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International Issues
in Financial
Reporting

International Issues in Financial Reporting

18

LEARNING OUTCOME

After studying this chapter, students should be able to:

- ▶ discuss major differences between IFRS and US GAAP and the measures designed to contribute towards their convergence.

18.1 Introduction

This chapter covers the area of international convergence. Section 18.2 introduces the developments in this area and the progress that has been achieved, together with some background information on recent developments in international reporting.

Section 18.3 – includes a discussion of recent developments in convergence between IFRS and US GAAP, and the significant differences that remain between international and US standards.

18.2 International convergence in financial reporting

First, it is worth considering why international convergence is considered to be of such importance. Entities have many reasons for engaging in international commerce. The potential for profits can be significantly expanded by seeking new markets overseas. The cost of labour across the world varies enormously, and entities may be able to obtain a competitive advantage by manufacturing a product in a foreign country where labour is flexible and cheap. Multinational entities attempt to minimise their risks and maximise their potential markets by operating in many countries across the globe.

The increase in international trade and commerce that has taken place in recent years often requires entities to seek additional resources in the form of capital to finance their international operations. Many multinational entities are quoted on more than one national stock exchange in order to obtain capital from a broad base. Financial reports play an

important role in informing the decisions of investors and potential investors. However, financial reporting has differed widely in the past from one country to another, and it has been difficult to make valid comparisons between financial statements prepared in different countries. Major differences in national regulatory and political systems have resulted in divergent sets of accounting regulations. Taxation policy and practice have contributed, in many cases significantly, to differences in accounting practice. The advent of international financial reporting standards is having a significant influence in diminishing the importance of such differences in practice, and in contributing to improved transparency in capital markets.

18.2.1 Recent history of international standard-setting

An international accounting standards board has been in existence in 1973, but the impetus for international harmonisation has gathered pace over the last 15 or 20 years. The International Accounting Standards Committee (IASC) was formed in 1973 with the objective of promoting convergence of the accounting principles that are used by businesses and other organisations for financial reporting. The objectives originally set out by the IASC were as follows:

- to formulate and publish in the public interest accounting standards to be observed in the presentation of financial statements and to promote their worldwide acceptance and observance;
- to work generally for the improvement and harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements.

The IASC lacked the kind of formal authority that is lent by backing under a national legal system, and so its objectives were necessarily quite general in nature. Compliance with its standards could not be enforced, and so instead was 'promoted'. The objective of standardisation of accounting practice internationally would have been unrealistic at the time, and so a more general thrust towards 'harmonisation' was encouraged. More recently, the emphasis in international accounting has changed from the promotion of 'harmonisation' towards 'convergence'. Harmonisation is a process or set of processes by which differences in financial reporting between countries can be reduced. Harmonisation does not aim for complete uniformity in practice, but rather at the minimisation of differences over time. Convergence, on the other hand, implies a much closer drawing together of accounting practices in different jurisdictions.

The work of the IASC was given significant additional relevance during the 1990s because of the international securities regulator, IOSCO (the International Organization of Securities Commissions). IOSCO was formed in 1983 as a representative body of securities regulators and stock exchanges. Its own legitimacy was assured when the most influential body of all, the USA's Securities and Exchange Commission (SEC), joined it in 1986/7. IOSCO became instrumental in augmenting the authority of international standards when, in 1995, it agreed to adopt a 'core' set of thirty international accounting standards as binding upon its members in respect of cross-border listings, provided that the standards reached a certain quality threshold. The IASC was required to have the 'core' standards in place by the end of 1998, a deadline which it only just succeeded in achieving. In May 2000, IOSCO concluded its deliberations by endorsing the 30 'core' standards.

The work done by the IASC towards the 'core' standards project tended to emphasise its own limitations as an underfunded and somewhat unwieldy organisation. Reform was initiated during the 1990s and came to fruition as a new organisational structure was put in

place between 1999 and 2001. The International Accounting Standards Board (IASB) has, since 2001, assiduously followed its demanding program of work, under the chairmanship of Sir David Tweedie. The IASB's objectives are:

- (a) to develop, in the public interest, a single set of high-quality, understandable and enforceable global accounting standards that require high-quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions;
- (b) to promote the use and rigorous application of those standards;
- (c) to bring about convergence of national accounting standards and international financial reporting standards to high-quality solutions.

