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## Who's Left? The Process of IFRS/US GAAP Convergence

Gary Illiano, Grant Thornton LLP - 03 Jul 2007

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*This article looks at the roots of accounting standards around the world, and finds that convergence between international and US standards is coming closer than ever.*

With their disparate cultures, laws, commerce, and tax regulation, individual countries have, over time, come to develop their own accounting systems. In the US, the Financial Accounting Standards Board (FASB) was formed in 1973, the third group to develop generally accepted accounting principles (GAAP) in the US since formal standard setting began in 1939. The FASB was the first group to employ full-time professionals, to be independently funded and independent of the accounting profession. Officially sanctioned by the federal regulator, the Securities and Exchange Commission (SEC), in December 1973, the FASB continues to set US accounting standards today.

Shortly after the birth of the FASB, the International Accounting Standards Committee (IASC) was formed, also in 1973, to develop internationally accepted accounting standards. In the early 1970s, the global economy was marked by an expansion of cross-border activities. The time seemed right to consider whether a universal set of accounting standards was needed to address the shrinking world.

The IASC, in trying to promote acceptance of a single set of accounting standards worldwide, tended to write inclusive standards. Often, committee members had difficulty achieving consensus on the proper accounting treatment for the same or similar transactions. Preferred treatments were identified, but different accounting, with different results, was allowed. This was considered necessary to promote acceptance of a complete set of global accounting standards. If a particular standard was too different from what had become generally accepted in a particular country, that country might reject the whole set of standards. Better to allow for alternatives so as to bring more countries into the fold. Inevitably, criticism followed. The international standards lacked comparability, they sought the lowest common denominator, it was a race to the bottom, and so on.

### Beginning of a New Era

Ultimately, after issuing 41 international accounting standards, in 2001 the IASC was replaced by the International Accounting Standards Board (IASB). More than just a change in the last letter of an acronym, the new board was structured more like the FASB, overseen by a foundation that raises money and appoints members, with a separate advisory council to provide input from constituents. Since its formation, the IASB has issued eight International Financial Reporting Standards (IFRS) as well as modified several IASs, the standards promulgated by its predecessor.

The European Commission gave international standards a large boost in June 2000 when it announced an initiative to require all listed companies throughout the European Union to use IFRS beginning in 2005. The measure, which did not affect Europe's non-listed companies, was approved by the European Council of Ministers in June 2002. About 7000 companies made the change on 1 January 2005. About 6500 of those had been reporting in their home-country GAAP, with about 3000 in the UK alone.

However, the EU did not endorse three paragraphs of IAS 39, the standard that deals with recognition and measurement of financial instruments. The potential volatility of earnings related to those paragraphs' macro hedge accounting and the fair value option sent the standard setters back to the drawing board more than once, but no silver bullet appeared. To this day, the EU has not endorsed the full set of IFRS promulgated by the IASB.

The failure of the EU to endorse the full set of IFRS is a significant issue for several reasons, not the least of which is the requirement in IAS 1, *Presentation of Financial Statements*, that a company explicitly state that its financial statements comply with IFRS. Further, companies are not allowed to describe financial statements as complying with IFRS unless they comply with the whole body of IFRS. The Europeans managed to work around this by saying, "IFRS as adopted by the EU."

For accounting standards to garner worldwide acceptance they must be universally applied. Comparability is essential. A set of financial statements prepared using Country A's GAAP is not suddenly comparable to another set prepared using Country B's GAAP simply because the statements say IFRS across the top. Consistent application is definitely a key priority for the US regulator. The SEC generally likes IFRS, but what the SEC does not like is what Ethiopis Tafara, director of the SEC's Office of International Affairs, referred to on 8 May 2007 as "nationally-tailored versions of IFRS" that will "plunge us back into a Babel of national GAAPs."

However, if "in accordance with IFRS" means that the same or similar transactions are accounted for the same

way everywhere, producing financial statements in accordance with IFRS will add value. Investors would no longer need to waste time and effort to reconcile financial information as they compare similar companies from different countries. Capital would flow more efficiently, at less cost to more companies in more places.

Another big boost towards acceptance of IFRS took place in 2002 with the signing of the 'Norwalk Agreement', which was reaffirmed in a February 2006 Memorandum of Understanding. The IASB in London and the FASB in Norwalk, Connecticut, agreed to seek to remove differences between their two sets of standards, and to converge on *high-quality* standards. The emphasis on high-quality means that if an IASB standard or a FASB standard is deemed to be the better one, then convergence will be to the superior standard. If neither standard is of sufficient quality, the boards would then work together jointly to develop a new standard. For example, the FASB converged to international standards with accounting changes and the fair value option; the IASB converged to US standards with borrowing costs and segment reporting. The two boards' first big joint project, on business combinations, is scheduled for release in the third quarter of 2007. Work has already begun on joint development of a single conceptual framework to guide future standard setting.

