

The Future of Financial Reporting: Convergence or Not?

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Introduction

"I would like to thank the US Chamber of Commerce and its Center for Capital Market Competitiveness for organising today's event on the future of financial reporting. I have a great affinity with the United States and have always enjoyed my time here. With that in mind, it is not surprising that we at the IASB and the Financial Accounting Standards Board (FASB) have worked so successfully in partnership over the past decade. I am delighted to present at the same event as my friend and colleague, Leslie Seidman.

This event on the future of financial reporting is timely. Years from now, we will look back on 2011 as a year when the future path of financial reporting was determined. There are two key activities coming to a head this year. First, the IASB and the FASB are now nearing the completion of a nine-year programme to improve International Financial Reporting Standards (IFRSs) and US generally accepted accounting principles (GAAP) and to bring about their convergence. Second, the US Securities and Exchange Commission (SEC) will make a decision on the use of IFRSs by US domestic companies.

The SEC's decision will be felt well beyond the borders of the United States. Today, more than 100 countries either require or permit the use of IFRSs for listed companies in their domestic markets. This includes, among the Group of 20 (G20) members, Australia, Brazil, Canada, the 27 member states of the European Union, Korea and Mexico. However, China, India and Japan have yet to make a formal and full commitment to domestic adoption of IFRSs. Their work towards adopting IFRSs in their countries has been, in part, predicated on the implicit understanding that a truly global accounting standard must include the United States. They are therefore closely watching the SEC's decision.

Global standards: we are almost there....

Today, I would like to present my vision of the future of financial reporting. My vision, not surprisingly, includes IFRSs as the common basis of financial reporting for listed companies throughout the world, including the United States. These standards, applied consistently, will provide high quality, transparent and comparable information for investors and other users of financial information. The standards must be based upon clearly articulated principles and not unnecessarily laden with detailed rules and guidance.

In the setting of IFRSs, the IASB must remain independent, not beholden to undue national, regional or special interest pressure. This independence is balanced with appropriate levels of public accountability. The IASB will continue to run an open, transparent and intensive due process, which has already been recognised as best practice amongst comparable international organisations. The IASB has clear accountability lines to an oversight body of Trustees who will continue to assure accountability to public authorities, now embodied in the IFRS Foundation Monitoring Board.

Now, some in this room may view this vision as a utopian one. It is not. Indeed, those of you among us today who closely follow the work of the IASB will know that this is not some pipedream. It is a vision on the cusp of becoming a reality. We are almost there. We are almost there in terms of a clearly articulated case, in terms of global acceptance, and in terms of our governance arrangements.

My confidence that we are achieving this vision is bolstered by the strong case for global standards. In a world in which capital flows freely across borders, the same economic transaction should be accounted for in the same way, regardless of whether you are in Washington, Warsaw, Wellington or Winnipeg. Global standards make it easier for investors to make comparisons between companies operating in different jurisdictions. Multinational companies benefit from reduced compliance costs and reduced translation risks when consolidating multiple international subsidiaries into a single set of consolidated financial statements.

Global accounting standards will enhance the drive towards the free trade of capital internationally. By adopting a globally accepted set of standards, all companies—large and small—are able to attract capital from a larger pool of investors, driving down the cost of capital and facilitating cross-border mergers and acquisitions activity and strategic investments. Finally, a common set of standards eliminates opportunities for regulatory arbitrage and permits regulatory authorities to develop more consistent approaches to supervision across the world. In other words, financial reporting is a key element of post-crisis global regulation.

Indeed, this case has achieved growing global acceptance. The leaders of the G20 nations have committed themselves to global financial reporting standards. Today, over 100 countries either require or permit the use of IFRSs for publicly traded companies. We are now witnessing a new wave of IFRS adopters, including countries that have strong ties to the United States. Last year, Brazil

adopted IFRSs. This year and next, Canada, Korea and Mexico are all requiring the use of IFRSs. Japan now provides an option for domestic Japanese companies to prepare financial statements in accordance with IFRSs, while formally deciding next year on mandatory adoption of IFRSs. Japan has also signalled that it will eliminate the option for the use of US GAAP in 2016.

