

CHAPTER 1

WORLDWIDE CONVERGENCE ON IFRS

This chapter is introductory in nature. It explains the origins of the use of IFRS for multinational companies and the notion of convergence. It reviews the progress of convergence and the case for and against use of a single comprehensive basis of accounting in the international capital markets.

In this century, financial reporting by large companies has undergone a transformation. In 2000 there was a picture of global diversity with each multinational mostly using the accounting rules of the country where it maintained its head office and (usually) primary stock exchange listing, with US principles dominant where a choice was available. By 2010 the world had changed to one where many of the top international companies use international rules: International Financial Reporting Standards, or IFRS.

The main aim of this book is to introduce to you the principal features of IFRS and provide some of the context to help explain the role

of IFRS in the world. It will also tell you how IFRS are formulated and how you can influence that process and be part of it if you wish. The first chapter looks at the convergence process and tells you the story so far. The following section is the main technical content of the book – an analysis of the main issues under IFRS reporting. This includes a chapter devoted to the *IFRS for SMES*. The final section tells you about how IFRS are created and gives you some of the historical background, as well as some comments on the fundamental thinking behind IFRS.

Although IFRS have been developing since as far back as 1973, their role in international capital markets started when the International Organization of Securities Commissions (IOSCO) decided in the 1980s to develop an international ‘passport’ for companies seeking secondary listings on foreign stock exchanges. At that time each major stock exchange had its own listing requirements – the information that it asked companies to provide if they wanted their securities quoted on the exchange. The requirements were less for secondary listings (i.e. companies whose home exchange was elsewhere) but nonetheless were different country by country. In particular, a company could find itself having to produce accounting information on several different bases, which was very costly.

IOSCO, which is a voluntary association of national stock exchange regulators such as the SEC (Securities and Exchange Commission), decided that it should organize a uniform approach to secondary listings. The idea was that if a company provided information – financial statements and other disclosures – in a uniform manner, this information package would be accepted for secondary listings anywhere in the world. This would significantly cut the cost of listing and provide more encouragement to companies to seek new markets.

IOSCO got together with the international accounting standard-setter to work on extending the reach of IFRS (they were then called International Accounting Standards – IAS) to meet this purpose. At the time, the biggest incentive was access to the US capital market.

The SEC required foreign companies to either provide full US GAAP¹ financial statements or supply domestic statements with a reconciliation of earnings and net assets to what they would have been under US GAAP, known as the '20F reconciliation' after the SEC form. People hoped that a successful IOSCO passport would enable them to prepare IFRS statements without a reconciliation.

Convergence

This would have led to widespread use of IAS/IFRS for secondary listings. In addition, some countries already used them either to meet gaps in local rules or as the model for national rules. However, everything changed in 2000 when the convergence initiative could be said to have taken over. In 1999 the international standard-setter completed an overhaul of its standards and in May 2000 IOSCO accepted them as the basis of its secondary listing approach. But in June the European Commission announced that it would bring forward legislation to make IAS/IFRS compulsory for the **primary** financial statements of companies listed on European Union (EU) stock exchanges. This was the start of the worldwide move to use only IAS/IFRS for financial statements provided by companies using public capital markets. National GAAP was set to disappear progressively and be replaced by IAS/IFRS, at first in the EU but progressively in Australia, South Africa, Canada, India, Brazil, South Korea, Japan, China and many other countries. Even the US is thinking about it.

Convergence, then, is the move towards using a single, globally accepted set of financial reporting standards in preference to using standards developed nationally. Why has the world suddenly decided after centuries of national rules that international ones are necessary? The short answer is that the world economy is increasingly being

¹ Generally Accepted Accounting Principles – an expression that is used to designate the totality of standards, rules, etc., that govern financial statements in any country.

polarized into small and large business, and financial reporting is also being polarized as it responds to business needs.

Smaller businesses do not typically have foreign subsidiaries nor do they raise finance on the public markets. Their financial statements are used primarily for tax assessment and to provide confirmation to bank lenders of the information given in management accounts and estimates. The main influence on their rules is likely to be national taxation.

Listed companies, on the other hand, need to communicate with a wide range of external stakeholders, especially the capital markets. They

have to compete with other companies for finance and it is in their interests for their financial statements to be comparable. A market investor will ask for a higher return to compensate for higher risk. Lack of knowledge of the basis of accounting used is regarded as a risk factor and will therefore cause shares to be more expensive for the issuer. IAS/IFRS are now widely understood and accepted, not only in markets where they are the required reporting base. Consequently a foreign company using IAS/IFRS is able to present itself in a manner that does not increase perceived risk – raising capital in the public markets is cheaper under IAS/IFRS!

