

# COMPLIANCE WEEK

THE LEADING INFORMATION SERVICE ON CORPORATE GOVERNANCE, RISK AND COMPLIANCE

## Following the Road to IFRS Convergence

By Harvey L. Pitt, *Compliance Week Columnist* — April 27, 2010

In signing the Gold Standard Act of 1900, President William McKinley declared that gold, not silver, would underlie the U.S. monetary system. That Act didn't last long, predictions to the contrary notwithstanding, and today, our nation's economy is based on only two things expected from Washington, D.C.: promises and trust. The former is found in great quantities, while the latter is definitely a dissipating asset!

So much for the lasting effect of legislative solutions. In the same year gold was anointed, L. Frank Baum published his classic, "The Wonderful Wizard of Oz." Some scholars (unlike children content with its simplicity) say Baum's story was allegorical—Dorothy is every American, trekking home after being led astray, while Tin Woodsman reflects degraded industrial workers, rusty and helpless until teamed with Scarecrow, approximating the Farmer-Labor party coalition. Notably, Dorothy made her way home in *silver* slippers (ruby in the 1939 film), walking down the yellow (or gold) brick road.

History frequently poses difficult choices—like that of silver or gold—leading the 20th century's greatest philosopher, Yogi Berra, to recommend: "When you come to a fork in the road, take it!" Today we confront just such a fork in the road. Global commerce requires adoption of a single set of accounting principles applicable to all corporations reporting operating results, wherever located. This choice tests our accounting mettle—either U.S. Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS).

From the 1990s to 2009, four successive chairmen at the Securities and Exchange Commission (including me) embraced convergence between GAAP and IFRS; indeed, a roadmap—the yellow brick road to the goal of unified standards—was published by the SEC in 2008. Corporations and accountants dutifully began learning new standards. But implementation now rests with a fifth chairman, who isn't certain in which direction the yellow brick road should lead.

### 'Ease on Down the Road'

Responding to prior SEC encouragement, in 2002 the Financial Accounting Standards Board and International Accounting Standards Board pledged to achieve convergence of their competing standards, setting 2011 to complete convergence. When the SEC published its roadmap six years later, it reflected a multi-year plan leading to IFRS use by all U.S. issuers. It contemplated a final agency vote in 2011 on whether to use IFRS starting with fiscal years on or after December 15, 2014, with complete transition to IFRS by 2016.

A flurry of IFRS-related activity ensued, but screeched to a halt in 2009 when Mary Schapiro, the new SEC chairman, announced a deceleration of the gathering momentum for a U.S. transition to IFRS, partly due to the estimated conversion cost for each U.S. public company (about \$32 million) amid a deep recession. Schapiro expressed support for the *concept* of a unitary standard, but left open exactly how and where that would lead. In recent weeks, however, the focus on convergence has renewed interest, as the SEC issued a “Statement on Global Accounting Standards,” directing its staff to study whether:

- IFRS is sufficiently developed to serve as the world’s accounting standard;
- IFRS standard setting is sufficiently independent;
- Investor education about IFRS is adequate;
- Changed financial standards would affect existing U.S. laws and regulations;
- Conversion to IFRS requires corporate changes in existing accounting systems and corporate governance; and
- Finance and accounting professionals are sufficiently prepared for conversion to IFRS.

The SEC will still vote on IFRS in 2011 if two criteria are met: its staff study project gets done, and the FASB-IASB convergence project is completed. If the SEC approves IFRS adoption in 2011, however, U.S. public companies would not need to use IFRS before 2015, relaxing the 2008 Roadmap’s timeline. SEC staff also was asked to address over 200 Roadmap comment letters.

The SEC’s statement raises many questions, including what the SEC is trying to accomplish, and whether FASB and IASB can achieve convergence by 2011. Since the staff study’s completion is subject to control by the SEC chairman, in essence the vote can be delayed (or advanced) as the chairman sees fit.