The IFRS governance model assures that the IASB will remain an independent standard-setter, committed to writing standards aimed at investors. The IASB's governance model should be familiar to our US stakeholders because it is based upon the FASB's governance model. Like the FASB, the IASB has a three-tier structure. The Monitoring Board plays a similar role to that of the SEC in the United States, and the chairman of the SEC is a member of the Monitoring Board. The Memorandum of Understanding governing the relationship between the Monitoring Board and the IFRS Foundation incorporates much of the language of the policy statement that governs the relationship between the SEC and the FASB.

In a similar way to how the Financial Accounting Foundation oversees the FASB, the IFRS Foundation Trustees are responsible for the governance and oversight of the IASB and are responsible for appointments and financing arrangements. And, like the FASB, the IASB is composed of full-time professionals, subject to similar independence and due process requirements. The IASB is supported by a professional technical staff of nearly 60, employed in London, and a network of national standard-setters throughout the world.

A number of commentators, particularly in the United States, have questioned whether the IASB is more susceptible to undue political pressure than national standard-setters. I will not deny that we do get our share of pressure. So has the FASB and every other accounting standard-setter that I have observed.

It is my firm belief that an international process, bolstered by an effective system of governance, is better able to stand up in the face of such pressure. To paraphrase Federalist Paper 51, the expansion of the number of major economies adopting IFRSs should mean that no particular interest will dominate—too many others will be affected. We have already seen where this is the case. The IASB, by issuing a standard on the expensing of stock options, was able to assist the FASB in breaking the deadlock that existed in the United States.

Finally, on the topic of governance I would like to say something about the financing of the IASB. The issue of financing is closely tied to the issue of governance and independence. What is clear is that any standard-setter's funding system must maintain the independence of the standard-setting process, while providing the necessary financial resources. In this regard, the IFRS Foundation, the IASB's oversight body, has made much progress.

Since 2006, the Trustees have established national financing regimes, proportionate to a country's relative Gross Domestic Product, that establish a levy on companies or provide an element of publicly supported financing. As a result, today, the great majority of the Foundation's finances are based on such regimes. The Trustees have been particularly successful in Asia-Oceania, Europe, and are making gradual progress in Latin America. It is primarily in the United States that the IASB remains dependent on voluntary contributions from corporations. I know that the IFRS Foundation Trustees, working with the SEC and the FAF, are seeking a more sustainable solution for the US funding element.

The case for a 2011 IFRS decision

Not surprisingly, I have painted an optimistic picture on the state of IFRSs. None of this is to suggest that IFRSs are yet a global standard. Indeed, the United States still does not formally accept IFRSs for its domestic companies. We all know that there cannot be a global system without US acceptance of IFRSs. This is an objective that I have been fully committed to over the past ten years.

I would like to make the case today on the pressing need for the United States to commit itself this year to a clear, defined, and workable timetable for the incorporation and use of IFRSs, as published by the IASB.

It is in the United States' economic interest to be part of the global system. When the IASB began its work in 2001, the United States was seen as the leading forum in which to raise capital. The US financial reporting and regulatory system was the undisputed gold standard. It is not surprising that many here and elsewhere believed that if you wanted to adopt international standards, you should adopt US GAAP. However, the shape of the world's capital markets has changed rapidly in the past ten years. First, we have seen the rise of the capital markets in Asia and Europe. According to World Federation of Exchanges statistics, at the end of 2001 the United States counted for 52 per cent of the world's equity market capitalisation. In contrast, at the end of 2009, its share had declined to approximately 31 per cent. During this period, we have seen the rise of Asian capital markets, which have essentially doubled from 14 per cent to 31 per cent of the world's market capitalisation. With capital increasingly mobile and the public sector now requiring more borrowing, US companies (like others internationally) will increasingly need to turn to international investors for capital.

Delaying the adoption of IFRSs imposes unnecessary costs and risks on US companies. Already US-based multinationals need to maintain multiple sets of accounting books, filing statements prepared in accordance with US GAAP with the SEC while reporting under IFRSs or national standards for their international subsidiaries. Their foreign competitors could use IFRSs for all purposes, even for filing with the SEC, now that the reconciliation requirement has been removed.

