PART I

Phenomenon of Convergence

In order to provide a solid foundation for the remainder of this book, Part One describes and explains the phenomenon of Convergence. This part consists of three chapters:

- Chapter 1 will introduce you to the phenomenon of Convergence.
- Chapter 2 will summarize how Convergence will impact U.S. companies and their financial managers.
- Chapter 3 will explain why you must prepare for Convergence now.

To get the maximum benefit from this book, be sure to read the preface, then read this part thoroughly. Your investment in understanding the origin, nature, and scope of Convergence, along with other fundamental concepts covered in this part, will be well rewarded as you continue through the rest of the book.

CHAPTER 1

Introduction to the Convergence of Financial Reporting Standards

This chapter provides an in-depth introduction to the phenomenon of Convergence. In this chapter, you will learn exactly what Convergence is—*and isn't*. You will also learn *why* Convergence is happening.

Financial Reporting Supply Chain

To understand the phenomenon of Convergence, it is helpful to begin by looking at the *financial reporting supply chain*, which refers to "the people and processes involved in the preparation, approval, audit, analysis and use of financial reports."[1] Just as the supply chain for tangible products is the network of parties that manufacture, inspect, distribute, and use the products, the financial reporting supply chain is the network of parties that prepare, audit, distribute, and use financial reports.

In the financial reporting supply chain, financial information flows through various stages. The flow of information starts with raw data about the financial effects of transactions and events on an enterprise. That raw data is processed progressively until it is eventually presented to end users in a highly filtered, summarized, and structured fashion.

As financial information flows from one stage to the next in the financial reporting supply chain, the various supply chain participants (preparers, auditors, etc.) add value to the information. This is analogous to the way in which manufacturers of tangible products add value to raw materials by transforming raw materials into finished goods, or the way in which distributors add value to finished goods by transporting specific goods to specific locations at specific times in order to meet the demand of end users.

While it is universally agreed that the financial reporting supply chain starts with the enterprises that prepare financial reports for use by parties outside of those enterprises, there is less agreement on who the primary end users of the financial reporting supply chain are. However, in the United States and increasingly throughout the world, the primary end users in the financial reporting supply chain are assumed to be investors and creditors, that is, individuals and institutions who seek to profit from allowing enterprises to use their financial capital.

In the United States, for example, the primary objective of external financial reporting is considered to be providing "information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions."[2] Of course, there are other users of financial reports, such as government agencies and academic researchers, who may use financial reports for different purposes. But meeting the information needs of such users is of secondary importance to meeting the information needs of investors and creditors.

Thus, the financial reporting supply chain exists in the United States and elsewhere in the world primarily to provide investors and creditors with information that is useful in making economic decisions about the allocation of capital to the enterprises that operate within our economy. Investors and creditors obviously benefit directly from the financial reporting supply chain, but it should be noted that a well-functioning financial reporting supply chain also serves the public interest. By helping investors and creditors to make sound capital allocation decisions, the financial reporting supply chain makes our economy more efficient at satisfying people's needs and wants with our scarce resources. This is true on a both a national and global scale.

Even though financial reports are only one source of information that investors and creditors use in making economic decisions, they are a very important source of information for the economic decisions that investors and creditors make. Many of the economic decisions made by investors and creditors result in transactions or events that are accounted for and reported by the enterprises in the financial reporting supply chain that prepare financial reports. But other economic decisions affect how the financial reporting supply chain itself works, that is, the ways in which supply chain participants add value to raw data about the transactions and events that enterprises account for and report.

One of the most pervasive ways in which economic decisions affect the working of the financial reporting supply chain is through the imposition of *standards* on the supply chain's participants (i.e., preparers, auditors, and distributors of financial reports), processes (i.e., preparing, auditing, and distributing financial reports), and products (i.e., information having specific content and format that is passed from one participant in the supply chain to the next). Today, the economic decisions that individuals and institutions are making with regard to financial reporting supply chain standards are causing those standards to change in the United States and throughout the world

P1: OTA/XYZ P2: ABC
c01 JWBT050-Pounder December 6, 2008 13:4 Printer Name: Yet to Come

in profound ways. Because those economic decisions and the resulting changes in standards are the very essence of the process of Convergence, the next section of this chapter will further explore the role of standards in the financial reporting supply chain as well as the economic decisions that individuals and institutions make with regard to such standards.