Convergence between IFRS and US GAAP does not mean that the accounting standards become identical. Convergence means that where transactions are the same or similar, the accounting should be the same, or there should be enough transparency in the disclosures to allow the reader to understand the differences. Also required, though, is a continued effort by the standard setters to try to reduce differences between the systems over time.

Another very strong boost towards acceptance of IFRS in the US came from the 'Roadmap'. Published as an appendix to an April 2005 article in the *Northwestern University Journal of International Law and Business* entitled, "A Securities Regulator Looks at Convergence," the Roadmap is a timeline set out by then SEC chief accountant Donald Nicolaisen that details the necessary steps to eliminate the reconciliation requirement. Currently, if a foreign issuer files with the SEC in either its local GAAP or IFRS, it must also include a footnote reconciling the differences between those statements and statements prepared under US GAAP. The Roadmap's milestones and dates along a timeline lead to the conclusion that the reconciliation requirement can be eliminated by 2009 or sooner.

### **Gathering Pace in 2007**

On 6 March 2007, the SEC held roundtable meetings in Washington, DC. The roundtables were organized as three panels discussing the impact of IFRS and ending the reconciliation requirement. The most significant result of the roundtable discussions was the emergence of a clear consensus that the SEC should end the reconciliation requirement as soon as possible.

Two corollary themes emerged from the roundtables as well. First, US investors today aren't using the reconciliation because it is not provided in a timely manner. Foreign issuers aren't required to file their annual Form 20-F in the US until six months after their year-end. Underwriters, analysts and credit rating agencies have become comfortable working with the home country IFRS statements that are available much sooner. For some industries and peer groups, IFRS has already become the reporting standard.

Second, US issuers should be allowed to use IFRS in their US filings. This is something of a competitive issue, as the US firms should not be prevented by their own regulators from providing their financial statements in the form most coveted by the market if, or more likely when, that becomes IFRS. Some US issuers are already producing IFRS statements for different purposes, such as for regulatory reporting of subsidiaries. Participants did acknowledge that much needed to be done in the areas of training and guidance for preparers and auditors before IFRS could be widely implemented in the US.

In the wake of the roundtables, the SEC moved into action. On 24 April 2007 the Commission issued a press release on next steps for IFRS. This was significant in that the communication came from the Commission itself, rather than members of the Commission staff. The SEC announced plans for a Proposing Release in the summer of 2007 that would give foreign issuers a choice between using IFRS and US GAAP, which would effectively eliminate the reconciliation requirement where IFRS is used. The SEC also said they are planning a Concept Release to solicit comments on allowing US issuers the alternative to use IFRS in their SEC filings.

The staff moved quickly to clarify what the commissioners meant by IFRS. John White, the head of the SEC's Division of Corporation Finance, emphasized in a speech on 2 May 2007 that the standards the SEC would accept must be "IFRS as published by the IASB." Furthermore, "jurisdictional adaptations," he said, would not be recommended to qualify for no reconciliation.

With time running out, the current US regulators are pushing hard. When issuing the April 2007 press release, the SEC Chairman reaffirmed that the elimination of the reconciliation by 2009 is "on track." In a speech on 3 May 2007, the SEC's chief accountant, Conrad Hewitt, encouraged the FASB and IASB to continue to work towards convergence. He suggested that compromise would be better than delay. On 20 June 2007, the commissioners unanimously approved the proposal to eliminate the reconciliation from IFRS to US GAAP. After a 75-day comment period, it can be formally adopted. The proposal calls for the elimination of the reconciliation to US

GAAP to be effective for the December 2008 annual reports that will be filed in 2009. Chairman Christopher Cox, a former Republican Congressman, may be hoping to make this his legacy before, as is the custom, he tenders his resignation to the new American president in early 2009.

## Conclusion

Acceptance of IFRS continues to build momentum. In 2005, when the EU-listed companies had to switch to IFRS, about 7000 companies were affected. Current estimates suggest that 9000 European companies are now using IFRS. Convergence programs between the IASB and the standard setters of Japan, Canada and the US are going strong. China is requiring its listed companies to use IFRS beginning in 2007. Canada, which represents nearly half of the foreign issuer filings with the SEC, recently decided to switch to IFRS from 1 January 2011. Estimates vary, but IFRS is accepted in over 100 countries. Some believe that will grow to 150 countries in the next few years.

As IFRS is accepted in more places around the world, it seems likely that financial reporting will be effectively reduced to two standards: IFRS and US GAAP. Although US GAAP has been battle tested for well over 60 years, IFRS, now in its mid-30s, is coming on strong, as more countries adopt IFRS as their accounting standards. We are likely to end up with one globally accepted set of accounting standards - probably IFRS. And it may be happening sooner than you think.

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