

ViewPoint

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Convergence of IFRS and US GAAP

The convergence of accounting standards is of decisive strategic importance to the future of the global capital markets.*

*connectedthinking

Current accounting and reporting practices fall short of meeting the information needs of the capital markets in the 21st century. A critically important element in the solution to this problem is the convergence of US GAAP and IFRS, a process now under way at an early stage. Will convergence rise to the challenge of meeting those needs?

The goal, in brief, is an improved reporting model built on principle-based standards that can be applied in a cost-effective manner.

The convergence of accounting standards is a matter of decisive strategic importance to the future of global capital markets. High-quality information is essential to high-quality markets. All stakeholders who rely on high-quality markets need to understand the issues surrounding convergence, form a point of view and take the time needed to participate in the global debate. The debate will have several phases. Currently the uppermost issue is the process for achieving high-quality converged standards, which will be substantially equivalent although not uniform in every detail. Later the issue is likely to be the possibility of achieving a single set of global high-quality standards and a single global standard setter.

Now that the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have jointly set out on the path of convergence, the scope and nature of accounting and reporting standards will be gradually altered. Two accounting, regulatory and legal ‘cultures’ – the US and all territories now following IFRS – will need to come into a new and closer relationship if the convergence process is

to succeed. All major stakeholders have the opportunity to influence this challenging process in positive ways that reflect both their business interests and their commitment to sound global capital markets.

Five fundamental points

We believe five major points bear close consideration.

1 The global convergence of accounting standards is a very positive development.

The convergence of financial reporting and accounting standards is a valuable process that contributes to the free flow of global investment and achieves substantial benefits for all capital markets stakeholders.

It improves the ability of investors to compare investments on a global basis and thus lowers their risk of errors of judgment. It facilitates accounting and reporting for companies with global operations and eliminates some costly requirements. It has the potential to create a new standard of accountability and greater transparency, which are values of importance to all market participants including regulators. It reduces operational challenges for accounting firms and focuses their value and expertise around an increasingly unified set of standards. It creates an unprecedented opportunity for standard setters and other stakeholders to improve the reporting model.

Convergence is a long-term process. While it may take years to reach the important goal of a single set of standards, progress has already been achieved. In the near term, there will be two standard setters and a mix of standards, some prepared and issued jointly, others prepared and issued independently within the framework of convergence. Variations in standards are likely to remain for some time, particularly in guidance that predates the effort to converge. Ultimately, the two standard setters will achieve a level of ‘substantial equivalence’ sufficient to eliminate the SEC’s required reconciliation to US GAAP for foreign private issuers. Both standard setters should move with a sense of urgency toward this goal. The appropriateness of maintaining two separate standard setters on a long-term basis is a complex question, deserving careful analysis as convergence progresses. It’s worth restating that the goal is an improved reporting model built on principle-based standards that can be applied in a cost-effective manner, delivered through a convergence process that will go as far as it can.

It’s helpful to think of the evolution of convergence as phases of a continuum:

- **Phase I (2001-2005).** The European Commission decides to require the use of a common financial reporting language (IFRS); completion of the ‘stable platform’ of IFRS; and mass adoption of IFRS by more than 8,000 companies in the European Union and world-wide by 2005.
- **Phase II (2006-2009).** Inaugurated by the February 2006 Memorandum of

Understanding between the IASB and the FASB, Phase II represents rigorous market and regulatory testing of IFRS, and further convergence activities by the separate Boards to address significant differences. The objective is the achievement of substantial equivalence of IFRS and US GAAP and elimination of the SEC's reconciliation requirement for foreign private issuers.

- **Phase III (beyond 2009).** In this period, the separate standard setters are expected to operate in a well-coordinated, lock-step fashion; in most if not all cases, identical standards are issued. During this phase, the FASB becomes increasingly redundant as a separate entity, although the nature and timing of decisions by the Board's trustees and by regulators concerning the future of the FASB is unpredictable at this time.
- **Phase IV (longer term).** Resources from the FASB are subsumed into the IASB structure, and a single global standard setter (IASB) and accounting framework (IFRS) is used by all territories.

2 Continued convergence depends on achieving a new 'blueprint' focused on the scope of reporting, simplification and market relevance. Informed global debate on these issues is needed.

Focused on realistic economic representation, accounting standards should address the legitimate needs of key stakeholders and provide a comprehensive overview of financial information. Standards must be as simple and understandable as possible, recognising the complexity of transactions, and should be practical and cost-effective. Addressing broad issues, they should favour principles

and the exercise of professional judgment over rules, safe harbours and exceptions. The reporting model must facilitate prediction of future performance and provide comparability across companies and industries.

3 The process of creating this blueprint should clarify the scope and purpose of reporting and determine the role of standard setters.

The investment community has made incontrovertibly clear that, from the perspective of expert investors, the current reporting model under-delivers.

How far must convergence go to satisfy investors? The removal of the current IFRS/US GAAP reconciliation is a valid short-term goal; priority should be given to removing material reconciling items. But the blueprint for the future of reporting, including the conceptual framework now under development, also needs to be agreed. Topics for consideration by the Boards, surfaced by investor community research, include the following:

- The balance between principles and rules
- The ability and willingness of management and auditors to exercise judgment
- The bases of measurement (historical cost, fair value, current value) that need to be reported in different circumstances (e.g., industry type, life cycle of company, economic cycle)
- The relevance of data presented under existing GAAP (e.g., the ability to assess operational performance, the quality of segment reporting, etc.)

