

Dennis Nally Remarks
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I think we're all familiar with the observation that "the only constant is change."

We all know that complex forces of change are at work today. And only those who are flexible enough to respond appropriately will survive and prosper in the 21st century. Interestingly, Charles Darwin recognized this more than 150 years ago, when he said "It is not the strongest species that survive, nor the most intelligent ... but the ones most responsive to change."

The way I see it, the need to master occasional change has been replaced by the challenge of mastering continual change.

How all this change will affect our clients in the future is an important issue for PricewaterhouseCoopers.

We have developed some interesting research on how the world is likely to change over the next decade, and I'd like to share some of it with you this afternoon. In addition, I'd like to focus on a number of changes that will result from the movement to International Financial Reporting Standards, or IFRS—a subject that will be of interest to you—changes which I believe will provide us with an opportunity to address some of the real problems with our financial reporting system in the United States.

But first, let's step back and consider a couple of possible future scenarios.

We examined two broad trends which—depending on how quickly or slowly they move—will create potentially very different future scenarios for business:

- The first trend is the rate of growth of the emerging world, and what this implies for U.S. businesses and American competitiveness
- And the second is the speed with which the world achieves economic and cultural integration.

We define economic integration to be a function of a country's participation in international business and trade.

Cultural integration is the degree to which it embraces the cultural achievements of other nations.

The speed at which the world moves up these two trend lines will also influence both economic and cultural stability. In our judgment, this will create a number of opportunities and challenges that we will experience over the next ten years.

Let me begin by asking what the world of 2018 would look like if emerging economies continue to grow steadily over the next ten years, while economic and cultural integration also keep pace.

This happens to be a very likely scenario in my view.

Today, as we all know, world economic activity continues to be dominated by “developed countries.” Namely—the United States, Western Europe and Japan.

But consider the projected growth among the BRIC countries—Brazil, Russia, India, and China.

By 2018, the dollar-denominated GDP of both Russia and India will surpass Italy’s, while China’s GDP will exceed that of the United Kingdom, Germany, and Japan.

Interestingly, within just fifteen years the GDP of the remaining BRIC country—Brazil—will also pass Italy.

Now, I know what many of you must be thinking: Why am I picking on Italy?

Well, I guess I am—but I don’t mean to. But Italy illustrates an interesting trend we see in many developed countries. Namely, Italy’s population is shrinking, or more specifically, its birth rate is not enough to replace its population.

The important point is that the flat or contracting population growth we’re seeing in many developed countries will accelerate the influence of the emerging economies. And in fact, within 30 years, the BRIC countries will have larger GDPs than the G6 nations.

One result of this global economic expansion will be that the United States will no longer be seen as the primary driver of worldwide economic growth.

That’s right; the United States will no longer be seen as the primary driver of global economic growth.

So, how should we all feel about this?

Well, I, for one, have long believed that America should not fear change, but embrace it—treat it as an opportunity. For example, instead of being deciders—or acting unilaterally to influence global economic policies—we could actually become conveners. Said another way, we would convene nations, industries, or businesses in an attempt to lead them toward consensus in establishing rules and practices affecting commerce.

That would create opportunities for the United States to be seen as “an honest broker”—helping all parties to advance toward prosperity.

But that can happen only if the United States remains actively engaged in the ensuing debates—as we are now in the debate about IFRS.

To be sure, this scenario of strong growth for emerging economies, plus rapid economic and cultural integration will yield some important challenges.

But, in my judgement, none are insurmountable.

One such challenge would be an accelerating global scramble for talent more so than what we have today. Expanding businesses everywhere would be bidding for the best and the brightest.

Another challenge might be higher energy and materials costs as companies bid for the same raw materials they all need to continue to grow and prosper.

There would also be some social costs, associated with rapid integration and globalization that could affect the fastest growing economies.

Now, we never advise companies to predict one future scenario for setting their strategies.

After all, as Yogi Berra once said, “It’s tough to make predictions, especially about the future.”

So, even though I am optimistic by nature, I recognize that we need to consider other, more difficult future scenarios.

Everyone talks about the future dominance of China and India...But what if this doesn’t happen?

If it were to turn out that growth of the emerging world slowed over the next decade, while economic and cultural integration also lagged, 2018 would look quite different.