### **Still ‘King of the Forest’**

The past few years have been an SEC nightmare. It’s been publicly castigated for various missteps—some real, many imagined. Under new leadership, the SEC is working assiduously and successfully to improve perceptions of its effectiveness and relevance in a changing environment. That said, however, anyone publicly bashed—especially a regulator—is prone to becoming even more risk-averse and sensitive to doing anything that could be criticized as being weak or ineffectual. The difficulty, of course, is that those hell-bent on criticism will often excoriate action or inaction. IFRS is a principles-based accounting system, whereas GAAP has is a prescription- or solution-based system. There are disadvantages in either approach, although I believe a principles-based approach is superior because it requires its subjects to focus on the core problem being addressed, rather than seeking helpful verbiage or using checklists.

In Washington, one way to defer decisions is “studying” issues. Studies can deflect criticism at least temporarily while efforts continue to gather data before taking a position. That possibility may not have motivated the SEC’s current approach, but convergence has been an issue for a long time. Indeed, one might assume the SEC answered questions now under study before issuing its 2008 Roadmap.

Other factors may contribute to new SEC hesitance about IFRS. A major change introduced by the Sarbanes-Oxley Act in 2002 was to make FASB’s funding independent. IASB has no similar protection from economic duress. The SEC’s Statement flagged the need for assurances regarding the governance, composition, and independence of IASB, as did the 2008 Roadmap. Punting IFRS adoption further down the road allows IASB adequate response time.

Similarly, FASB and IASB often face pressure over sensitive accounting questions, like fair-value accounting. In 2009, for example, when FASB proposed amending fair-value accounting, external pressures caused an expedited comment period and changes responding to concerns of legislators, regulators, and bankers, who blamed fair-value accounting for the financial crisis. Responsiveness by standard-setting bodies is good—within reason. If IASB sets future standards, however, it may prove less responsive to U.S. pressures than FASB, including pressures from the SEC.

The IASB governing body, the International Accounting Standards Committee Foundation (IASC), has 22 seats, six of which are U.S. seats. Having one-fourth of the IASC seats will diminish the SEC’s current primacy over GAAP with respect to IFRS, where the SEC’s voice will be one among many, and FASB will be an IASB subsidiary. Some critics worry the IASC board may become too academic and bereft of adequate investor representation. And, the recently established monitoring board, which appoints IASC members and permits country input on accounting policies, is too new to assess, even with SEC membership.

The SEC’s vigorous moves to restore its reputation as the leader in investor protection may be jeopardized by its seeming slow-down of the transition to IFRS. The United States, of course, must adopt IFRS inevitably. Most countries already have adopted IFRS. As investors and businesses continue to focus on global opportunities, IFRS is a constant factor. If investors can’t compare U.S. corporate financial statements with companies in the rest of the world, U.S. standards, not to mention U.S. companies, will slowly become irrelevant. The SEC has signaled it will move cautiously before committing to a fundamental shift in accounting principles. But, the longer it takes, the less influence the SEC likely will have over the future articulation of accounting principles.

### **Leading the Way**

To permit an SEC vote in 2011, FASB and IASB must complete their joint convergence projects. Pursuant to the so-called “Norwalk Agreement” entered in 2002, FASB and IASB pledged best efforts to make GAAP and IFRS compatible, a pledge renewed last year. Both also committed to sharing resources, coordinating future work programs, and maintaining compatibility once work is completed.

The major convergence projects address areas such as financial instruments, business combinations, consolidations, revenue recognition, derecognition, fair value, leases, and Compliance Week can be found at <http://www.complianceweek.com>. Call (888) 519-9200 for more information.

financial statement presentation. FASB and IASB also are developing a methodology for creating joint standards. Reaching their 2011 target date and clearing the path to convergence for the SEC is challenging, but not impossible.