Market pressures have pushed governments to recognize that large companies are different animals, with different accounting needs, from smaller companies, and to accept that different sets of accounting rules can co-exist within the same economy. While it has gone for global convergence on IFRS for listed companies, the EU is planning to give member states the right to exempt companies with fewer than 10 employees from producing any accounts at all. This is a direct reversal of its policies in the 1970s and 1980s when, through a series of company law directives, it sought to establish

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the same accounting for all companies, even if smaller ones had fewer disclosures.

Large company advantages

Depending on the circumstances of the company, a multinational should benefit from a number of cost savings when using IFRS. As discussed, there should be a reduction in the cost of capital based on the fact that very many investment managers now know and understand the use of IFRS. Consequently the company that wishes to reach a wider group of investors will find IFRS statements accepted in all major markets.

In terms of secondary listings, the use of IFRS will indeed fulfil IOSCO's aim of providing financial statements that stock exchange regulators will accept to support foreign listings. In particular, the SEC in 2007 abandoned the 20F reconciliation for companies that prepared IFRS statements. This means that non-US companies using IFRS can have a New York listing without providing US GAAP information – something that AXA, the French insurer, estimated to cost it in the region of \$20m in 2006.

Not all companies want a US or other foreign listing, but some chief financial officers (CFOs) consider that going to a large market enables them to raise capital more cheaply. There is also the argument that a foreign listing also carries with it a lot of publicity in that country and is much cheaper than the equivalent advertising. Bay & Bruns (2003, 386–387) say:

The decision to establish or expand a presence on a foreign capital market allows a company to extend its position as a global financial player as well as to underline its commitment to that foreign market. This signal is strongest when the shares of the company are quoted on the local stock exchange. These apparently rather abstract aims bring with them a number of concrete advantages that support foreign ventures and listings.

Hans-Georg Bruns and Wolf Bay were involved in listing Daimler Benz on the New York Stock Exchange. Dr Bruns was the chief accounting officer when Daimler merged with Chrysler. He was later a member of the International Accounting Standards Board (IASB). Bay & Bruns (2003) suggest that a foreign listing:

- signals that its objective is a long-term involvement in the country
- generates increased interest through financial press analysis and significantly increases a corporation's visibility
- may avoid constraints in its home stock exchange
- enables it to market its financial products to the most appropriate customers.

In principle, reporting using IFRS will make it much cheaper to have secondary listings in other countries, because there is no need for figures drawn up under other accounting bases. It will also result in a better cost of capital because investment managers are increasingly used to IFRS statements.

Moreover, there are other advantages for multinationals. As the number of countries where IFRS are accepted continues to grow, so more and more foreign subsidiaries of multinationals can file local financial statements using IFRS. Traditionally a multinational had two basic choices with foreign subsidiaries: (1) they could install worldwide uniform accounting systems and have all subsidiaries account in the same way, with local GAAP accounts prepared by a local accounting firm; or (2) subsidiaries use local GAAP and their figures are re-stated at head office for consolidation purposes. The use of IFRS as a reporting basis for the group eliminates the need for duplicate sets of numbers.


Peggy Smyth, vice president and controller of United Technologies, the US conglomerate, is a member of the IFRS Interpretations Committee (this provides clarifications – see Chapter 9 for more detail). She told members of the international committee when she was appointed that her company had 60 subsidiaries that used IFRS.

Using IFRS throughout a group has other advantages, such as making the audit easier and also making it easier to move staff around throughout the group without re-training. Preparing internal accounting manuals is more logical and there can be economies in staff training. It is no longer necessary to monitor accounting developments in each of a series of major economies.


Why governments support IFRS

There are a number of public policy reasons that also support a move to using IFRS. The most fundamental is probably that using the same accounting basis provides greater comparability between companies. Greater comparability in turn should lead to more efficient investment. The argument is (and there is research evidence to support this) that investors are reluctant to invest across national boundaries because they do not understand the financial statements of foreign companies. Investors face therefore a limited choice, which allows inefficient managements to stay in control of assets. Once investors can compare apples with apples, they can invest more efficiently, which in turn should lead to assets being used more productively.

Access to international markets also means that companies can have access to wider sources of finance, which should in turn mean their finance becomes cheaper. Supposing national governments want their domestic businesses to expand, access to foreign financial markets may be important if the domestic financial market is limited. This was one of the reasons cited by the European Commission for moving to IFRS. It would give smaller listed companies access to more liquid markets. In the case of the European Commission there was also the major motive that use of the same accounting basis across the EU would do (and has done) a great deal to create a single European capital market.



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Another side of this argument is that helping foreign companies to list in your country makes your domestic financial market busier and gives local investors wider choices. In the past this has been an argument advanced by the New York Stock Exchange to allow companies using IFRS not to have to provide a reconciliation to US GAAP.