Even if you accept the need for a global standard, you may disagree with my assessment that the SEC must make a decision this year to allow the use of IFRSs. The window of opportunity will close if a decision is delayed. At the same time, a decision this year will provide US companies, auditors and educators with the necessary certainty and time they require to prepare for IFRSs. Now, I have heard many reasons for delaying the decision—Dodd-Frank implementation, the cost associated with the implementation, or the desire for even further convergence.

There are three points to make here. First, on the issue of cost, it is important to distinguish between the decision to incorporate and the date of implementation. It is the unambiguous commitment to IFRSs in 2011 that is essential. The SEC has already indicated that the earliest implementation date when IFRSs would be required for the largest US public corporations will not come until 2015 or 2016 at the earliest. Implementation for smaller companies could come later. In my view, such a commitment would be sufficient. It would also provide ample time for planning, education and training. Change is never easy. The goal is for all of us to work together to implement the benefits of global standards while minimising, as best we can, the costs of getting there. Indeed, many US companies have already begun preparations for IFRSs. What they need now is certainty and a date that they can work towards.

Second, the alternative of delay or further intensive convergence work is not a viable option. The IASB and the FASB have worked together for nearly 10 years on the convergence programme. We have made significant progress in improving accounting and eliminating major differences. The countries that have adopted IFRSs, or that have committed themselves to adopting IFRSs, have already accepted convergence with the FASB as a necessary step to facilitate US adoption. However, there is no appetite internationally for the IASB to work in exclusive partnership with the FASB beyond 2011.

Consequently, putting off adoption could impose unnecessary costs in the future. The completion of our joint convergence work provides the moment in history when transition to IFRSs will be easiest. At that moment, IFRSs and US GAAP will be most closely aligned with each other. On the other hand, without an SEC decision, the clear risk is that having once converged, standards could then diverge.

More strikingly, as my friend and current IFRS Foundation Trustee Harvey Goldschmid has stated, ‘a negative decision on IFRSs in 2011 by the SEC—or, as bad, a decision to delay an adoption commitment—would likely have tragic consequences’. Harvey imagines two scenarios.

First, the coalition of nations supporting IFRSs could break apart. Rather than two sets of accounting standards, namely IFRSs and US GAAP, we could go back to the fragmentation in standards that existed before the year 2000. We would once more have many incompatible national or regional

accounting systems. The cost, in terms of lack of transparency and comparability, would be extremely high.

The second basic scenario is even worse from a US perspective. The coalition in support of IFRSs could hold together but the pressure to remove US interests from the IASB, the Trustees and the Monitoring Board would be overwhelming. The absence of any formal convergence programme would almost certainly lead to divergence between international and US financial reporting standards. To my mind, this would lead to lower quality standards internationally.

In my opinion, neither of these alternatives is acceptable or in the interest of the United States. Remember, the United States has made an enormous investment in the development of global standard—in establishing the IASB in 2001, through the convergence process, and through the involvement of US Trustees, IASB members and the input of US stakeholders. If this occurs, all of our efforts over the past ten years will have been largely for nothing.

Finally, let me address the issue of sovereignty. I know that accepting standards from an international body is a difficult one. Indeed, global adoption of IFRSs does not require an abdication of a country's sovereignty in the field of accounting standards. In most countries, there is an endorsement mechanism in place to bring IFRSs into national law or regulation. In Australia and Canada, the national standard-setter plays this role, and IFRSs are being introduced without modification. The assumption in both jurisdictions is that standards are to be accepted without change. Without prejudicing the outcome of the FASB's deliberations, I would expect FASB to play a similar role in the United States.

Furthermore, the SEC would retain full control of enforcement of accounting standards in the United States. This is particularly important for those concerned with the consistency of application of IFRSs. The SEC will be able to require the same level of consistency within the United States, as it has today with US GAAP. Furthermore, by making a firm commitment to IFRSs, the SEC will be better positioned to influence consistent enforcement globally.

The state of convergence

It may sound odd that, as an accounting standard-setter, I have yet to address technical accounting issues today. This is because many of the most important issues facing the IASB are matters of public policy and strategy, rather than matters of technical accounting.

But let me now turn to how I see the state of convergence, the future of accounting standards and how the IASB could address concerns that are being expressed in the US about a post-IFRS-adoption world.

