NO CONVERGENCE?

As the US continues to drags its heels over adopting International Financial Reporting Standards, does it matter, given that the rest of the world is coming together?

It has been a lengthy, troubled courtship that is heading for an acrimonious divorce before the marriage has even taken place. Since the beginning of the year, the rumblings around the growing divergence between the world's powerful accounting standard-setters have been getting louder.

Despite calls from the G20 nations for convergence on accounting standards and pressure from the Financial Stability Board (FSB), some of the world's largest banks and the support of more than 120 nations that have adopted or permitted International Financial Reporting Standards (IFRS), this arranged match has fallen into disarray and prospects of a reconciliation look slim.

In February, the International Accounting Standards Board (IASB) – the body responsible for IFRS – and the Financial Accounting Standards Board (FASB) – the US standards setter with oversight on US generally accepted accounting principles (GAAP) – parted ways over classification and impairment of financial instruments.

An IASB podcast following that meeting provides significant detail about the decision but, in essence, it means that the FASB will not adopt IFRS 9, *Financial Instruments*, which has been proposed to replace IAS 39, *Financial Instruments: Recognition and Measurement*. A key goal of IFRS 9 is convergence, and the FASB's decision has offered a clear signal that the US standard-setter is no longer committed.

The decision was met with frustration and disappointment, with IASB chairman Hans Hoogervorst saying after the meeting: 'A lot of work has been done for nothing, it seems.'

Similarly, the decision to abandon the joint project regarding convergence on insurance contracts, revealing the growing dissonance between the FASB and the IASB, has served US insurers well, but will lead to greater uncertainty in other parts of the world, such as Asia, where insurance is growing rapidly in economies that have varying levels of sophistication in accounting standards.

Critical blow

The February decision to part ways over classification and impairment as well as insurance contracts – the latter followed intensive lobbying by US-based insurance companies to retain the 'gold standard' of US GAAP and pursue targeted improvements – is a critical blow to the convergence movement. Numerous organisations have repeatedly called for greater harmonisation between the two standards, including the International Federation of Accountants (IFAC).

IFAC is deeply concerned about the latest developments. CEO Fayezul Choudhury believes that the worst-case scenario is that when the next major global economic crisis occurs, global leaders and governments will be as ill-equipped to deal with it as they were in 2008.

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TO CONVERGE OR NOT?

Globalisation has been a powerful force behind moves to converge accounting standards. This was one of the primary motivators for the International Accounting Standards Board and the Financial Accounting Standards Board (FASB) to begin formal negotiations after 2002 to align their respective standards: the International Financial Reporting Standards (IFRS) and the US generally accepted accounting principles (US GAAP).

There are numerous differences between IFRS (which is already in use or will be soon in more than 120 countries) and US GAAP. The oft-cited difference, though, is that IFRS is principles-based, while US GAAP is more rules-based.

Proponents have long argued that convergence would facilitate cross-border investments and reduce, or eradicate, regulatory arbitrage. It would also create greater certainty for users of financial reporting by making comparisons easier, while companies themselves would benefit from lower compliance costs from needing to adhere to only one set of standards.

Convergence is also supported by the accountancy profession by reducing the burden of knowledge and specialisation needed to prepare two sets of accounts for one entity.

The impetus for creating aligned standards grew after the financial crisis of 2008, with the International Federation of Accountants, among others, maintaining that the need was greater than ever to support a sustainable economic recovery based on a stable platform of transparency.

Nonetheless, convergence has had its detractors, too. FASB former chairman Leslie Seidman said in 2012 that precise guidance was necessary in the US due to its litigious culture.

'The US financial reporting system can't function over the long run with accounting standards that provide only principles,' he said. 'This apparent need for some adjustments does not mean that IFRS is flawed. It simply suggests that a goal of 100% comparability is not achievable in the near term, for very legitimate reasons, in some of the world's largest capital markets.'

cooperation,' Choudhury says. 'For financial markets, the G20 – through the FSB – identified the need for immediate implementation around the globe of 12 key sets of standards including those for financial reporting (IFRS), auditing (ISAs) and corporate (OECD Corporate Governance Principles). Six years on, this important message seems to have become lost – with limited success at achieving global convergence and many jurisdictions reneging on the commitments made.

'Many people seem to be arguing that the G20 has lost its way, and the momentum that existed in 2008 is indeed waning. The commitment to convergence is no longer a priority as the shoots of economic recovery begin to emerge, political will dissipates, and governments make national-based decisions that promote regulatory fragmentation, create regulatory arbitrage and have extra-territorial impacts.

