THE ADVENT OF THE INTERNATIONAL FINANCIAL REPORTING STANDARDS: A CATALYST FOR CHANGING GLOBAL FINANCE

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We are now living through a transformational period marked by a fading American empire and an emerging global landscape. Recent years have seen globalization gain breadth and depth as the internet has leveled the playing field, more countries are producing and selling goods, and capital moves more freely. Despite twenty years of a very expensive dollar, U.S. exports have held their ground, and the World Economic Forum currently ranks the United States' $14 trillion economy as the world's most competitive.[1] Yet three years ago, the United States received a loud wake-up call in terms of its position as the nucleus of global finance. In 2005, twenty-four of the world's twenty-five largest initial public offerings (IPOs) were floated on exchanges outside the United States.[2] In a parallel development, the twelve non-U.S. sovereign wealth funds (SWFs) established then have grown to control roughly US$2.5 trillion.[3] These upheavals coincided with the introduction of a new principles-based uniform system of accounting standards in the European Union (EU), known as International Financial Reporting Standards (IFRS). These guidelines have since been adopted by more than 100 countries.[4] In response to these changes and to the recent market turmoil, the United States moved in August 2008 to adopt IFRS, conceding that it could no longer function in the global economy by prescribing American rules for other countries to follow.[5] The adoption of IFRS not only makes the United States more competitive in the world economy, it also provides a catalyst for change in the world's regulatory and legal frameworks utilized by all global market participants.

On 27 August 2008, the Securities and Exchange Commission (SEC), America's financial markets watchdog, made the landmark decision to adopt IFRS in an effort to promote the sharing of financial information across geographical boundaries by standardizing terminology. The Commission allowed large American-based multinationals to begin using IFRS for their annual reports as early as 2009 and expects that most firms will voluntary switch to the standards by 2010.[6] A road map for their

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mandatory adoption by 2016 has also been proposed.[7] This last measure was the latest in a string of proposals under the leadership of SEC Chairman Christopher Cox designed to bring American and foreign markets closer together. Announcing the decision, he hailed the new standards as a move to an "international language of disclosure, transparency and comparability," saying that the proposed road map marks a cautious step forward from the previously dominant U.S. standards.[8]

Despite the success of the new standards in integrating regional and global markets, reducing compliance costs by eliminating the need for reconciliation and lowering the cost of capital, IFRS only established their first real foothold in the United States in late 2007. On 15 November, the SEC announced it would allow foreign companies access to U.S. capital markets while reporting under IFRS.[9] That unanimous vote instantly affected roughly 1,100 companies with U.S. listings, along with any companies planning U.S. IPOs.[10] At the same time, the SEC started contemplating changes that would grant domestic firms the choice between reporting under IFRS or the previous set of accounting rules—known as the Generally Accepted Accounting Principles (GAAP). There were a number of considerations in favor of embracing IFRS. If the new accounting regime forced firms to be more forthcoming in what and how they report, investors would be better off. The lower costs and universality of IFRS also promised greater market access for foreign businesses. Until the November move by the SEC, if a European company wanted to list on the New York Stock Exchange (NYSE) or any other U.S. exchange, it had to engage in a costly reconciliation between its IFRS-compliant financial records and the results under GAAP.[11]

The Buildup to IFRS

The adoption of IFRS was the United States' answer to a leveling of the playing field it had once defined and an attempt to counterbalance the negative externalities of competition with emerging countries. Despite the size and dominant position of U.S. financial stock and capital markets, other regions are growing much more quickly due to the influx of capital from countries and companies with more investment options. While U.S. GDP accounted for approximately 20 percent of global output in 2007, it is sure to decline over time given that its investment climate is no longer as optimal as it once was.[12] Throughout the past few decades, the United States has had the lowest corporate tax rates of the major industrialized countries.[13] Today, it has the second highest rate after Japan.[14] Higher corporate taxes combined with stricter regulations about internal controls, such as the post-Enron laws like Sarbanes-Oxley (SOX), are causing more expensive compliance and inhibiting businesses from investing in the already saturated U.S. market. The additional financial burden of reconciling foreign financial statements or IFRS to GAAP would only add to the unfavorable investment climate.