18.2.2 The IASB's progress towards its objectives

There have been major developments in international accounting in recent years, most of which have tended to endorse the authority and scope of the international standards project. (The fact that CIMA examines financial reporting issues only in terms of IFRS exemplifies the point.) Many countries have already adopted IFRS either partially or fully. A very important endorsement of the international standards was made when the European Union decided to require listed entities throughout Europe to prepare consolidated financial statements in accordance with IFRSs by 2005.

There seems little doubt that IFRS are well on the way towards global acceptance. This is not to say that the process has been trouble-free. For example, the European Union requires an endorsement process for the acceptance of international standards. Whilst most of the international standards have been endorsed without significant problems (by the endorsing body, EFRAG), IAS 39 *Financial Instruments: Recognition and Measurement* proved to be an area of significant controversy, and it was not adopted in full in the first instance. Also, there is still a very large amount of work to be done to achieve convergence, and the process is unlikely to be substantially complete for many years yet.

Also, adoption of IFRS by many countries is incomplete. In Europe, for example, IFRSs are mandatory only for the consolidated financial statements of listed companies, and are optional for unlisted companies. National accounting standards regimes remain in many countries. While the national standard setters of some countries, such as the UK, are producing new standards that bring national practice into convergence with IFRS, this is not universally the case. Even where national and international practices are similar, important differences may remain. A further potential problem remains in respect of the extent of compliance with IFRS. Having no compliance mechanism of its own, the international standard setter relies upon national regulatory mechanisms to ensure enforcement of the standards. This may not be a uniformly successful process. Also, subtle differences in adoption and application may persist, even in financial statements that appear to be fully comparable with each other. An article by Professor Parker is included in the readings at the end of the chapter, exploring some of the problems of convergence.

18.3 Convergence between IFRSs and US GAAP

18.3.1 US GAAP – background

The SEC plays an important role in the accounting regulatory framework in the USA. It is an independent government agency, with a full-time staff of over 2,500, whose responsibility it is to oversee the activities of entities listed on Stock Exchanges in the US – some 12,000 entities. The SEC is authorised to issue accounting standards, but in practice it has always ceded this responsibility to private-sector accounting standard setters. Since 1973 the US standard setter has been the Financial Accounting Standards Board (FASB); during its lifetime it has issued many standards. US standards tend to be very detailed and to follow a ‘rule-book’ approach.

Although the SEC does not issue standards, it has a host of stringent disclosure requirements. Taken together the SEC requirements and the financial accounting standards issued by FASB contribute to the most tightly regulated and controlled capital market in the world. It was never likely that the US would simply adopt international accounting standards, and, indeed, in the 1990s the possibility of significant convergence between the two seemed fairly remote. However, in the early years of this century several factors combined to make convergence between the two both desirable and possible. The authority of the international standard setter was greatly increased by the IOSCO endorsement, the adoption by the EU and by its new constitution. In the US the stock market bubble came to an abrupt end, and the confidence of market participants was severely shaken by a series of major accounting scandals. The most significant of these in terms of economic significance was probably WorldCom, but it was Enron that really undermined confidence in the US regulatory system. Suddenly, it seemed distinctly possible that the rule-book approach to accounting regulation might not be the most effective.

In September 2002, IASB and FASB agreed to undertake a convergence project with the objective of reducing differences between IFRS and US GAAP. The full text of the so-called ‘Norwalk agreement’ between the two bodies is given below:

At their joint meeting in Norwalk, Connecticut, USA on September 18, 2002, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) each acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. At that meeting, both the FASB and IASB pledged to use their best efforts to (a) make their existing financial reporting standards fully compatible as soon as is practicable and (b) to coordinate their future work programs to ensure that once achieved, compatibility is maintained.