Role of Standards in the Financial Reporting Supply Chain

Both users of financial reports and institutions that exist to serve the public interest have strong economic incentives to impose standards on the various participants, processes, and products of the financial reporting supply chain. For example:

- The existence and enforcement of high-quality financial reporting supply chain standards improves the usefulness of financial reports, and therefore helps investors and creditors make better economic decisions regarding the allocation of their capital. This in turn improves investors' and creditors' returns and makes our economy as a whole more efficient at satisfying people's needs and wants.
- The existence and enforcement of high-quality financial reporting supply chain standards lowers the risk that investors and creditors perceive to be associated with making capital allocation decisions, which provides investors and creditors with a greater number of less risky opportunities to deploy their capital profitably and which ultimately produces broad benefits to society from economic growth.

Thus, standards that pertain to the financial reporting supply chain have the potential to deliver significant economic benefits to both users of financial reports and society in general. But the economic benefits of standards do not come automatically. This is because standards do not occur naturally—they must be created and updated. Also, participants in the financial reporting supply chain cannot be relied on to comply automatically with pertinent standards—enforcement is needed. Without effective compliance enforcement, standards themselves have little value.

Because the activities of creating, updating, and enforcing standards require economic resources, those activities will not happen unless someone chooses to sacrifice economic resources in order to make them happen. Specifically, people who expect to benefit from the existence and enforcement of financial reporting supply chain standards must make economic decisions regarding how much of their scarce economic resources they are willing to sacrifice in order to obtain the benefits.

P1: OTA/XYZ P2: ABC
c01 JWBT050-Pounder December 6, 2008 13:4 Printer Name: Yet to Come

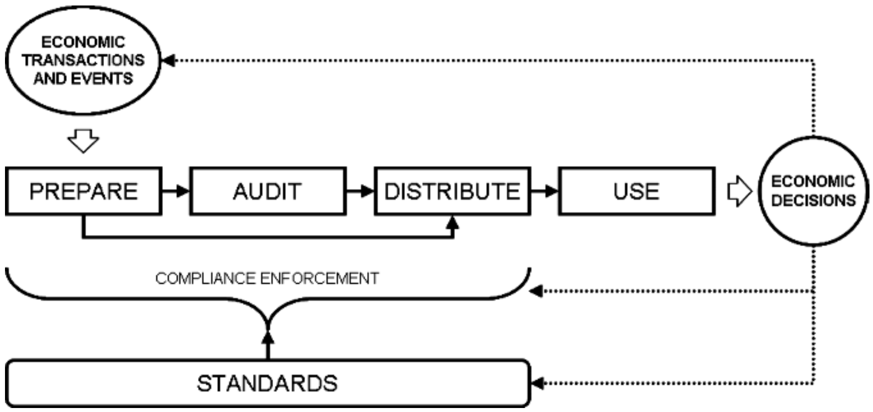

EXHIBIT 1.1 Financial Reporting Supply Chain

At this point, you may wish to review Exhibit 1.1 for a graphical summary of the financial reporting supply chain and the ways in which economic decision making by financial report users influences the supply chain through the existence and enforcement of standards.

Investors, creditors, and governmental bodies generally recognize that it is in their economic interest to sacrifice economic resources to some degree in order to develop, maintain, and enforce standards that apply to the financial reporting supply chain. In developed economies, standard-setting and standard-enforcing activities are typically carried out on behalf of investors, creditors, and the general public by formally organized bodies. Various funding mechanisms are employed to transfer economic resources from the beneficiaries of standards to standard-setting and standard-enforcing bodies.

In the United States, for example, the Financial Accounting Standards Board (FASB) is the recognized financial reporting standard setter for private-sector entities. Also, the U.S. Securities and Exchange Commission (SEC) enforces compliance with financial reporting standards by the entities that are under its jurisdiction (typically, those whose securities are issued to or exchanged among members of the general public).

Due to the existence of intermediaries such as the FASB and the SEC, most end users in the financial reporting supply chain do not participate directly in standard-setting and standard-enforcing activities. However, they generally have opportunities to participate indirectly through a "due process" that many intermediaries follow. Even though most end users in the financial reporting supply chain are not directly involved in the setting and enforcing of standards for the supply chain, it is important to recognize that standards are still set and enforced primarily to serve the information needs of those end users.