The most likely growth inhibitors would be country-specific internal problems—such as lagging infrastructure, environmental damage, income gaps, and social unrest. Shortages of energy and materials could also have an effect.

When high expectations for growth in emerging markets are not achieved, investors might engage in panic-driven withdrawals of capital. All of this could worsen an economic slow-down.

With slow growth keeping many emerging economies from diversifying and evolving, they would have to rely on cheap labor and natural resources as their relative strengths.

High-skilled workers and innovative companies would probably leave these troubled economies in search of more fertile areas of opportunity.

All in all, this 2018 scenario would result in a less appealing world for many of us.

We've talked about a very favorable scenario - with high growth and a great deal of economic integration. We've also talked about a very unfavorable scenario - low growth and poor integration. But what happens if the future falls somewhere in between?

We might experience a future where there's overall growth in worldwide GDP, but where it's uneven from country to country. For example, there could be growth in the emerging world, but not in the United States. And, in fact, some economists are projecting exactly this sort of outcome from our present economic difficulties.

What would happen if this were accompanied by less economic integration and cooperation? Well, this would probably result in more protectionist or nationalist policies. Again we see evidence of this today, not just in some developed countries, but also in the emerging world.

It's clear to me and many of those who look at future scenarios that the emerging markets are likely to continue to grow—perhaps strongly—over the next ten years.

What are going to help the U.S. economy, in my opinion, are greater cooperation and more economic integration. And, as I will discuss later, greater cooperation is also important when we look at the future of financial reporting.

But let me address several factors which will likely affect how rapidly our two trends evolve.

One of them is climate change. You might recall Mark Twain's famous line—"Everybody talks about the weather but nobody does anything about it." It's hard to imagine that this will no longer be true by 2018.

Investments could shift to sustainability and climate change in a significant way, just as they did toward technology in the 1990s. And weather prediction models will become much more significant.

Competition will exist between state-directed and private innovations for dealing with climate change.

The costs to businesses trying to manage in this environment will be high as a result of unpredictable climate shifts.

For example, insurance models will be under great pressure since cost histories may not be relevant to future projections.

My point in taking you through these possible scenarios is that forces of significant change are at work.

Their dynamic impact is without question. And several reactions are possible. Some will conclude that coping with new realities is too difficult, too unpredictable, and they will stick with what's worked for them in the past.

Others will simply pretend these scenarios don't exist.

However, what I'm suggesting is that the right approach is to turn the forces of change to our own advantage. And the real question is: How do we do this?

So by way of example, let me talk about an issue that is close to all of us, the growing convergence of international accounting standards. I am convinced that this change—as challenging as it is—will provide the opportunity to correct aspects of the U.S. financial reporting process that—frankly—aren't working very well.

Whether we like it or not, this train has left the station.

Recall the scenario I described earlier about the changing nature of U.S. influence, and how we're becoming conveners rather than deciders. I mentioned that this is exactly what's evolving with regard to IFRS. At one time in the not too distant past, whatever standards the United States favored would likely be followed by the rest of the world.

Clearly, this was the direct result of the critical need to have access to the U.S. capital markets.

But as we are seeing with the apparent selection of IFRS over U.S. GAAP, this is clearly no longer the case. Frankly, I think this caught all of us by surprise over the past five to eight years. But it's a great indication of what we're likely to see as we approach 2018.

There is no question in my mind that IFRS is growing as the de facto reporting standard around the world. Already 100 countries now allow—or even require—IFRS to be used in the preparation of financial statements.

To some, this may seem to be no more than an accounting issue. But I believe it goes well beyond that. For example, a major driver in the acceptance of IFRS was that European companies did not intend to be burdened by the requirements of U.S. GAAP, nor subject themselves to the cumbersome regulatory system and difficult legal environment that accompanied it.

My point is that even in cases like this—where our own standards do not prevail—we should not necessarily assume that what does prevail will be at the expense of American business.

In fact, the adoption of IFRS will make our own capital markets more competitive for several reasons.

One is because U.S. issuers will be better able to compete for capital in sectors in which non-U.S. companies now report under IFRS.

Another is that embracing a single set of global accounting standards will contribute to a higher degree of investor understanding and confidence.