We are in the final stretch on the convergence work with the FASB. We have completed work in the areas of business combinations, share-based payment, pensions, fair value measurement, aspects of financial statement presentation, consolidation and derecognition, among others.

From the 10 major projects that were originally identified as the joint programme in the 2006 Memorandum of Understanding, the IASB and the FASB now have only three major projects remaining to be completed—revenue recognition, leasing and financial instruments. We are also working jointly on a new standard for insurance contracts.

The IASB believes that a June 2011 completion target remains our goal. Successful completion by June 2011 will provide an earlier stable platform of standards for those countries that have already committed themselves to adopting IFRSs this year and next. We also know that convergence will be an important factor in the IFRS decisions by the SEC and the Japan Financial Services Agency.

However, let me state one thing clearly—while I reiterate our focus on June, we will not sacrifice quality in the process. Keep in mind that the two boards have been working on these remaining convergence projects for more than five years. This is no rush job. Both the IASB and the FASB have followed, and will continue to follow, their due process fully.

In terms of the standards, we are in the process of redeliberations on the three remaining projects from the Memorandum of Understanding and also on the insurance projects. When finished, we will have a leasing standard that puts the great majority of lease contracts on the balance sheet for the first time. As some will remember, this is an area that the SEC staff identified in their post-Enron report to the US Congress as requiring attention.

I am confident that the new revenue recognition standard will provide a high quality, principle-based, and common standard. Those applying IFRSs will have a more comprehensive set of requirements that will no longer rely on the detailed guidance found in US GAAP. And the acknowledged inconsistencies in the very specific industry requirements that permeate US GAAP will be replaced by a cohesive set of principles that make cross-industry comparisons much more meaningful. This is a clear win for all.

The IASB is making rapid progress on its insurance standard. This is a particularly important standard for IFRSs. The existing IFRS is a stopgap standard. There is no commonly accepted approach to insurance accounting internationally, and there is a strong sense among investors that insurance accounting is deficient. The FASB was a late joiner to our project, as it seeks to make much needed improvements to US insurance accounting. It is proving to be a real challenge overcoming entrenched views within sectors of the insurance industry. But the prize will be improved transparency and comparability.

Lastly, a few words on financial instruments. The IASB and the FASB are working hard to reach a common standard here. We currently have a common position on the issues of impairment and balance sheet netting requirements. As many know, the FASB is now considering the comments received on other elements of its own financial instruments proposals.

Rather than commenting on the FASB's proposal, let me explain the IASB position. We have completed our standard, IFRS 9, on measurement and classification of financial instruments. This standard reduces the significant complexity of previously existing IFRSs and US GAAP standards. The financial instruments are either at fair value or cost, depending upon their characteristics and on the business model. IFRS 9 is already being implemented in a number of jurisdictions and has received strong support from investors and corporate preparers.

We are now waiting to see what the FASB will decide on measurement and classification. We believe that IFRS 9 provides a high quality and well-supported approach. At the same time, the IASB will expose the FASB's conclusions for public comment.

We have recently developed proposals for a new general hedging accounting model. Our proposals would remove the artificial rules that dominate the current hedge accounting requirements. Our goal is to have reductions in economic volatility reflected by reduced accounting volatility. The proposals are not targeted exclusively at financial institutions. They will also benefit industries that manage pricing or foreign currency risk. We are also working on new requirements for portfolio hedges, which we expect to expose later this year. The FASB has recently published a document seeking feedback on our general hedging model.

There are two more pieces of the financial instrument puzzle—impairment and balance sheet netting, or offsetting.

Both boards have received broad support for moving to an expected loss impairment model. We have jointly published a proposal designed to bridge our previous differences. The boards believe the proposal will enable them to satisfy at least part of their individual objectives for impairment accounting while achieving a common solution.

Finally, in January we published with the FASB a joint exposure draft that would align the reporting of balance sheet netting of financial instruments, which is one of the single biggest differences between IFRSs and US GAAP for financial institutions. The changes we are proposing would be more significant for those entities currently applying US GAAP. It would lead to some US banks reporting significantly more assets and liabilities on their balance sheets. But one thing is clear—in the post-financial crisis world, we should have consistency in accounting for financial institutions. Our proposal would remove a major difference.