To achieve compatibility, the FASB and IASB (together, the ‘Boards’) agree, as a matter of high priority, to:

- (a) *undertake a short-term project aimed at removing a variety of individual differences between US GAAP and International Financial Reporting Standards (IFRSs, which include International Accounting Standards, IASs);*

- (b) *remove other differences between IFRSs and US GAAP that will remain at January 1, 2005, through coordination of their future work programs; that is, through the mutual undertaking of discrete, substantial projects which both boards would address concurrently;*
- (c) *continue progress on the joint projects that they are currently undertaking;*
- (d) *encourage their respective interpretative bodies to coordinate their activities.*

The Boards agree to commit the necessary resources to complete such a major undertaking.

The Boards agree to quickly commence deliberating differences identified for resolution in the short-term project with the objective of achieving compatibility by identifying common, high-quality solutions. Both Boards also agree to use their best efforts to issue an exposure draft of proposed changes to US GAAP or IFRSs that reflect common solutions to some, and perhaps all, of the differences identified for inclusion in the short-term project during 2003.

As part of the process, the IASB will actively consult with and seek the support of other national standard setters and will present proposals to standard setters with an official liaison relationship with the IASB, as soon as is practical.

The Boards note that the intended implementation of IASB's IFRSs in several jurisdictions on or before January 1, 2005 require that attention be paid to the timing of the effective dates of new or amended reporting requirements. The Board's proposed strategies will be implemented with that timing in mind.

18.3.2 Progress towards convergence

The IASB and FASB have lost no time in pursuing their convergence programme. The fruits of it to date include the following:

- An extensively revised version of IFRS 3 *Business Combinations* issued in January 2008.
- The standard on segment reporting (IFRS 8 *Operating segments*) issued in November 2006 (see Chapter 17 of this *Learning System*).
- IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.
- An extensively revised version of IAS 1 *Presentation of Financial Statements*, issued in September 2007.

As well as the projects currently under way which have reached the exposure draft stage (business combinations, non-financial liabilities and segment reporting), there are several other active projects:

Short-term convergence projects

- IAS 12 income taxes
- impairment.

Long-term projects

- revenue recognition
- the conceptual framework
- post-retirement benefits.

The biggest step so far was taken by SEC in December 2007 when it removed the need for companies listing in the US and preparing their financial statements in accordance with IFRS, to prepare a reconciliation to US GAAP. The removal of this requirement was seen as the most significant step towards full convergence.

Despite all this activity, many significant differences remain between IFRS and US GAAP. These are the subject of the following section.

18.3.3 Remaining differences between US GAAP and IFRS

The set of differences between the two sets of regulations changes frequently with the issue of new standards. Significant recent changes have included the issue of IFRS 8 *Operating Segments*, and the updated versions of IFRS 3, IAS 27 and IAS 1. All of these have significantly reduced differences between US GAAP and IFRS.

This means that any list of differences is soon out of date, and all such lists should be treated with caution. Nevertheless, the list provided by, for example, the accounting firm PricewaterhouseCoopers is helpful. It was last updated (at the time of the update of this Learning System) in August 2007, and is available at www.pwc.com.

The table below summarises some of the significant remaining differences:

Issue	IFRS	US GAAP
General approach	Broadly, principles-based	Broadly, rule-based
Comparative information	One year of comparative information is required	No specific requirement, but SEC rules required 3 years of comparative information (2 years for the statement of financial position)
Extraordinary items	Prohibited	Defined as being both infrequent and unusual, and are rare
Jointly controlled entities	Both proportionate consolidation and equity method are permitted	Equity method is required except in certain circumstances
Revenue recognition	IAS 18 contains general principles only	While principles are similar to IFRS, there is extensive industry-specific guidance
Development costs	Are capitalised and amortised when specific criteria are met	Development costs are expensed as incurred
Property, plant and equipment	Either cost or revaluation bases are permitted	Historical cost is used; revaluation is not permitted
Inventories	Use of LIFO is not permitted	Use of LIFO is permitted
Investment property	Measured at fair value or depreciated cost	Depreciated historical cost is the only permitted measurement

Detailed knowledge of the differences is not required for F2 *Financial Management*. However, it is expected that candidates will be able to identify some of the principal differences that still exist between IFRS and US GAAP. Questions are quite frequently set in this area, and are often badly handled by candidates.