Of the many standards that pertain to the financial reporting supply chain, *financial reporting standards* are the most fundamental in terms of ensuring that the information needs of investors and creditors are met. Because financial reporting standards are at the center of the phenomenon of Convergence, the next section of this chapter will provide a working definition of the term *financial reporting standards* as that term will be used throughout the rest of the book.

Financial Reporting Standards

Financial reporting standards pertain specifically to *preparers* of financial reports, the *process of preparing* financial reports, and the *products of the preparation process* (e.g., traditional financial statements such as the balance sheet). Financial reporting standards are distinct from other standards such as auditing and distribution standards that pertain to participants, processes, and products downstream from the preparation stage in the financial reporting supply chain.

In common usage, the terms *financial accounting standards* and *financial reporting standards* are sometimes used interchangeably with each other and are sometimes used in contrast with each other. When used interchangeably with each other, both terms refer broadly to standards that pertain to any aspect of preparing financial reports. When used in contrast with each other, the term *financial accounting standards* refers specifically to standards for the recognition and measurement of items of economic significance, whereas the term *financial reporting standards* refers specifically to standards for the presentation and disclosure of recognized and measured items in financial reports.

Because there is little need to distinguish between "accounting" and "reporting" standards in this book, the term *financial reporting standards* as used throughout the book refers broadly to any prescriptive guidance that pertains to:

- Preparers of financial reports
- The process of accounting for items of financial significance
- The process of preparing financial reports
- The content of prepared financial reports
- The format of prepared financial reports

Understanding that financial reporting standards can and do differ throughout the world is essential to understanding the phenomenon of Convergence, and so the next section of this chapter will examine how financial reporting standards differ among countries.

How Financial Reporting Standards Differ among Countries

There are several dimensions on which financial reporting differs among countries. Naturally, the language (e.g., English, Spanish) and currency units (e.g., dollars, euros) used in financial reports vary from country to country. Standards that pertain to the financial reporting supply chain also differ among countries, as does the enforcement of compliance with those standards.

In particular, companies in different countries have traditionally used different country-specific sets of financial reporting standards in preparing financial reports. In some countries, companies are legally required to use a country-specific set of financial reporting standards. In other countries, companies have more freedom to choose the financial reporting standards that they use, but as a practical matter, companies within a country typically gravitate toward using the same set of standards—standards that often differ from the standards used in other countries.

Different sets of financial reporting standards often go by different names around the world. In the United States, financial reporting standards are collectively known as *generally accepted accounting principles* (GAAP). While many observers disagree with the characterization of U.S. standards as "principles," that is what our standards have traditionally been called.

Other countries, such as Canada, have also traditionally referred to their standards as *GAAP*. But, over time, many standard setters throughout the world have moved from referring to their standards as *GAAP* or *accounting principles* or even *accounting standards* in favor of the term *financial reporting standards*, which reflects the evolving sense that "accounting" and "reporting" standards are largely inseparable from each other in practice and that both kinds of standards exist to support sound, informative financial reporting as an end goal. As explained earlier, this book uses the term *financial reporting standards* in the same broadly inclusive way that the world's standard setters are increasingly using the term.

In addition to nominal differences in what financial reporting standards are called, there are many substantive ways in which financial reporting standards differ throughout the world:

- The expressed objectives of financial reporting (e.g., assumptions about end users and their information needs)
- The overall content of financial reports (e.g., which kinds of financial statements are required)
- Individual accounting and reporting provisions (e.g., recognition, measurement, presentation, disclosure)
- Influences on the standard-setting process (e.g., economic, cultural, governmental, business practices)

P1: OTA/XYZ P2: ABC
c01 JWBT050-Pounder December 6, 2008 13:4 Printer Name: Yet to Come

At this point in time, there are easily dozens of different sets of financial reporting standards in use throughout the world. However, two particular sets of standards have come to dominate the world's financial reporting landscape. The first is U.S. GAAP, a country-specific set of standards that is developed and maintained for U.S. private-sector reporting entities by the FASB. The other set is called *International Financial Reporting Standards*, officially abbreviated as *IFRSs*, although in the United States the name is almost always abbreviated as *IFRS*. Because this book is written primarily for a U.S. audience, the more common abbreviation *IFRS* is used in this book.