- The role of disclosure and the nature of information needed to assist in assessing future performance
- The drive toward simplification. The Boards will need to create clear standards that cannot reasonably cause confusion in the marketplace.
- Field-testing of standards is now somewhat perfunctory. In a world of principle-based standards, robust field-testing will be a needed quality control.
- The scope of information to be reported on an interim and annual basis (contextual – financial and non-financial)
- The timeliness of periodic reporting (historically, the responsibility of regulators). The advent of XBRL reporting will undoubtedly change the dynamics of what gets reported when.

As well, the Boards' development processes need to include checks and balances to ensure the following:

- A sustained simplification agenda, supported by visible and rigorous cost/benefit analyses
- A focus on ease of understanding and a reasonable level of ease in implementation by preparers and auditors world-wide
- Prevention of undue influence on standard setting by constituencies focused on their self-interests
- Due focus on incorporating important innovations in electronic reporting
- Standards that improve the predictability of future performance

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4 Cultural, legal and political obstacles along the convergence path cannot be underestimated. The appropriate authorities should make every effort to minimise these difficulties.

Legislators, regulators and standard-setting bodies need to be aware of the fault lines in the current convergence process and, where appropriate, should take action to ensure progress. In particular there is significant concern that, without some revision, the existing U.S. legal, regulatory and standard-setting system will unduly influence the next critical phase of convergence.

While few may doubt that the correct focus of regulation is to maximise investor protection in a cost-effective manner, legal and regulatory frameworks and cultural histories surrounding financial reporting vary greatly across territories. Some long-standing accounting and reporting practices may be hard to overcome in certain territories: even after territories adopt IFRS, their traditions may influence how they interpret and apply standards. For example US GAAP, while based in sound principles, has evolved into a complex framework of detailed rules and bright-line exceptions that are difficult to apply and can result in financial engineering, litigation and regulatory penalties. The highly litigious US environment and strong US enforcement policies have tended to encourage the creation of standards with rules and exceptions as a means of finding safe harbour. US standards that could be 20

pages in length, were they entirely focused on principles, can stretch to 200 pages or more as rules are laid out and exemplified.

It is also true that regulatory and enforcement practices vary greatly among territories. Reform of the legal and regulatory environments, insofar as they unduly impede convergence, will be a long-term, challenging process. Broadly speaking, key stakeholders need to evaluate the regulatory and legal frameworks in which the standard-setting process is embedded in order to make convergence toward principle-based standards a realistic, workable reality. Global regulators must be encouraged to collaborate to ensure that significant divergences do not occur.

5 Additional strategies, protocols and tactical agreements are needed to further the convergence process.

The Memorandum of Understanding issued by the FASB and IASB in February 2006 is a statement of goals that does not address the overall philosophy, process and resource issues that will inevitably come up. It was a positive step, but only a beginning. Attention must be given to the process of developing converged standards that fairly reflect the views of the global audiences to which they are accountable. The Boards commit to coordinate agendas and work programmes with the ultimate goal of achieving fully compatible, high-quality financial

reporting standards. However, they do not commit to avoiding the creation of new areas of divergence, and they do not acknowledge other key forces that influence standard setting in the EU – specifically, the ARC/EFRAG endorsement process at the European Commission level. Likewise, some believe that the SEC greatly influences the application of US GAAP and occasionally influences the actual content of standards. The Boards need to engage investors, corporate preparers and auditors in a much more robust and thorough way.

Further, developing high-quality standards to meet the needs of today's global capital markets may well require adding new skills to the existing organisations. The existing processes, working environments and results of the Boards need to be constructively questioned to ensure that high quality is achieved and to prevent national biases and exceptions. Co-operation from major securities regulators is also critical to enforce consistent application and protect global investors.

There is a clear need to rethink how the views of key stakeholders (investors, corporates and auditors) are captured by the Boards. A robust, collaborative, global standard-setting process is needed in which representative perspectives are heard and acted upon. When a strong majority of stakeholders reject a proposal, that position should only be ignored in rare circumstances.

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The CEOs of the six major accounting firms speak up

The global convergence of accounting standards is clearly a major issue, and it has the attention of the standard-setting community and the accounting profession. But who else is listening? Who else recognises the implications of convergence for 21st-century markets? Still too few. In an important departure from traditional competitive attitudes, the CEOs of the six major accounting firms published in November 2006 a joint white paper entitled *Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks*.¹ It is intended to launch a robust discussion about how global financial reporting and public company auditing procedures must adapt to better serve capital markets around the world. The CEOs make the case that several initiatives must be undertaken to benefit global financial markets and their stakeholders, including at the top of the list the global convergence of accounting standards.

The CEOs advocate the point of view in this white paper. They argue forcefully, for example, for principle-based standards and the exercise of professional judgment. 'Accountants and auditors are trained professionals who have the ability, by virtue of their education and professional experience, to apply the spirit of broad principles in deciding how to account for and report financial and other information.

Rules that allow this judgment to be exercised will produce better, more reliable and more useful information.... If there is to be convergence to a single set of accounting standards or something very close to it – as we believe the increasing globalization of capital markets demands – the resulting standards should be those that permit judgment rather than stifle it, and those that reflect simplicity over complexity.'

Summing Up

The capital markets are the joint creation of many different stakeholders – investors, corporates, securities exchanges, lenders, accountants and auditors and market information packagers, among others. Every stakeholder stands to gain from active participation in shaping the successive phases of the convergence process. We must all help ensure that it remains focused on delivering a more effective, market-oriented reporting model built on principle-based standards that can be applied in a cost-effective manner. We can all contribute to this outcome.

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¹ Available for download at <http://www.pwc.com/extweb/pwcpublishations.nsf/docid/a3263860a2ac0059802572220057ef35>