18.4 Summary

This chapter has examined a range of issues relating to international financial reporting. Section 18.2 examined the important issue of international convergence in financial reporting. Three relevant readings are appended at the end of this chapter which will help to consolidate knowledge of this important topic. Section 21.3 examined the special case of convergence between IFRS and US GAAP, providing a list of some of the important differences that remaining, as well as a discussion of the substantial progress towards convergence that has been made in a short period of time.

Students should note that the position changes rapidly. They can keep up to date by referring to the IASB website (at www.iasb.org). FASB's website is excellent and comprehensive (www.fasb.org).

Examination questions can be expected relating to the areas covered in this chapter. One possibility is to present a financial statement (or statements) prepared under international standards and to require comment on/calculation of the differences if the statement were presented under US GAAP (or vice-versa). Questions requiring discussion of the issues are also likely to occur from time to time. Students who prove themselves to be knowledgeable about current/recent developments are likely to be at a distinct advantage.

Have IFRSs conquered the world?

Bob Parker, *Accountancy*, November 2005.

It's far from a foregone conclusion, argues Bob Parker

'Learning International Financial Reporting Standards (IFRSs) is a chore for us accountants in the UK but once we have mastered them, then not only do we know the rules of British accounting we also know the rules throughout the world.' How true is this? Have IFRSs really conquered the world?

Certainly they seem at first sight to have conquered the two parts of the world to which the UK has the greatest political attachment: the EU and the Commonwealth. From 1 January 2005 (or at the latest from 1 January 2007), the consolidated financial statements of listed companies within all 25 members of the EU are required to comply with all International Accounting Standards and IFRSs approved by the European Commission (EC). Leading members of the Commonwealth such as Australia, South Africa, New Zealand and Singapore all claim to have adopted international standards. Canada has pledged convergence by 2011.

Not the only game in town

But there is the great exception: the US is not giving up US GAAP. IFRSs are not the only game in town. The US Financial Accounting Standards Board is the best-funded in the world, and the Securities and Exchange Commission (SEC) the strictest enforcer of accounting standards. Nevertheless, strenuous efforts are being made to bring IFRS and US GAAP closer together. There has been a 'race to the top' as international and US standard-setters have competed to produce standards acceptable to stock exchanges and government regulatory bodies. International standards have appealed to the EC not only because they are not US GAAP but also because they are not all that different from US GAAP.

However, within the EU, harmonisation is not as great as it might appear to be. The UK is exceptional in its strong support of the concept of international standards. This should not surprise us. British accountants were active in the formation and development of the International Accounting Standards Committee from 1973 onwards. International standards have been much more influenced by UK accounting rules and practices than by continental European ones and thus the adjustment we have to make is much less.

Since IFRSs are mandatory within the EU only for the consolidated statements of listed companies, the great majority of German and French companies will not be applying international standards. In particular, the subsidiaries of German and French parent companies

will be using local GAAP. Adjustments will of course be made during the consolidation process, but many local features (for example, the way depreciation is calculated) are likely to remain.

Casting doubts

One may also be permitted to have doubts about the extent to which IFRSs will be complied with in practice. For several years now several large companies in Germany and France have purported to be applying International Accounting Standards or US GAAP in their consolidated statements, but research has shown less than complete compliance and a tendency to pick and choose. The monitoring and enforcement of accounting standards is strongest in the US and the UK but noticeably weak in Germany. Germany has recently set up institutions based on both the US SEC and the UK Financial Reporting Review Panel. It remains to be seen how successful they will be.

Finally, there has been an understandable reluctance for national standard-setters and government authorities to accept international standards which they see as against their own interests, especially if major companies lobby against them. Commonwealth countries other than the UK are converging with international standards rather than adopting them. Close scrutiny of what is happening in Australia, for example, suggests convergence rather than adoption, with portions of standards omitted or amended.

