



The convergence of accounting standards

Introduction

On 29–30 June 2010, members of the European and North American Audit Committee Leadership Networks met in Amsterdam for their fifth annual summit meeting to discuss several topics¹, including the convergence of accounting standards.² During a session on 30 June, members were joined by Mr Prabhakar Kalavacherla, International Accounting Standards Board (IASB) member, and Ms Leslie Seidman, Financial Accounting Standards Board (FASB) member.³

This topic was also addressed in an education session on 29 June designed to help audit chairs understand the history and context of convergence, including the perspectives of the various stakeholders. During the education session, members were joined by two senior professionals from the global Ernst & Young organization: Ms Ruth Picker, global leader for IFRS services, and Mr Ken Marshall, Americas financial accounting advisory services markets leader.

*ViewPoints*⁴ contains a summary of the key points raised during these discussions, along with background information and selected perspectives that members and experts shared before and after the meeting. For further information on the networks, see “About this document,” on page 8. For a full list of participants, see Appendix 1, on page 9.

Executive summary

The world’s main accounting standards setters are currently forging ahead with an unprecedented agenda of standards development in an attempt not only to bring International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Principles (US GAAP) closer together, but also to achieve substantial improvement of these standards. This agenda is likely to have a major impact on the companies that use these standards for their financial reports and the stakeholders that rely on those reports. The ongoing process of reforming and converging the world’s accounting standards continues to challenge standards setters and worry stakeholders.

- **Standards setters still aim to complete critical projects by 2011** (*Page 2*)

Despite recent adjustments to the timeline for convergence, the FASB and the IASB still hope to finalize a number of important accounting standards by the end of 2011, including standards for financial instruments, revenue recognition, leases, the presentation of other comprehensive income, and fair value measurement. Though the dates by which companies will have to apply these standards

¹ Other summit discussions included “Tax issues and the audit committee,” and “Shareholder engagement: the influence of proxy advisory firms and the role of the board.” *ViewPoints* for these discussions can be found at http://www.tapestrynetworks.com/networks/net_audit_summit5.html.

² The members are audit committee chairs on the boards of leading global public companies, typically with over \$10 billion in revenue.

³ Ms Seidman and Mr Kalavacherla spoke as individuals and their views did not represent official positions of the boards.

⁴ *ViewPoints* reflects the networks’ use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made before, during and after meetings are not attributed to individuals or corporations. However, the guests have given permission for their remarks to be attributed. Comments by the guests and network members are shown in italics.



are still to be determined, they will ultimately have a significant impact on stakeholders such as companies and investors.

- **Audit chairs are frustrated with the state of accounting standards** (*Page 4*)

Audit chairs are worried that the efforts to converge standards are not serving the chairs' preferred objectives for accounting standards: transparency, practicality and certainty. Standards setters acknowledge these concerns, but they are struggling to balance multiple perspectives in a complex, politically charged environment in which powerful policy makers have different priorities.

- **Standards setters want more input from constituents** (*Page 6*)

To improve the quality and acceptance of the emerging standards, the FASB and IASB are seeking as much input as possible from constituents. Stakeholders have a variety of ways of making their voices heard, including comments on discussion drafts, participation in field studies and one-on-one meetings with members of the standards boards.

Appendix 2, on page 10, includes a list of discussion questions for audit committees.

Standards setters still aim to complete critical projects by 2011

The two leading accounting standards-setting organizations in the world today are the IASB and the FASB. The IASB sets the accounting standards for over 100 countries that have adopted IFRS, while the FASB develops US GAAP, which serves the world's largest capital market. Working closely together, and spurred on by the G-20, these two organizations hope by the end of 2011 to finalize several revised standards that have been "converged" to be as comparable as possible. Ms Seidman noted, "*We selected the [standards] most in need of improvement, and we hope the most significant differences will be resolved.*" Mr Kalavacherla added, "*These changes were chosen because they go to the root of the accounting differences between the two standards setters [that have been there] for a long time.*"

If the standards setters succeed, it will be a major step toward the ultimate goal of creating a single, unified set of accounting standards, developed and managed by one global standards body. The US Securities and Exchange Commission (SEC) will consider the status of the convergence projects when it decides whether or not to adopt IFRS for US-based companies.