The future of IFRSs

The work of the IASB will not be complete when the convergence programme is finished. We will provide sufficient time to implement the new standards and a period of calm for investors and companies to get used to the new standards resulting from the Memorandum of Understanding work.

I should also state that, even though the conclusion of the Memorandum of Understanding formally ends the exclusive partnership between the IASB and FASB, we want to retain a strong partnership with the FASB, which we would expect to continue to play a leading role in the international standard-setting process.

Later this year, the IASB will launch a consultation on its future work programme. I encourage all with an interest in accounting standards to participate in this consultation. Although my term of office will come to an end by the time the IASB decides on its future work programme, my hope is that the IASB will remain firmly committed to the principle-based approach. This is an approach that both the IASB and the FASB have reflected in their convergence programme.

I understand that there is some trepidation in the United States about principle-based standards, so let me explain what we are trying to accomplish and what I believe the FASB and the IASB have accomplished with the MoU standards. The core principles of any standard must be clearly worded. Other sub-principles are then articulated in a tree-like structure. Inconsistencies with other standards must be avoided, if possible, or fully explained.

All application guidance and examples that are aimed at helping users to understand the principles have to justify their inclusion. Would anything be missed if they were deleted? If guidance is necessary, is the principle sufficiently clearly stated? Does the standard include bright lines and arbitrary limits? Why are these necessary? Does the transition follow the normal pattern? If not, why is a change proposed?

I believe that this approach is superior, because the use of principles eliminates the need for anti-abuse provisions. It is harder to defeat a well-crafted principle than a specific rule that financial engineers can bypass. A principle followed by an example can defeat the 'tell me where it says I can't do this mentality'. If the example is a rule, then the financial engineers can soon structure a way round it. For example, if the rule is 'when A, B and C happen the answer is X', the experts would restructure the transaction so that it involved events 'B, C and D' and would then claim that the transaction was not covered by the standard. We only need to recall the abuse of unconsolidated special purpose entities which came home to roost during the financial crisis to see how well-intentioned rules present opportunities for financial engineering.

A principle-based standard relies on judgements. Disclosure of the choices made and the rationale for these choices will be essential. If in doubt about how to deal with a particular issue, preparers and auditors should refer back to the core principles. The basis for conclusions should also include, in particular, the question of whether there is only a single view on how to tackle the economics of the situation. Often there are competing views—is one deemed to be more relevant? If so, the reasons for choosing that particular view should be explained in the basis for conclusions and the reasons for rejecting the others should be clearly stated.

Now, is this principle-based approach practical in the United States? My first answer is that we already have it through the new convergence standards.

Even so, I acknowledge that it will be more difficult to implement and sustain a principle-based system in the United States, given the propensity for litigation. I believe that this challenge is overstated and that it can be mitigated by the careful generation, collection and retention of documentation and by seeking of expert advice and the views of professional colleagues throughout the life cycle of transactions. Above all, those who make such judgements, document them and make an honest and fair attempt to meet the principle should be defended.

I would also make the point that many in the United States believe that the status quo of rule-based systems cannot be maintained. There is a realisation that if a rule-based system is pursued, financial reporting will be governed by the search engine, rather than skilled professional judgement seeking to reflect the economics of a particular situation.

However, if the United States struggles with the degree of judgement applied by other countries that use IFRSs, then the FASB may have to issue requirements in addition to those of the IASB. The IASB would then have to consider ways of ring-fencing the additional US guidance to prevent such guidance being deemed compulsory for other followers of IFRSs.

Reaching the finish line

Today, we are closer than ever to achieving our objective of a single set of high quality global accounting standards. Much will depend on the continued spirit of co-operation and commitment that each of the FASB and IASB board members have demonstrated and the decision of the SEC on IFRSs. At the end of the day, the IFRS Foundation and the IASB cannot impose their standards on any country. Each jurisdiction has the right to choose whether or not to accept IFRSs. We will continue to do our part—a strong commitment to independent standard-setting, a due process that fully engages affected parties throughout the world, and standards aimed at investors and other providers of capital.

I am grateful for the support that the IASB has received from the United States and the FASB. The IASB appreciates the seriousness of the IFRS decision facing the United States, and we stand ready to meet the responsibility that a positive decision would entail.