'The G20 needs to demonstrate leadership, and countries need to support the commitments made by their leaders.'

According to Francesco Nagari, Deloitte Global IFRS insurance leader, there will be a visible impact within Asia, given that financial reporting within the insurance sector has made use of both IFRS and US GAAP. 'This dual reporting is a more marked characteristic of the Asian insurance sector compared to other parts of the world outside the US, where US GAAP for insurance companies is less relevant to local investors who only wish to receive IFRS financial reports,' he says.

'The prospect of both IFRS and US GAAP changing without convergence is likely to add costs to the financial reporting processes of Asian insurers, who may face polarised investors' demands for reconciliations to IFRS or US GAAP depending on their preference.'

At a wider level, convergence in Asia is seen as being vital to the region's economic growth. 'Convergence of accounting and reporting standards is important to businesses as it will provide a common language that gives investors – local and foreign – confidence in the financial system,' says Deloitte Singapore audit partner Shariq Barmaky. 'Investors can then more easily compare companies' relative performance and returns across jurisdictions, and weigh investment opportunities objectively.'

Like its peers, EY also supports the convergence movement, but Tan Seng Choon, assurance partner in Singapore, adds an important caveat.

'Differing regulatory environments may make it extremely challenging, if not impracticable, [to achieve convergence] and, to this end, we believe that timely finalisation of the accounting standards should take

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precedence and not be "sacrificed" at the expense of attaining convergence.'

He says that while convergence with IFRS will invariably bring benefits, it will also entail costs that will be borne by preparers of financial statements in that jurisdiction.

'It is important to note that different jurisdictions may be at different stages of economic development, and this could be further compounded by different local laws and regulations,' Tan adds. 'It is therefore critical for the national standard-setters to carefully consider all these unique features as they formulate their plans and set out their paths towards IFRS convergence.'

Balancing act

This view is echoed by Lynda Tomkins, EY's IFRS leader in Australia. She says that while the firm has long been concerned that any market that varies IASB standards is a step in the wrong direction, it recognises that the process of convergence may involve accepting 'temporary differences from global standards' to allow local financial reporting to develop and attract broader support.

'Countries often need to give up some practices that have evolved over time, and accept others that may not be to their liking,' she says. 'But this is all part of participating in a global process, and it will not be without controversy.'

Another tricky aspect that has littered the road to convergence with potholes is whether users of financial statements should be the primary reason for convergence, rather than the interests of companies themselves. Veronica Poole, Deloitte Global IFRS leader, says Deloitte supports the primacy of users of financial statements in the development of IFRS. 'In our comments to the IASB on the Conceptual Framework in January 2014, we noted that a critical test was whether reporting an item or the use of a particular measurement attribute provides information that is "relevant and useful to users",' she says.

In addition, Poole says, analysis of the adoption by the European Union of IFRS revealed increased transparency and greater comparability. 'Investors developed more trust in the numbers and the cost of capital went down,' she comments.

Tomkins adds, however, that standard-setting is a fine balancing act. 'The goal of financial reporting itself is to communicate to users relevant information about the financial performance and position of the company, and therefore meeting their needs is critical. However, this must not be at an unreasonable cost or burden on the companies themselves.'

This is not the only challenge. Kris Peach, a partner in KPMG Australia's Department of Professional Practice, agrees that financial reporting should have investors and users as the prime audience.

'But in recent years there has been criticism that the audiences have become blurred, resulting in unnecessarily complex requirements that are unlikely to serve investors, users or companies,' she says. 'Of course, the companies themselves and other stakeholders – such as regulators, customers, employees – are important.'

The future of convergence remains very uncertain. Some believe that the efforts of the past 12 years have come to nothing, and that the process is now over. Tomkins suggests that, in the short to medium term, there is a real danger that financial reporting will remain fragmented throughout the globe. 'While the underlying principles of IFRS mean that financial reporting will be more similar than it has traditionally been, it will not necessarily be the same as a global financial reporting language just with different accents,' she says.

'It will be more akin to having different dialects of the same language – still not necessarily understood by everyone. This will have the effect of reducing confidence in reported financial information in the context of global capital markets.'

Peach believes that market forces will determine the outcome. 'The capital markets will ultimately drive whether there is one set of international standards,' she concludes. 'The ability to prepare one set of financial statements and have them accepted by multiple jurisdictions will improve the costs of raising capital. However, regulatory and enforcement issues will need to be resolved from a global perspective.'

Amanda Vermeulen, journalist