So, have IFRSs conquered the world? Not quite, but the achievements of the IASC/B are surely greater than its founders in 1973 dared to hope.

Financial Analysis

The Examiner, Financial Management, December/January 2007/2008

The content of the following article is relevant to the F2 exam as the related learning outcome is the same for F2 as it was for P8.

Candidates have tended to struggle with questions on US GAAP versus IFRS. **The examiner for paper P8** offers her guidance on the topic.

The P8 learning outcome ‘identify major differences between IFRS and US GAAP’ has been tested twice so far. The November 2005 paper asked candidates to cite examples of the two systems’ differences and similarities, while a question in May 2007 asked for a brief paper describing the progress of the convergence project. These questions were answered badly in most cases – many candidates didn’t even attempt an answer.

The biggest weakness was a sheer lack of knowledge. Some candidates were unaware that convergence was occurring at all. In May 2007 they were asked to describe how it was progressing, giving examples. Many did the opposite by listing the continuing differences between IFRS and US GAAP. Others repeated the few relevant points that they did know in different guises – also a waste of valuable exam time.

The use of the verb ‘identify’ in the learning outcome means that the outcome is pitched at the level of ‘comprehension’ in CIMA’s hierarchy of learning objectives. This is a relatively low level, which means that advanced analytic and evaluative skills are not required to tackle questions in this area. So, although the differences between the sets of regulations are often extremely complex, for the purposes of P8 it’s necessary only to know the key issues.

At a meeting in Norwalk, Connecticut, in 2002 the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) agreed to start the convergence project. The Norwalk agreement set out their plan to reduce the differences

between IFRS and US GAAP. Today, a list of standards, exposure drafts and discussion papers bears witness to their progress. Some May 2007 P8 candidates could name a few of their joint projects, but many could not.

Despite all this work, there are still many differences that are likely to last. The one that everyone seems to know is that the use of LIFO as an inventory valuation method is permitted under US GAAP but not under IFRS. Some others were described in a Study notes article in the June 2007 issue of *FM*.*

Currently, foreign issuers listed on the US markets must submit a reconciliation of their financial statements with US GAAP to the US Securities and Exchange Commission (SEC). But the SEC recently proposed dropping this rule, so it's likely that filing a reconciliation will no longer be required by 2009. Even more striking is an SEC proposal, now out for comment in the form of a 'concept release', to allow US companies to file statements using IFRS rather than US GAAP. It's unlikely that many of them would take advantage of this change, but the fact that it's being discussed at all indicates how much more acceptable IFRS has become in the US.

Chapter 18.3 of the *Financial Analysis CIMA Learning System (now Chapter 18.3 of the F2 CIMA learning system)* covers the background to convergence, the Norwalk agreement, current developments and the key remaining differences. For the 2008 exams, any changes made up to and including December 1, 2007 are examinable. So, as long as you use the latest edition of the learning system, you shouldn't have a problem. For those students who wish to impress the examiner with the depth of their knowledge – and the examiner will be impressed – several other information sources can be consulted.

The following web sites are useful:

- The International Accounting Standards Board: www.iasb.org.
- The Financial Accounting Standards Board: www.fasb.org.
- The US Securities and Exchange Commission: www.sec.gov.
- Deloitte, which produces comprehensive updates: www.iasplus.com.
- PricewaterhouseCoopers, which has published a booklet entitled 'Similarities and differences – a comparison of IFRS and US GAAP': <http://snipurl.com/1t01q>.

Once they have gained an outline knowledge of the key issues, candidates should aim to improve this by keeping their eyes open for news of developments and consulting some of the above sources.

The May 2007 post-exam guide included the following observation: 'Candidates should be aware (but, on the evidence of this paper, are mostly not aware) that this is not a trivial or marginal topic. On the contrary, it could be argued that the issue of US GAAP/IFRS convergence is the most important contemporary issue in financial reporting.'

