vol. 11, No. 2, pp. 161–181.

- Krumwiede, T. (2008) "Why Historical Cost Accounting Makes Sense", *Strategic Finance*, Vol. 90, No. 2, pp. 33–39.
- Máté, D. (2010) "Estimating Labour Market Performance in Twenty-Three OECD Countries, 1980-2009", *Romanian Economic Journal*, Vol. 13, Issue 38, pp. 213-232.
- Nelson, K. K. (1996) "Fair Value Accounting for Commercial Banks: an Empirical Analysis of SFAS No. 107", *The Accounting Review*, Vol. 71, No. 2, pp. 161–182.
- Nour, A. N., AbuSabha, S., Al Kubeise, A. S. and Nour, M. I. (2013) "The Fundamental Issues with Financial Derivatives within the Framework of International Accounting Standard No. (39) and Their Relative Responsibility for the Current Global Financial Crisis", *Journal of Business Studies Quarterly*, Vol. 4, No. 3, pp. 173–222.
- Orbán, I. (2013) "Reporting companies' performance – in respect of the International Financial Reporting Standards (IFRS)", *Abstract – Applied Studies in Agribusiness and Commerce*, Vol 7, Issue 4-5, pp. 107-112.
- Park, M. S., Park, T. and Ro, B. T. (1999) "Fair Value Disclosures for Investment Securities and Bank Equity: Evidence from SFAS 115", *Journal of Accounting, Auditing and Finance*, Vol. 14, No. 3, pp. 347–370.
- Penno, M. C. (2008) Rules and Accounting: Vagueness in Conceptual Frameworks, *Accounting Horizons*, Vol. 22, No. 3, pp. 339–351.
- Petroni, K. R. and Wahlen, J. M. (1995) "Fair Values of Equity and Debt Securities and Share Prices of Property-Liability Insurers", *Journal of Risk and Insurance*, Vol. 62, No. 4, pp. 719–737.
- Power, M. (2010) "Fair Value Accounting, Financial Economics and the Transformation of Reliability", *Accounting and Business Research*, Special Issue, Vol. 40, No. 3, pp. 197–210.
- Raar, J. (2008) "A Basic User Utility Preference to Reduce Uncertainty: A Dissent to Reporting and Asset Measurement", *Critical Perspectives on Accounting*, Vol. 19., No. 5., pp. 785–804.
- Shortridge, R. T. and Smith, P. A. (2009) "Understanding the Changes in Accounting Thought", *Research in Accounting Regulation*, Vol. 21, No. 1, pp. 11–18.
- Sikka, P. (2009) "Financial Crisis and the Silence of the Auditors", *Accounting, Organizations and Society*, Vol. 34, No. 6–7, pp. 868–873.
- Tardos, Á. (2009) "Pénzügyi válság, valós értékelés, hitelek értékvesztése", *Számvitel Adó Könyvvizsgáló*, Vol. 51, No. 6, pp. 262–264.
- Venkatachalam, M. (1996) "Value-Relevance of Banks' Derivatives Disclosures", *Journal of Accounting and Economics*, Vol. 22, No. 1-3, pp. 327–355.
- Wallace, M. (2009) "Is Fair-Value Accounting Responsible for the Financial Crisis?", *Bank, Accounting & Finance*, Vol. 22, No. 1, pp. 9–18.