While much of the discussion of the loss of the United States' future market competitiveness has focused on American regulations, particularly SOX, and the constant threat of corporate litigation, these obstacles are only part of the reasons why business has shifted abroad. The United States was blind to the mounting corporate corruption in the lead-up to SOX and overreacted in its aftermath with compliance requirements that were too expensive and complex. It is unfortunate that corporate scandals were the catalyst for revealing the importance of transparency, accuracy, controls and security for investors. The scandals only triggered a sense of urgency for regulators caused by the widespread fear of losing public confidence. Instead of motivating the regulators to propose forward-thinking flexible and transparent regulation, the scandals led them to strengthen internal controls.

American adoption of IFRS has raised questions on both sides of the Atlantic. On one hand, critics of IFRS in the United States worry that America will lose control over its financial reporting and disclosures to foreign regulators. European critics are concerned about SEC interference with IFRS standard-setting, which they fear could cause the resulting principles to be too narrow and prescriptive.[15] Because IFRS standards are supposed to be endorsed without modification, any disagreement between foreign and domestic policymakers could come with burdensome legal ramifications. Many legal experts, regulators and policymakers are also concerned about equality of representation among standards-setters, noting that America is underrepresented on the International Accounting Standards Board (IASB), given that the size of America's equity markets represent almost half of global market capitalization.[16] Instead of debating the control of the standards, however, the United States should take a leadership role in setting them and establishing dispute settlement mechanisms, such as those that exist within the World Trade Organization (WTO). By becoming a proactive stakeholder in the formation of these guidelines, U.S. regulators will ensure the standards do not contradict the core of GAAP.

A Global Accounting Revolution

The combination of a more difficult U.S. investment climate with an increased number of stakeholders in global financial markets—thanks in part to emerging market economies—stimulated the creation of IFRS, as a means of providing comparability between investment opportunities in different countries and to draw companies from U.S. exchanges to launch their IPOs. London now competes with New York as the world's financial center and has already surpassed it in terms of number of IPOs it hosts.[17] Yet, the United States has not only been competing with the rise of Europe in the global economy, but also with the rise of the rest of the world. During 2006 and 2007 alone, 124 countries grew at a rate of 4 percent or more, including more than 30 countries in Africa.[18]

Over thirty years ago, experts were already thinking about the advantages of establishing a sole body of accounting rules that could be applied worldwide. In 1973, the International Accounting Standards Committee Foundation (IASC) was formed to address this issue. In 2001, the International Accounting Standards Board—a London-based, independent, privately funded organization—that IASC encompassed was given the task of drafting international accounting standards to regain investor confidence and provide a strong investment climate.[19]

The first major boost to the new standards came with the European Union's (EU) decision to adopt IFRS, bringing in nearly one-third of the world economy at once.[20] Under its Financial Services Action Plan, the EU planned to open up a single market for financial services, making a universal and flexible accounting system indispensable.[21] The EU decision provided momentum toward a single standard throughout the world by promoting a domino effect within other countries. To date, it has become a global phenomenon with approximately 12,000 companies in more than 100 countries requiring the use of IFRS.[22]

Like the European Union and United States, China is also adopting IFRS. However, rather than use the standards published by IASB, it has interpreted its own national interpretation of the IFRS called the Accounting Standards for Business Enterprises, which was issued by the Ministry of Finance in February 2006.[23] With the growth of countries in Asia, competition is increasing from domestic, international, traditional and non-traditional players to enter the Chinese market. This wave of new entrants into China's financial markets is heightening the competition. With China's accession to the WTO in December 2001, business activities with and within China have expanded further as the lifting of geographical and customer restrictions on foreign companies further promote China's integration with the rest of the world.[24] This increased internationalization and privatization of China's financial system has also focused the attention of institutions and regulators on performance and risk management. By increasing transparency of financial reporting and harmonizing Chinese national accounting standards with IFRS, the measures adopted in 2006 help enterprises reduce the costs of raising capital and alleviate the risks of financial crisis.[25]