IFRS are developed and maintained by the International Accounting Standards Board (IASB). The IASB is the standard-setting arm of the International Accounting Standards Committee Foundation (*IASC Foundation* or *IASCF*), a not-for-profit entity incorporated in the United States. What makes IFRS unique is that unlike the many sets of country-specific financial reporting standards used throughout the world, IFRS are *country neutral*. In other words, IFRS are designed to be used by enterprises regardless of which country or countries the enterprises operate in. The fact that most of the world's countries use or have committed to use IFRS in the near future is an important aspect of the phenomenon of Convergence. But the growing use of IFRS throughout the world is not all there is to Convergence. In particular, Convergence in the United States is a much more complex phenomenon. So at this point, we turn to examine the phenomenon of Convergence from a U.S. perspective. Along the way, we will debunk several prevalent myths about Convergence, so be prepared to unlearn some things that you may think you know about Convergence.

What Convergence Is—and Is Not

With regard to financial reporting standards, the word *Convergence* has two related meanings. First, Convergence refers to the ongoing efforts of financial reporting standard setters in the United States and around the world to eliminate differences in financial reporting standards among countries. Second, Convergence refers to the absence of differences in financial reporting standards among countries. Thus, as reflected in those two meanings, Convergence is both a *process* and a *goal*.

The *process* of Convergence can and does occur in different ways, often simultaneously. *Set-level Convergence* occurs when companies in a country adopt an entire existing set of country-neutral standards that has been (or will be) adopted by companies in other countries. In contrast, *standard-level Convergence* occurs when standard setters change individual standards within each of their respective sets of standards in order to make the individual standards the same as each other.

P1: OTA/XYZ P2: ABC
c01 JWBT050-Pounder December 6, 2008 13:4 Printer Name: Yet to Come

There are two variants of standard-level Convergence. In the *unilateral* variant, a standard setter replaces one of its existing standards with a different existing standard from another set of standards. In the *multilateral* variant, each of several standard setters replaces an existing standard with a common one that is different from any of the standard setters' existing standards. In both variants, it is possible for financial reporting supply chain participants to perceive a replacement standard to be "better" or "worse" than the standard it replaced.

Standard-level Convergence is not the same as standard-level *harmonization*. Harmonization refers to a situation in which similar individual standards in two different sets of financial reporting standards are not identical to each other, but allow reporting entities to make accounting policy choices that satisfy both. In the past, global harmonization of financial reporting standards, rather than global Convergence, was viewed as a primary goal by the world's financial reporting standard setters. But over time, for various reasons, standard setters came to pursue the more beneficial goal of Convergence instead of harmonization.

Because the process of Convergence is focused on the development and universal adoption of country-neutral standards, and because a high-quality set of country-neutral standards—IFRS—already exists and its use is spreading to more and more countries, it is tempting to conclude that Convergence from a U.S. perspective is all about the point in time when companies in the United States will adopt existing IFRS. But that is not what Convergence is about from a U.S. perspective. The United States has experienced and will experience Convergence differently from other countries. As a result, we should not expect to simply replicate other countries' choices or experiences regarding Convergence.

For example, many countries outside of the United States have imposed mandatory set-level Convergence to current IFRS on listed companies. The most notable examples are the countries of the European Union (EU), which required listed companies to switch to IFRS starting in 2005. But in the United States, companies are extremely unlikely to experience mandatory set-level Convergence with current IFRS, for three main reasons:

1. Current IFRS are high-quality standards and are superior in quality to the country-specific financial reporting standards that they have replaced in many countries, but current IFRS are not demonstrably superior in quality to current U.S. GAAP.
2. Current IFRS as published by the IASB have been locally modified through political action in many jurisdictions, including the EU. The existence of country- or jurisdiction-specific exceptions is fundamentally incompatible with the goal of Convergence. Until such exceptions are eradicated, there is less incentive for the United States to "buy into" IFRS.

3. The IASB's current funding mechanism and governance are generally viewed as being in need of improvement before participants in the U.S. financial reporting supply chain would acknowledge the legitimacy of the IASB as an authoritative setter of financial reporting standards that would apply to U.S. companies.

Another way in which the United States is experiencing Convergence differently from other countries is the way in which standard-level Convergence has occurred and continues to occur between IFRS and U.S. GAAP. While many countries, including the United States, have made unilateral standard-level changes to converge their country-specific standards with IFRS, U.S. GAAP is the only set of standards with respect to which the IASB has made significant unilateral standard-level changes to IFRS. Also, U.S. GAAP is the only set of standards with which the IASB is willing to converge IFRS at the standard level in a multilateral way.