Also, for global companies, moving toward one set of global financial standards should reduce costs over the long term.

Finally, for companies like yours, complexity is reduced by having a single set of standards you can apply from one opportunity to another—either domestic or international.

Yet positive change will not take place automatically.

With all its many appealing features, IFRS will not be successful if we don't take the steps to make it work the same way in the United States as it works in the rest of the world.

That means embracing the most critical feature of IFRS. And that is: Principles versus detailed rules.

Having fewer rules to comply with, IFRS enables accountants and auditors to do what they are hired to do: namely, exercise professional judgment in accordance with established principles. But for these benefits to occur, the legal and regulatory environment must allow for the exercise of professional judgment and not subject reasonable judgments to excessive second guessing or even litigation.

The fact that our present system is characterized by a set of very detailed rules—which inhibit making sensible judgments—is, in my opinion, an important reason why U.S. GAAP is not appealing outside the U.S. Our system has created too much confrontation and suspicion around the key relationship underlying any effective capital markets, and that is the relationship between companies and investors.

The adversity between companies and investors has had a domino effect on problems within the U.S. capital market. Litigation driven by securities class action suits has been very costly, but I think all would agree that it has created few real benefits for companies or investors.

There has also been an increase in trivial restatements, making it hard for the investor to know what's important and what's not.

And while financial statements and regulatory filings are most definitely thicker, I would submit they are less useful.

Clearly, we need to address the root cause of this problem.

Now some would argue that the Sarbanes-Oxley Act improved investor confidence, and in many respects it has.

And yet there is still a profound disconnect between regulators, investors and companies.

Most recently we have seen this in the dust-up attributed to fair value accounting. I believe this really had more to do with continuing mistrust among regulators, investors and companies rather than the right way to communicate important information.

We need to remember that financial reports, by and large, consist of estimates. And many of those estimates are based on judgments and assumptions about how current circumstances will play out in the future.

The impact those judgments and estimates have on financial statements has been magnified as business has become more complex.

Globalization and the rise of developing countries have made business models more complicated.

Also, the pervasive use of elaborate financial instruments has introduced a higher level of unpredictability.

Yet the notion that financial reporting is grounded in mathematical certainty is a common misperception.

I am convinced that now is the time to address these issues. And what's needed is an official framework for professional judgment and enhanced disclosure about material judgments and estimates.

But enhanced disclosure would not necessarily mean more disclosure. Instead, companies would focus on only the most important material judgments and estimates.

Of course, there is serious concern that more disclosure might create additional risks, and this is a very real issue that needs to be addressed in order for IFRS to be successful.

To me, the philosophy behind this is compelling: that it's unreasonable to penalize honest companies for their lack of clairvoyance. In other major capital markets around the globe, reasonable professional judgment in matters of financial reporting is, in fact, well-respected.

If we continue in the way we've always done things, the core foundation of IFRS will be eroded. The result will be that the United States will find itself out of step with the changes that the rest of the world is undertaking in financial reporting.

That is hardly an ideal position for the United States if it wishes to assert leadership on the other changes that will come.

So it all comes down to this: are we ready to make this leap?

But maybe, the more important question is: do we really have any choice?

American businesses, regulators and policy makers must behave differently over the next ten years as we participate in ever-increasing discussions about the convergence of standards, rules, and principles.

As we help determine convergence—rather than dictate it—we will not only be participating in the selection of the criteria that will define business success, we will also be proving to the world that American business is international in outlook—not provincial.

And as I travel around the world, I believe that substantive American business leadership is crucial to our future business success.

I am confident that if we engage change—treat it as an opportunity—the United States and our businesses will remain influential participants in creating the converging standards that will define the future for all of us.

We will be well-positioned to master the challenges that will face us as we approach 2018. When I think back ten years ago, and we were talking about change, I believe we were addressing it in a very different way.

There was no such thing as the BRICs; we didn't hear much about climate change; one set of global financial reporting standards was only a concept; and America was clearly leading the world economy.

Today things are very different.

What we have is an opportunity—as long as we engage with the rest of the world on subjects like IFRS.

Clearly, our seat at the global table is much different than what it was in the past... and what it will be in the future. How we choose to use our influence in the future will determine our collective success.

Are we up to the challenge?

I believe we are.