The use of IAS/IFRS in the world

In the 1990s, when the international standard-setter was working hard to complete its IOSCO package, its standards were already in use in a number of different ways. A number of European countries allowed domestic multinationals to use IAS if they were active on international capital markets. This was the case for Germany, Belgium and France, within the EU. Italy required the use of IAS by listed companies where national rules had no standard and Switzerland recommended use of IAS. Indeed Swiss international companies such as Nestlé and Roche have long reported using international standards.

In addition to this use by individual companies, a number of developing and newly industrialized countries, such as South Africa, Singapore and Malaysia, used IAS as a model for their domestic standards. These were generally countries with a history of using Anglo-Saxon accounting as a result of their colonial past. The World Bank was (and is) a significant agent in encouraging countries to use international standards. While at the time the international standard-setter was happy to provide this input, it has now resulted in a situation where a number of countries claim that their domestic standards are in line with IAS/IFRS. However, they do not necessarily adopt all the continuing changes to IFRS, and potentially cause confusion in the international markets by offering slightly different variants.



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One of the issues in this situation is that countries are understandably reluctant to give up their freedom to regulate accounting in their own country. By issuing a local variant they retain the notion of local control, but at the cost of potentially not having their standards accepted as being as good as IAS/IFRS, and therefore not gaining the full benefits from the international markets. When Australia first adopted IFRS in 2005, it took the opportunity to remove some options from them, but finally changed its mind. The regulators took the view that being able to say they used full IFRS was more useful.

The French government in particular has most publicly had difficulties in coming to terms with using IFRS. President Jacques Chirac famously wrote to the Commission in 2004 asking them to modify the accounting for financial instruments and assert European authority. In 2009, French finance minister Christine Lagarde similarly wrote demanding that the IASB's financial instrument proposals be stopped. A report to the French parliament in 2009 agreed that IFRS were a reality, but asked the French government to use the European endorsement mechanism to modify IFRS as used in the EU. Such attempts to modify IFRS can also damage the credibility of worldwide convergence. Governments in effect give away some part of everybody's gains in order to try to get a package that suits them.

The EU has, however, been a catalyst in the progress of IFRS. When it announced in 2000 that it would adopt them from 2005, it started a momentum that is still continuing. Australia and South Africa decided to switch at the same time and, at the time of writing, more than 100 countries worldwide either require or permit the use of IFRS for listed companies. 2011 has been fixed by the G20 countries for US GAAP to be converged with IFRS so that there is a single global standard.

It remains a question as to whether US GAAP, which operates in a very litigious and law-oriented environment, can converge in great detail with IFRS that have to be written without reference to a national legal framework. It is, however, true that a number of major economies will be moving very shortly to the use of IFRS. China

has mandated since 2007 its own Accounting Standards for Business Enterprises that are modelled on IFRS and are not that distant. Listed companies in Brazil moved in 2010. Canada, Korea and the largest listed companies in India are moving in 2011. Argentina, Mexico and Malaysia are moving in 2012. Japanese companies can adopt voluntarily and the country will decide in 2011 whether to make IFRS compulsory.

The SEC published a road map for discussion in 2008. This would have had an IFRS decision made in 2011, followed by a stepped adoption for US listed companies from 2012. However, since that draft road map was published the US has experienced a change of government and the full effects of the financial crisis. Most people do not expect the US to move very soon.

Problems with convergence

Because there are lots of positives for global business in having global accounting standards, this does not mean that there are not negatives as well. From the individual company perspective, the biggest disadvantage is the cost of making the transition. All the accounting managers in a group will need training, and there may be significant systems changes as well. Estimates of costs vary. A study by the Institute of Chartered Accountants of England and Wales for the European Commission suggested the following estimate:

- companies with turnover below €500m: 0.31% of turnover
- companies with turnover from €500m to €5,000m: 0.05% of turnover
- companies with turnover above €5,000m: 0.05% of turnover.

Clearly the cost varies a lot with size and with the extent to which you can use your own staff to carry out the transition as opposed to hiring outside consultants. It also depends on whether you were already using accounting standards that were similar to IFRS, such as US GAAP

or UK GAAP, or relatively different such as French GAAP or German GAAP. Moving to different standards may also affect your monthly management reports so that it changes how managers see the company.

Not all large companies can get benefits after incurring these costs. The large, national player with little foreign activity and no secondary listings will see very little advantage. The costs of complying with IFRS might even persuade some smaller listed companies to de-list. Accounting costs least per transaction for the largest companies, and bears disproportionately on smaller companies.