The question of whether or not the learning outcome is likely to be examined again in the foreseeable future should, therefore, be relatively easy to answer.

* One of the differences identified in that article is no longer valid: changes in accounting policy under US Gaap are now handled in the same way as they are under IAS8 – that is, there is a requirement to make a full prior period restatement. (Thanks to Malcolm Greenbaum of BPP Professional Education for highlighting this development.)

Revision Questions

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? Question 1

You are the management accountant of X, an entity with a number of subsidiaries located in Europe and the United States of America (USA). One of these subsidiaries is US Inc., a entity incorporated in the USA. You are looking at the differences between the accounting treatment used in the accounts of US Inc. and X, which prepares financial statements in accordance with IAS.

The financial statements of US Inc. (drawn up in US dollars) are prepared in accordance with generally accepted accounting practice (GAAP) prevailing in the USA. The draft financial statements of US Inc. for the year to 31 December 20X5 showed a profit before taxation of \$25 million. You are given the following information regarding US Inc.:

- (i) During 20X4, US Inc. completed a development project, incurring costs of \$20 million. US Inc. has no other development projects. The project was expected to generate cost savings of at least \$5 million per annum for 5 years from the end of 20X4. All necessary market testing was carried out in 20X4 and the anticipated savings did in fact materialise in 20X5 and are expected to continue through until the end of 20X9. The costs of \$20 million were written off in the income statement of US Inc. in 20X4 in accordance with GAAP in the USA. In the consolidated financial statements, X capitalises development expenditure whenever required by IAS 38.
- (ii) The financial statements of US Inc. carry stocks at cost determined according to the last in, first out (LIFO) basis of valuation. However, stock values are also computed and reported to X using the first in, first out (FIFO) basis of valuation. X uses the FIFO method of stock valuation in its own (and in its consolidated) accounts. Relevant figures for US Inc. for 20X5 are given below:

<i>Date</i>	<i>Valuation of stocks of US Inc. under:</i>	
	<i>LIFO</i>	<i>FIFO</i>
	\$m	\$m
1 January 20X5	41	44
31 December 20X5	55	65

Requirement

Prepare a schedule in US dollars, which reconciles the profit before taxation of US Inc. as computed for its own draft financial statements with the profit before taxation which will be used for incorporation into the consolidated financial statements of X. Explain clearly the reasons for the adjustments. **(10 marks)**



Question 2

At a recent staff seminar on accounting standards, a senior member of your firm's accounting staff made the following observation:

'International standards have now been adopted in many countries across the world. Unfortunately, though, they can never be truly international because US GAAP will continue to dominate accounting in the USA and therefore in many multinational businesses.'

Requirement

Explain the rationale for this observation, illustrating your explanation with examples of significant differences and similarities between US GAAP and international accounting standards. **(10 marks)**

Solutions to Revision Questions

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Solution 1

Reconciliation of US to IAS

	\$m
Profit of US Inc computed according to American GAAP	25
1. Development costs – share charged against profit	(4)
2. Stock valuation – reduction in cost of sales under FIFO	<u>7</u>
Profit of US Inc to be incorporated into X group accounts	<u>28</u>

- IAS 38 requires development costs to be capitalised and spread over the life of the development, whereas in the US a more conservative rule prevails and such costs are written off against profits when they are incurred. The project is expected to last 5 years and therefore the profits would be reduced by $(\$20 \text{ m}/5 \text{ years}) = \4 m amortisation of development costs.
- Group policy is to value stock using FIFO.

Solution 2

IFRS have, indeed, been adopted in many countries across the world: for example, compliance with them is compulsory in companies listed on a Stock Exchange within the European Union, and their adoption in Australia and New Zealand is well underway.

Nevertheless, it is certainly the case that accounting in accordance with international standards continues to differ from US GAAP in many respects. To this extent, the observation by the senior staff member has some validity. An example of an important difference is: *Valuation*. International accounting practice allows the option to value property, plant and equipment at either depreciated cost or fair value. US GAAP is more restrictive in this respect and reporting at depreciated cost is much more prevalent.