Some participants in the U.S. financial reporting supply chain still cling to the outdated belief that Convergence means other countries will discard their own financial reporting standards in favor of U.S. GAAP. But the reality is that more than 112 countries around the world have explicitly rejected set- and standard-level Convergence with U.S. GAAP in favor of set-level and unilateral standard-level Convergence with IFRS. This reality comes as a surprise to many people in the United States. For decades, U.S. GAAP was universally recognized as the most complete, highest-quality set of accounting standards in the world. Consequently, many observers believed that U.S. GAAP would be the focal point of Convergence. But U.S. GAAP has been slow to evolve and improve as the business world has become increasingly complex and global, and so it became possible for alternative, country-neutral standards to emerge and overshadow U.S. GAAP. It is now very clear that U.S. GAAP will *not* be the focal point of Convergence.

Another common misconception about Convergence in the United States is that giving companies their choice of using current U.S. GAAP or current IFRS is the goal of Convergence. But nothing could be further from the truth. Convergence is ultimately about all companies in all countries using the same set of country-neutral financial reporting standards. Although the SEC and other parties in the U.S. financial reporting supply chain have been increasingly willing to accept financial reports prepared in accordance with either current U.S. GAAP or current IFRS, such a choice does not constitute Convergence. However, there are some very significant implications of U.S. companies being able to choose which set of standards they will use, and those implications will be addressed in Chapter 20.

Yet another example of wrong thinking about Convergence stems from misinterpretations of the word *international* (the "I word" in IFRS, IASB, etc.). Many people in the United States incorrectly think that *international* is synonymous with *foreign*, and are prejudicially opposed to the idea of substituting "foreign" standards for U.S. standards, especially since many of those same people think that *foreign* is synonymous with *inferior*. Other people in the United States misperceive the point of converging U.S. GAAP with "international" standards based on the erroneous belief that such standards would apply only to multinational enterprises or those engaging in cross-border transactions, which is simply not the case. It is truly unfortunate, then, that the "I word" crops up so often in discussions of Convergence. It is helpful to think of Convergence not as focusing on *international* standards as much as on *global* standards. The word *global* implies *pervasiveness, uniformity,* and *country neutrality*—attributes that collectively constitute the essence of the goal of Convergence. To avoid potential misinterpretations, you can expect to see the word *global* in this book far more often than the word *international*.

To summarize, here are three main points to remember about Convergence from a U.S. perspective:

1. Convergence is *not* about what U.S. GAAP or IFRS are today, how those sets of standards currently differ from each other, or the opportunities that companies may have to choose between the two. Convergence is about what both U.S. GAAP and IFRS are *becoming*. And what they are becoming is a single set of higher-quality standards that companies in all countries will use.
2. U.S. GAAP has already changed in significant ways as a result of unilateral standard-level Convergence with IFRS. And IFRS has changed significantly as a result of unilateral standard-level Convergence with U.S. GAAP. Going forward, both U.S. GAAP and IFRS will change in profound ways as they converge with each other multilaterally at the standard level.
3. As a result of future multilateral standard-level Convergence between U.S. GAAP and IFRS, the global standards that we will end up with will *not* simply be cobbled together from the individual standards that exist now in U.S. GAAP and IFRS. Rather, future global standards will be substantially *better* than existing U.S. GAAP and IFRS. Why? It is difficult for the FASB or the IASB to justify changing their standards simply for the sake of Convergence, but both boards view changing to improved standards as highly desirable and consistent with their existing mandate to continuously improve their standards. So even though Convergence, per se, does not necessarily imply improvement, improvement will be inseparable from Convergence in practice.

Now that you know what Convergence is—and is not—you may be wondering "*Why* is Convergence happening?" The short answer is "Because

P1: OTA/XYZ P2: ABC
c01 JWBT050-Pounder December 6, 2008 13:4 Printer Name: Yet to Come

it makes economic sense." A slightly longer, but definitely more enlightening answer about the causes of Convergence can be found in the next section.

What Is Causing Convergence?

Recall that existence and enforcement of financial reporting standards are the result of economic decisions made by end users of financial reports and by institutions that act on behalf of those end users. This implies that financial reporting standards will change if economic decisions about those standards that are made by or on behalf of end users change. And that is the fundamental cause of Convergence: the economic decisions that financial report users around the world are making with respect to financial reporting standards are different from the decisions that users have made in the past, and those different economic decisions are causing financial reporting standards around the world to become different from what they have been in the past.