A Firm's Transition to IFRS Becoming a Catalyst for Global Change

Because the accounting framework of IFRS is largely subjective, the rules-based American system will need to evolve if the new standard is to succeed in the United States.[26] As two of the world's premier business thinkers—C.K. Prahalad and M.S. Krishnan—explain, the internal management systems that feed external reporting can become an impediment. Building in flexibility, they say, is a prerequisite to dealing with a world marked by constant change and innovation.[27] Despite the one-off fixed costs in the tens of millions of dollars to implement IFRS, accountants point out that the savings over time will dwarf the initial outlay, because the compliance costs of duplicate accounting, the bulk of which investors ultimately bear, will disappear.[28] It could even mean greater profits for firms. A recent study by Jack T. Ciesielski in *The Analyst's Accounting Observer* found that among the 137 companies reporting 2006 results under both GAAP and IFRS, 63 percent showed higher earnings with the international standards in place and for the median company, profits jumped by 11 percent.[29] Investors will also have reason to rejoice, as the new standards make company financials easier to compare, enabling them to invest internationally with more knowledge and confidence.[30] Like investors, auditors will appreciate the switch as it grants them greater room for judgment and interpretation.[31]

Transitioning to IFRS is likely to impact the way in which management communicates with investors and companies conduct business with customers and vendors, as well as the key processes of daily operations. These modifications may further change employee responsibilities. Because IFRS conversions will also require the retroactive restatement of certain historical periods and alter the baseline for each of many key performance indicators, many of the metrics used by investors and analysts to assess and compare companies are likely to change.[32] In addition to differences in bottom-line results, earnings volatility may vary when reporting under IFRS. As more companies consolidate their businesses under the new financial reporting requirements, they may need to renegotiate financing agreements, adjust debt covenants and reconsider the implications for other long-term contracts such as leases and derivative arrangements.[33] Internal operations may need to change as well as companies begin to integrate the new reporting scheme throughout their businesses. Control over processes and information may need to be revisited, new treasury and cash management strategies devised and information technology systems upgraded.

Another important internal factor for most companies is taxes, which IFRS may impact in terms of the amount of taxes paid and the effective tax rate. Because various aspects of corporate culture have long conformed to GAAP, businesses may need to modify compensation structures and appropriately train their workforce under IFRS. Despite the potential burden and expense of all of these changes—as several multinational Fortune 50 companies have already discovered—transition-related changes have the potential to deliver future dividends, such as streamlined operations and reduced costs.[34] With this longer-term outlook, instead of viewing the changes as part of a compliance exercise, companies can strategically approach their conversion efforts and embed them into their operations.[35]

Given that almost worldwide acceptance of the IASB's principles-based rules is due within the next decade, accountants are now debating the goals of the profession; should accounting be a driver for economic behavior or the point-in-time reflection of a company's performance? Increased global mobility, transparency and complexity, as reflected through business, dictates a change in the role of the accountant. Sir David Tweedie, head of the IASB and perhaps the world's most important accountant, says, "The accountant is an artist, but he has to portray his subject faithfully. I don't believe the accounting profession should have to endure the 25,000 pages of U.S. GAAP where judgment is replaced by a search engine."[36]

However, with accountants' judgments come differences in interpretation that run counter to the comparability achieved through global IFRS implementation. The mass global differences in definition and interpretation of a consolidated accounting system will have to allow for diverse cultural interpretations causing enforcement of the international rules to vary by country and thus potentially reducing a main advantage of IFRS. It is already estimated that twenty-nine countries that use IFRS have added their own exceptions to the rules, defeating the purpose of a global standard.[37]

While mass resistance to change is prevalent in global finance, countries like the United States should promote the global implementation of IFRS as an opportunity to streamline, standardize and ease reporting for companies as well as improve regulatory frameworks. If the global implementation of IFRS is used as a vehicle of change, the many advantages of IFRS to investors will dwarf any minor discrepancies with the local standards based on differences in interpretation. The real goal of the United States should not be to retain financial dominance or seek a post-American order in global finance, but instead should be the creation and maintenance of a coalition of equals based on a sense of responsibility and stability that promotes global economic growth and prosperity for all. Successful global implementation of IFRS has the power to transform global finance by reinvigorating and realigning the relations between business and society. Rather than fearing an absolute decline in its power and influence, the United States should instead adjust to the rise of the rest of the world and lead by example. Thus, IFRS adoption will not only make the United States more competitive in the world economy, but it will also function as the beginning of a new chapter in global finance through better regulatory and legal frameworks in this post-American world.

NOTES

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