On the other hand, convergence between US and international practice is becoming increasingly common. For example, a significant area of difference in the past has been that of business combinations: it was common in the US until recently to account for many business combinations as pooling of interests. While international practice did not outlaw pooling of interests, its use was far less common. However, developments in US and international standards have now resulted in a position where pooling of interests accounting is no longer available.

The senior staff member does not mention the 'Norwalk agreement', which established a formal convergence project between the IASB and its US counterpart, the Financial Accounting Standards Board (FASB). Under the terms of this agreement, the IASB and FASB agreed to work together to remove differences between their respective sets of standards, and to co-ordinate their future programmes of work. The agreement has already resulted in a narrowing of differences: for example, IFRS 5 *Disposal of Non-Current Assets and Presentation of Discontinued Operations* brings international practice into line with US GAAP. Major recent developments include the issue of the IAS 1 (revised) *Presentation of Financial Statements* which brings international and US practice much more closely into line with each other.

There is a great deal of work to be done before US GAAP and international practice can be described as 'convergent'. However, much has already been achieved in a short time. The view expressed by the senior staff member would have been widely regarded as valid until very recently, but it has been overtaken by events. The convergence project has undoubtedly been given additional impetus by the recent, spectacular, corporate and accounting failures in the US. These have resulted in a period of introspection and self-criticism amongst US regulators and in a push towards significant improvement in financial reporting. Traditionally, the US approach to accounting regulation has been 'rules-based'; this has resulted in the production of very lengthy, detailed accounting standards. By contrast, international accounting standards have tended to be 'principles-based'. For example, instead of having a very detailed international standard addressing substance over form, international accounting practice relies much more upon promulgation and acceptance of the general principle of substance over form. The recent US accounting scandals have led to a great deal of criticism of the 'rules-based' approach and greater acceptance of the value of the 'principles-based' approach. On the other hand, international regulation appears to be moving to some extent in the opposite direction, as international standards become lengthier and more prescriptive (e.g.: IAS 39 *Financial Instruments: Recognition and Measurement*). Therefore, it seems likely that US and international regulators will find it easier to occupy common ground in their approach to standard setting.



Solution 3

The convergence project: progress to date

Traditionally, the US has adopted a 'rule-book' approach to financial reporting standard setting, whereas the approach taken by the IASB, and its predecessor body, has been to encourage adherence to principles. This fundamental difference in approach made it appear, for a long time, as though the US would never accept international standards. However, the rule-book approach was found wanting in a series of financial scandals in the US in the late 1990s and early years of the 21st century. The climate was therefore amenable to a change in approach which would make convergence possible between US and international financial reporting standards.

In September 2002 the US standard setter (Financial Accounting Standards Board – FASB) and the IASB agreed to undertake a project which would have the objective of converging their accounting practices, reducing the number of differences between US GAAP and IFRS. This agreement (the 'Norwalk agreement') committed the parties to making their existing standards fully compatible as soon as practicable, and to co-ordinating their future work programmes. In order to address the first commitment, a short-term project

was undertaken to remove some of the differences between existing standards. The second commitment was to be met by collaborating on the development of standards.

A memorandum of understanding between FASB and the IASB sets out a 'Roadmap of Convergence between IFRS and US GAAP 2006-8'. This is aimed at removing the need for a reconciliation to US GAAP requirement for those companies that use IFRS and are registered in the USA.

Progress to date has been impressive. Projects undertaken jointly between FASB and IASB have produced the following:

- IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*
- IFRS 3 *Business combinations*
- IFRS 8 *Operating Segments*
- IAS 1 *Presentation of Financial Statements: a revised presentation*

There are several on-going projects that will run into the longer-term. For example, the amendment to IAS 1 noted above represents just a first phase in a larger project on financial statement presentation. Subsequent phases will address fundamental issues in presenting information and the issue of interim reporting.

Other longer-term projects include convergence of the conceptual frameworks and revenue recognition.

Finally, despite the high level of activity on convergence, it should be noted that many significant differences remain between US GAAP and IFRS.