In a nutshell, Convergence has happened and will continue to happen as the inescapable result of powerful economic forces within an increasingly globalized economy. But that does not mean that Convergence is some kind of sinister plot hatched by malevolent "foreign" powers bent on destroying our American financial reporting system. In fact, the strongest advocates of U.S. companies using a set of globally accepted standards in the future—standards that will be of higher quality than current U.S. GAAP—are found right here in the United States.

It was the United States that took the lead role in launching the modern Convergence movement in 1973, when it along with eight other countries formed the International Accounting Standards Committee (IASC), the predecessor to the IASB. (It is interesting to note that the FASB was not formed until *after* the IASC was formed). American institutions including the FASB, SEC, and the American Institute of Certified Public Accountants (AICPA) have all strongly supported true Convergence, that is, the adoption by companies in the United States and throughout the world of a single set of high-quality, country-neutral standards that would be superior in quality to current U.S. GAAP and current IFRS. Thus, Convergence is not the result of any attempt to forcibly replace U.S. financial reporting standards with "foreign" standards. Rather, it has arisen from the desire of investors, creditors, and other participants in capital markets to see companies in the United States and throughout the world eventually using a common set of standards that is better than any set that exists today.

It is no secret that the world's capital markets are becoming increasingly globalized. And so is the financial reporting supply chain. Investors, creditors, standard setters, and standard enforcers in the United States and

P1: OTA/XYZ P2: ABC
c01 JWBT050-Pounder December 6, 2008 13:4 Printer Name: Yet to Come

throughout the world recognize that differences in financial reporting standards among countries make the global financial reporting supply chain less effective and less efficient than it would be if a single set of high-quality standards were used worldwide. In particular, the world's financial reporting standard setters, including the FASB, generally believe that the interests of investors, creditors, and the general public would be best served if all reporting entities throughout the world were to use the same set of high-quality, country-neutral financial reporting standards instead of the hodgepodge of country-specific standards that reporting entities use now.

The key chain of assumptions underlying that belief is as follows:

- The global use of a single set of high-quality, country-neutral standards would enhance the comparability of financial reports across all enterprises worldwide.
- The enhanced global comparability of financial reports would make capital markets throughout the world more efficient, that is, investors and creditors would be able to consider a much broader range of opportunities when making capital allocation decisions, which would in turn increase the likelihood of optimal capital allocation.
- Greater efficiency in the world's capital markets would (1) improve investors' and creditors' returns; (2) make our economy as a whole more efficient at satisfying people's needs and wants; and (3) stimulate greater investment in enterprises as a result of lowering costs of capital at all levels of risk. And greater investment in enterprises would stimulate economic growth, which would in turn result in further widespread economic benefits such as job creation.

Reporting entities themselves also have economic reasons to support converged financial reporting standards. For example, multinational enterprises would be able to reduce their costs of accounting and reporting if they were able to use a single set of standards across all business units, regardless of where in the world those business units were located. Even small, privately held domestic firms would enjoy both cost-savings opportunities and expansion opportunities as a result of the universal availability of financial reporting talent trained in globally accepted, country-neutral standards.

Conclusion

In ten years' time, companies in the United States and throughout the world will be using a set of high-quality financial reporting standards that will be unlike any set of financial reporting standards in use today. The financial

P1: OTA/XYZ P2: ABC
c01 JWBT050-Pounder December 6, 2008 13:4 Printer Name: Yet to Come

reporting standards that U.S. companies will use in the future will not be U.S. GAAP. Nor will U.S. companies use IFRS as we know them today or any other existing set of standards. Rather, global standards of the future will be what current U.S. GAAP and IFRS are converging into.

While achieving the goal of Convergence—a single set of high-quality, global financial reporting standards—will result in economic benefits on a global scale, the process of Convergence will impose costs and challenges on all participants in the financial reporting supply chain. This book is meant to help you deal with the personal and managerial challenges of Convergence, and Chapter 2 will introduce you to the many ways in which Convergence will impact corporate financial reporting in the United States.

Notes

1. Norman Lyle, *Financial Reporting Supply Chain: Current Perspectives and Directions*. New York: International Federation of Accountants, 2008.
2. Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises*, 1978.