### **We're Not in Kansas Anymore**

The road toward regulatory convergence is more difficult to navigate, with the Roadmap's timing and direction up in the air. But in the real world, issuers already have begun to consider the transition's effect on their businesses. Because IFRS is principles-based, each company will have to develop its own procedures and policies for applying these principles. Companies viewing IFRS as an abstraction, without planning for its implementation, will confront self-inflicted difficulty. To assist, here are reasons companies might embrace IFRS *now*:

1. *Globalization.* World markets are truly global and interconnected. For capital to flow across borders freely, issuers, investors, and regulators must speak the same language. Financial reports must be universally comparable.
2. *Exception to American exceptionalism.* More than 100 jurisdictions already use IFRS or its equivalent, with more on the way. Laggard U.S. companies risk losing a competitive edge. This isn't like opting out of the metric system. Failing to adopt IFRS poses dire consequences.
3. *Reality is the best policy.* IFRS uses principles rather than prescriptions (and proscriptions), and that will lead to more effective financial reporting. Prescriptive rules permit circumvention. Principles tied to economic reality discourage "creative" accounting.
4. *Ignorance is not bliss.* Worrying about how or when to switch is wasted effort. If change is inevitable, companies preparing now can identify how a transition will affect them and the resources required.
5. *Be ahead of the curve, not behind the eight ball.* Smart companies will move quickly to understand issues posed by IFRS and put systems in place in advance of deadlines. This permits kinks to be ironed out before regulators come knocking. Waiting until change is mandatory surely adds costs.
6. *Avoid becoming road kill.* SEC hesitancy may cause some to wait, freezing them like proverbial deer caught in the headlights, waiting to see if they're hit. To avoid becoming road kill, doing nothing isn't an option. During difficult and uncertain times, leadership and decisive action is critical.
7. *You must speak up to be heard.* Only companies engaged in preparing to switch will be able effectively to shape the implementation process and future regulation.
8. *Good help is hard to find.* Companies planning now, ahead of the crowd, will have better access to able outside advisers, and time to facilitate a smooth transition. At the 11th hour, good advice and assistance is harder to obtain, and more expensive.

9. *Invest in your investors.* Firms beginning early can effectively educate their investors and aptly communicate the transition's effects, generating investor confidence.
10. *Don't get lost in translation.* Self-interest is the reason companies should want to switch from GAAP to IFRS. It's good business, whatever the U.S. government does. Speaking the global language of financial reporting will provide greater access to foreign markets and capital.

At the end of the 1939 movie version of "The Wizard of Oz," the Tin Woodsman asks Dorothy what she's learned. She replies, "If I ever go looking for my heart's desire again, I won't look any further than my own back yard."

Life was simpler then. Dorothy's myopic assumption—everything she desires is found in her backyard—has occasionally characterized the SEC's regulatory approach. American geo-centrism—the assumption that U.S. regulations or standards are always best—has long given way to the recognition that other regulators also have developed effective forms of capital market regulation. In the area of accounting principles and standard setting, it's time to face that reality, and embrace IFRS.

#### ABOUT THE AUTHOR



Compliance Week columnist Harvey Pitt is a former chairman of the Securities Exchange Commission and founder of Kalorama Partners.

As the 26th chairman of the SEC, Pitt led Commission adoption of dozens of rules responding to corporate and accounting crises, created an SEC "real time enforcement" program, and responded to market disruptions from the Sept. 11 terrorist attack.

Before becoming SEC chairman, Pitt was senior corporate partner at Fried, Frank, Harris, Shriver & Jacobson, an international law firm, for nearly 25 years.

He served previously with the SEC from 1968-1978, including three years as Commission General Counsel.

In 2003, Pitt founded Kalorama Partners with former SEC Chief Accountant Robert K. Herdman.

---

#### Contact Information

Harvey Pitt can be reached via email at [hpitt@complianceweek.com](mailto:hpitt@complianceweek.com) or (202) 349-4170.

---

Compliance Week provides general information only and does not constitute legal or financial guidance or advice.