Members of the European and North American Audit Committee Leadership Networks have discussed the ongoing convergence efforts at previous summit meetings, focusing on the progress being made, the emerging implications and the political dynamics that are both driving and impeding change. At the 2009 summit, members were joined by the FASB's chairman, Mr Bob Herz, in a discussion of the effect that the fair value controversy was having on convergence and accounting standards setting in general.⁵ With the planned deadline for the convergence projects now a year closer, leading audit chairs are seeking to understand not only the projects' impact and current status, but also the evolving challenges that are shaping these projects and the role that they and their companies can play to make the projects successful. Many audit chairs have been surprised by the magnitude of the efforts under way.

⁵ Audit Committee Leadership Summit, "[Current issues in financial reporting: a discussion with Bob Herz.](#)" *ViewPoints*, 4 August 2009.

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Both the FASB and the IASB are devoting considerable resources to the convergence projects, which were initially specified in the Norwalk Agreement of 2002. The intent is still to complete as many projects as possible by 2011, though the precise timetable is subject to change. Recently, the FASB and the IASB announced that the target completion dates for some projects would be extended into the second half of 2011 and that the number of significant exposure drafts issued in any one quarter would be limited to four.⁶ Nevertheless, a large number of exposure drafts are scheduled to be released in 2010, and it is already clear that the coming changes are significant.

Examples of important convergence projects

Several of the projects that the FASB and the IASB have made a priority are of particular interest to audit committee members:⁷

- **Revenue recognition.** An audit expert noted the main impact is expected to be on accounting for long term contracts (such as construction contracts), where revenue can be recognized according to the percentage of completion method only if the transaction satisfies the test of “continuous transfer” of the goods in their incomplete state. Accounting for warranties is also expected to change. *Exposure draft released in the second quarter of 2010.*
- **Leases.** Bringing lease assets and obligations onto the balance sheet could have significant operational and financial implications for most companies, and companies will need a lot of lead time to gather the data. Research participants in a recent Tapestry Networks study recommended companies get ahead of such change “in case the changes blow through their debt covenants.”⁸ *Exposure draft scheduled for the third quarter of 2010.*
- **Financial instruments reporting.** An audit expert noted that while the treatment of fair value by the FASB and the IASB appears to be diverging, it is clear that the standards will have significant implications for companies because they represent a “*fundamental change in how financial instruments will be measured.*” The IASB standard requires entities to apply a business model test in order to determine which categories of financial assets should be measured at fair value. The FASB’s proposed approach requires the use of fair value for almost all financial assets and liabilities. *Development by the IASB being completed in several phases, with the first phase completed in the fourth quarter of 2009 and the last exposure draft expected in the third quarter of 2010. Exposure draft from the FASB released in the second quarter of 2010.*

These convergence projects will present major challenges for companies’ information technology systems, internal controls and staff resources. They will also present communication challenges as companies attempt

⁶ Financial Accounting Standards Board and International Accounting Standards Board, “[Joint statement by the IASB and the FASB on their convergence work.](#)” June 2010.

⁷ Ernst & Young and Tapestry Networks, “[Regulatory change is driving audit committee agendas.](#)” *InSights*, April 2010, page 3.

⁸ *Ibid.*, page 3.



to educate investors and analysts so that they do not misinterpret the numbers produced by the revised standards. In a letter to the chairmen of the FASB and the IASB, Financial Executives International (FEI) noted that because of these challenges, convergence would require a three-year implementation period.⁹

For their part, the two boards have not yet determined effective dates for the standards. As Mr Kalavacherla noted during the meeting in Amsterdam, *“There is no mention of effective dates in any [of the] exposure drafts we are issuing because we don’t want to ram them down your throats ... It’s better to issue a separate consultation on the appropriate effective dates, let it be socialized and then come to a conclusion.”* In order to garner input on how to transition to the new standards, the boards plan to issue a consultation document in the third quarter of 2010.¹⁰

Audit chairs are frustrated with the state of accounting standards

Despite the measurable progress toward convergence, audit committee members in the networks are unhappy with many aspects of the convergence effort and with the state of accounting standards in general. They are frustrated by the pace of progress on convergence, and one US audit chair voiced doubts about the US ever adopting IFRS: *“I don’t even ask about IFRS anymore.”* They are also frustrated by the increasing complexity of accounting standards and by the content and quality of specific standards. Networks members elaborated on their expectations of accounting standards and their disappointment with the current situation:

- **Transparency.** Members highlighted the importance of having standards that allow companies to convey accurately to the investor community how they have performed. Audit chairs decried the fact that financial statements are becoming less and less useful. One member noted, *“Most investors don’t understand financial statements.”* Another remarked, *“Chairmen’s statements now comment on how accounting standards are distorting results.”*
- **Practicality.** Members want high-quality standards that are practical to implement and easy for investors to use. One European audit chair remarked, *“Our annual report is 500 pages long, which is longer than a Harry Potter book and too heavy to be legally carried by the postal service [in my country].”*
- **Certainty and stability.** Members expressed considerable frustration with the lack of certainty around the convergence process. If it is unclear when standards will actually be completed, or if standards are continually changing, companies are less likely to take them seriously. One US audit chair noted, *“At my company, we don’t want to spend a ridiculous amount of money on something politicians can change in 10 minutes.”*

Ms Seidman and Mr Kalavacherla acknowledged members’ concerns. Mr Kalavacherla said, *“Our goal is to improve and converge the standards. Convergence for the sake of convergence would be miserable. We need to take into consideration the quality of standards, and consider staggering them.”* But progress is hampered by the significant challenges the boards face, including a diverse array of stakeholders and policy priorities, divisions within the boards themselves and insufficient input from some constituents. Ms Seidman said, *“It’s a double-edged sword – we want to move as quickly as possible, but a robust due process takes time, and the input can cause us to change course.”*

⁹ Arnold Hanish to Robert Herz and Sir David Tweedie, [“Re: Effective Dates for the Major Convergence Standards,”](#) 12 February 2010.

¹⁰ Financial Accounting Standards Board and International Accounting Standards Board, [“Joint statement by the IASB and the FASB on their convergence work.”](#)

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Standards setters are struggling to address diverse stakeholder expectations

During the education session, Ms Picker and Mr Marshall discussed the various groups that have a stake in accounting standards, highlighting their differing perspectives on the goals of standards setting and the standards setting process (see table below).

Stakeholder	Goals
Investors/analysts	Transparency, comparability, consistency
Preparers	Practical application, certainty, business sense
Securities regulators	Transparency, independence
Prudential regulators	Financial stability
Governments	Accountability
Auditors	Auditability, consistency of application

With regard to these stakeholders, Ms Seidman and Mr Kalavacherla identified slightly different priorities for their respective boards. Ms Seidman ranked investors and preparers as her top two priorities, while Mr Kalavacherla listed, in order, investors, regulators, preparers and (as a fourth priority) auditors.

For both boards, however, investors are the most important constituent. Mr Kalavacherla said that “*investors are the party we aim for,*” and Ms Seidman noted that “*ultimately, our customer is the investing public.*” In this regard, the IASB in particular has encountered resistance from policy makers. The new European commissioner for internal market and services, Michel Barnier, has made the argument that the IASB goes too far in favoring investors’ interests over the interests of regulators and preparers, and he has linked proposed European Commission funding of the IASB to reforms in representation.¹¹

Ms Seidman and Mr Kalavacherla noted that regulators are also an important priority for the boards. Both the IASB and the FASB are monitored by securities regulators. Ms Seidman mentioned that the FASB’s relations with the SEC are good: “*We meet frequently with the SEC staff to identify issues with the standards and the proposals. They have authority over us and have delegated standards setting to us for over 30 years. They have the right to overrule us, but it’s rare for them to do that.*”

With regard to banking regulators, however, the two boards are facing somewhat different pressures, which may be forcing the IASB to focus more on financial stability. Mr Kalavacherla explained that in continental Europe and Asia, the views of regulators are considered to be very important in accounting standards setting: “*Neutral standards setting is less familiar in this region.*” In the United States, however, standard setting tends to be more accepted as independent of prudential regulation. Ms Seidman noted: “*My objective is to report as neutrally as possible – if there is volatility, it’s due to the inherent volatility in the business. That may or may not be appropriate for regulatory capital purposes.*”

¹¹ Rachel Sanderson, “[Accounting convergence threatened by EU drive,](#)” *Financial Times*, 4 April 2010.