Another disadvantage for companies is that they need to change the way they work with standard setters. For large companies it was not that difficult to have informal contacts with national standard-setters and indeed ministries to put across a point of view about changes. Under an IFRS system, national government has much less influence on standard-setting – not least because there are many governments using IFRS. Companies need to find different ways to participate in the standard-setting process. (This is quite easily done by sending people to working groups, offering to field test proposed changes, etc., as we will explore in Chapter 9.)

One of the reasons for the rise of IFRS is that governments, and for that matter companies and stock exchanges, are generally quite reluctant to spend any money on formulating accounting standards. Consequently they are in normal times quite happy to use a 'free' import of reputable standards. However, the financial crisis showed that in difficult times governments do not then have control of the standard-setting process. The French government took the view that measuring banks' financial instruments at fair value (current market value) was exacerbating the collapse of the market. It wanted to change the way French banks account but could not do so. It had to build a coalition



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of EU member states, and threaten action that would have jeopardized global convergence, to get what it wanted. The financial crisis underlined that global convergence also involves loss of sovereignty.

Another question is whether using converged standards gets you converged financial statements. After the 2005 EU adoption of IFRS many studies show that different companies interpret IFRS differently, and commentators question whether convergence achieves anything. Part of this question is whether you thought financial reporting in a country was uniform **before** convergence. Research suggests that it was not, and there is always room for subjective judgement in financial reporting. Therefore it may be that the variability that some people report now has always been there and has nothing to do with IFRS.

At the same time, many efforts have been made to put structures in place to minimize different national interpretations. On a global level the standard-setter has its own interpretations body (the International Financial Reporting Interpretations Committee – IFRIC) that provides detailed rulings. There are other national interpretations bodies that can and do make local rulings. IFRIC tries to liaise with these and ensure consistency. Most countries have stock exchange regulators that carry out scrutiny of company reports. The securities regulators can also therefore make interpretations. Here again efforts are made through regular conferences and also the use of databases of decisions (IOSCO runs one) to ensure that decisions are coherent with each other. Within the EU, regulation of stock exchanges remains national, but there is a coordinating committee (Committee of European Securities Regulators, which became the European Securities and Markets Authority in 2011) that arranges regular exchanges of information between national bodies and also maintains a database of decisions.

The remaining key players are the Big Four international audit firms. Each of them maintains a global IFRS desk in London that liaises with the standard-setter but also tries to ensure consistency of application across their global networks. KPMG doesn't want KPMG Spain approving an application that is prohibited by KPMG Singapore any

more than IOSCO wants the Spanish regulator to differ from the Singapore regulators. The auditors have direct oversight of the accounting of their clients and are the front line in maintaining consistency. Another part of this is that they all publish authoritative accounting encyclopaedias that provide a reference for nearly all transactions.

Modified convergence

It is worth pointing out that the literature is starting to refer to convergence in a slightly different sense as well. China, as noted above, has not adopted IFRS as such but has chosen to issue local standards that are largely the same as IFRS but reflect the local economic and legal framework. Japan has said that it will do the same, although it now lets Japanese companies use IFRS voluntarily and may still go for adoption. Convergence in the Chinese manner is therefore slightly different than the general convergence movement discussed above, even though it is a subset of that. Chinese convergence will result in standards very similar to the international model but not the same. A report by the staff of the SEC in October 2012 raised the possibility that this modified convergence might be a route that the US could follow instead of full adoption of IFRS.

Generally the IASB does not like the modified convergence approach. Their call is 'adopt, do not adapt'. It is confusing to investors if there are several comprehensive bases of accounting in use in the international markets, all claiming to be more or less IFRS. Also the IASB does not want its standards devalued (as happened to an extent in the 1990s) by countries using all the standards except the tough ones.

Small and medium-sized business

A very special standard prepared by the IASB is its *IFRS for SMEs*. There is a chapter devoted to this later (Chapter 7). Essentially it stands to one side of the other IFRS and is intended to be a stand-alone, complete set of accounting standards for small and medium-sized business. It aims to cover most transactions that a simpler company might

be likely to encounter and was drafted with a company with about 50 employees in mind – not that small!

When a country mandates the use of IFRS, this does not include the SME standard; however, some countries – such as the UK – are planning to use it for all but the smallest privately held companies. The rules are very similar to IFRS but there are some simplifications. The standard also includes a cut-down conceptual framework.



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Conclusion

Convergence on a single set of high quality accounting standards has been a key theme in the first decade of the century – which is probably why you are reading this book. Convergence brings lots of benefits for multinational companies and goes a step further towards an easily accessible global capital market. It makes raising capital cheaper and should give investors wider choices. It simplifies international transactions both within groups and by groups.

The cost of transition may be high, and the benefits may not be reaped by all who have to bear the cost. In addition, application of the standards may not be uniform, even though standard-setters, stock exchange regulators and auditing firms have made a significant effort to reduce difference interpretations.