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These differences are reflected in the way the two boards are proposing to apply fair value in the standard for financial instruments. Despite extensive outreach and consultations with stakeholders, the two boards continue to struggle to reconcile differences in how fair value should be applied. At the time of the meeting in Amsterdam, they were still proposing different approaches, and both boards are internally divided on the issue as well.

The resolution of difficult issues such as the more extensive use of fair value is further complicated by disagreement among individual board members. When an exposure draft is issued, there may be a sizeable dissenting vote, and this vote can be strengthened during the ensuing comment period, leading to significant changes in the standard. Board members may differ on general approaches as well as specific technical points. Some board members, for example, may be particularly interested in the concerns of a certain set of stakeholders. Ms Seidman commented, *“If preparers of financial statements can’t implement the standard, it’s pointless. This is where I’m very vocal.”*

Standards setters want more input from constituents

Despite the significant ramifications of accounting standards for a variety of stakeholders, some of these stakeholders are not always as forthcoming with their views as the standards setters would like. Both the FASB and the IASB are trying to increase the input that they receive from their constituents in the hopes of improving standards’ quality and practicality.

Analysts provide little input

Analysts in particular have provided little input to date. One audit chair said, *“Companies need to ask their analysts to step up and make noise.”* Mr Kalavacherla described his efforts to reach out to analysts: *“My solution is that I ask for access to analysts. I say, give me three names, and I ask [them], what do you really want? To my surprise, they are not interested in the nuances of what we’re trying to get through ... It’s like ships crossing in the night. [Companies] need to fire up [their] analyst base and keep talking to them.”* The IASB also has a new outreach program targeting investors that aims to enhance investors’ understanding of accounting standards and make it easier for them to provide input to the board.¹²

Ms Seidman said that the FASB has been *“experimenting with a variety of techniques”* for understanding investor needs. In addition to speaking with investor trade groups, the FASB has initiated conference calls with investors, hosted roundtable discussions with investors and preparers at the same table and implemented a survey on the FASB website. She noted that the new chairman of the Financial Accounting Foundation (FAF), John Brennan, is the chairman and former CEO of the Vanguard Group and that one of the FASB’s five board members has an analyst background.

Preparers can participate in several ways

While preparers of financial statements tend to write more comment letters than analysts, Ms Seidman and Mr Kalavacherla made it clear that they are interested in expanding the input they receive from preparers as

¹² International Accounting Standards Board, [“IASB Foundation and IASB emphasise greater investor participation in the development of IFRSs,”](#) press release, 29 April 2010.

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well as analysts. In fact, the involvement of all constituents is critical for producing high-quality standards. The long-term viability of IFRS depends on the development of standards that will not provoke carve-outs or more dramatic defections. Some jurisdictions, including the EU, already use carve-outs – their own versions of certain standards.

Companies have a variety of avenues for influencing standards setting. During the meeting, participants discussed several approaches:

- **Comment on discussion paper drafts.** In addition to commenting on exposure drafts, companies can weigh in earlier by providing feedback on the discussion papers that the boards often release during the process of developing an exposure draft. For example, on 1 July 2010, the FASB and IASB released a staff draft on financial statement presentation, seeking input before publishing a formal exposure draft.¹³
- **Participate in field testing.** The boards frequently field-test a proposed standard, both before and after an exposure draft is released. Taking part in these studies provides an opportunity to wield influence. Ms Seidman strongly urged audit chairs to push their companies to get involved: *“If you can contribute resources to this, you will have a far more notable impact.”*
- **Initiate one-on-one conversations with members of standards boards.** Reaching out to individual board members can be very effective, especially during the comment period. Mr Kalavacherla urged members and their companies to contact him or the other members of the IASB: *“You should appreciate your clout and that of the companies you represent ... Conversations that we have with you and your companies would make us appreciate your point of view. Please have someone on your team contact us before the exposure draft comments come in – that’s the best time.”*
- **Participate in roundtables.** The boards hold public roundtable discussions about proposed standards, allowing constituents to debate proposals with board members and each other. To facilitate participation, the IASB hosts these discussions in a variety of locations across the globe.
- **Understand the political complexion of the standards-setting boards.** The boards publish dissenting views when they issue a proposal. A divided board offers an opportunity to change a standard, possibly leading to a more protracted process, but a better standard. Ms Seidman (who dissented on the FASB’s financial instruments proposal) explained: *“Exposure drafts contain tentative conclusions that are intended to provoke discussion. Surely, if you agree with some or all of the dissent, you should say so.”*

Conclusion

The long and laborious march toward convergence is testing the patience of stakeholders and the stamina of standards setters. Audit committee members are concerned about the quality of emerging standards and the uncertainty surrounding the convergence process. Meanwhile, the FASB and the IASB are struggling to balance the interests of different constituents as they attempt to meet aggressive deadlines. In order to improve quality and acceptance of the new standards, both boards are seeking extensive input from stakeholders, and they are offering access to the process in a variety of ways. As the endgame approaches for

¹³ Tammy Whitehouse, “FASB, IASB Staff Preview New Financial Statements,” *Compliance Week*, 2 July 2010.

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several important standards, audit committees should ensure that their companies gauge the potential impact of proposed standards and make their voices heard.

About this document

The European Audit Committee Leadership Network (EACLN) and Audit Committee Leadership Network (ACLN) are groups of audit committee chairs drawn from leading European and North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The networks are convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit committee environment.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management and their advisors as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, members of management and advisors who become systematically engaged in this dialogue, the more value will be created for all.

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Appendix 1: Participants at the Audit Committee Leadership Summit

European and North American Audit Committee Leadership Network members participating in the summit, who sit on the boards of approximately 50 large-, mid- and small-cap public companies between them, included:

- Mr Aldo Cardoso, Audit Committee Chair, GDF SUEZ
- Mr Leslie Brun, Audit Committee Chair, Merck
- Mr John Dillon, Audit Committee Chair, Caterpillar and DuPont
- Mr Douglas Flint, Audit Committee Chair, BP
- Mr Phil Hodgkinson, Audit Committee Chair, BT Group
- Ms Judy Richards Hope, Audit Committee Chair, General Mills and Union Pacific
- Mr Labe Jackson, Audit Committee Chair, JPMorgan Chase
- Ms Marie Knowles, Audit Committee Chair, McKesson
- Mr Daniel Lebègue, Audit Committee Chair, SCOR
- Mr Mike Losh, Audit Committee Chair, Aon and TRW Automotive
- Mr Oscar Munoz, Audit Committee Chair, Continental Airlines
- Sir Ian Prosser, Alumnus, former Audit Committee Chair, BP
- Mr Hans-Joerg Rudloff, Audit Committee Chair, Rosneft
- Ms Guylaine Saucier, Audit Committee Chair, Areva and Danone
- Mr Kees Storm, Audit Committee Chair, Anheuser-Busch InBev and Unilever
- Mr Tom de Swaan, Audit Committee Chair, GlaxoSmithKline and Royal Ahold
- Mr Jack Tai, Audit Committee Chair, ING
- Dr Bernd Voss, Audit Committee Chair, ABB
- Mr Mario Zibetti, Audit Committee Chair, Fiat Group

Ernst & Young leaders participating in the meeting included:

- Mr Tom Hough, Americas Vice Chair of Assurance Services
- Mr Steve Howe, Americas Managing Partner
- Mr Tom McGrath, Managing Partner, EMEIA Financial Services
- Mr Christian Mouillon, Global Vice Chair Assurance
- Mr Mark Otty, Managing Partner, EMEIA

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Appendix 2: Questions for audit committees

- ? Which convergence projects are of most concern to your company's management? How are they staying abreast of the projects and their status?
- ? How is the audit committee monitoring your company's preparations? Has the audit committee discussed the possible impact of the new standards on business processes/areas?
- ? Are you concerned about how the IASB and the FASB set standards? Are certain interests over- or underrepresented in decision making? Is the process too political or not independent enough?
- ? Does your company typically comment on accounting standards? If not, why not? Is it trying to influence standards setting in other ways?
- ? What impact is the continuing turmoil around accounting standards having on your company? What, if anything, is it doing to prepare for various contingencies?
- ? How important, ultimately, are global accounting standards? What would be the consequences if standards setting reverted back to the national or regional level?