CONVERGENCE IN INTERNATIONAL FINANCIAL REPORTING

The word harmonization appears to have had its day. It mean different things to different people. Some view harmonization as the same as standardization. However, whereas ***standardization*** implies the elimination of alternatives in accounting for economic transactions and other events, **harmonization refers to the reduction of alternatives while retaining a high degree of flexibility in accounting practices**. Harmonization allows different countries to have different standards as long as the standards do not conflict. For example, prior to 2005, within the European Union harmonization program, if appropriate disclosures were made, companies were permitted to use different measurement methods: German companies could use historical cost for valuing assets, while Dutch companies could use replacement costs without violating the harmonization requirements. Harmonization is a process that takes place over time.

Accounting harmonization can be considered in two ways, namely, harmonization of accounting regulations or standards (also known as formal or de jure harmonization), and harmonization of accounting practices (also known as material or de facto harmonization). Harmonization of accounting practices is the ultimate goal of international harmonization efforts. Harmonization of standards may not necessarily lead to harmonization of accounting practices adopted by companies. For example, a study in China in 2002 found that despite the Chinese government's efforts through legislation to ensure harmonization between Chinese GAAP and IASC GAAP, there was no evidence that such efforts eliminated or significantly reduced the differences that exist between earnings calculated under Chinese and IASC GAAP. Other factors such as differences in the quality of audits, enforcement mechanisms, culture, legal requirements, and socioeconomic and political systems may lead to non-comparable accounting numbers despite similar accounting standards.

Convergence, like harmonization, is a process that takes place over a period of time. Unlike harmonization, however, convergence implies the adoption of one set of standards internationally. The IASB's main objective is to achieve international convergence with its standards. In other words, the efforts of the IASB are directed toward developing a high-quality set of standards for use internationally for financial reporting purposes (global standard setting). Convergence means reducing international differences in accounting standards by developing high-quality standards in partnership with national standard-setters. This process applies to all national regimes. 4

ARGUMENTS FOR AND AGAINST INTERNATIONAL CONVERGENCE OF FINANCIAL REPORTING STANDARDS

Arguments for Convergence

Proponents of accounting convergence put forward the following arguments.

i. **Globalization of Capital Markets:** comparability of financial statements worldwide is necessary for the globalization of capital markets. Financial statement comparability would make it easier for investors to evaluate potential investments in foreign securities and thereby take advantage of the risk reduction possible through international diversification.
ii. **Simplification of Investment Appraisal:** Second, it would simplify the evaluation by multinational companies of possible foreign takeover targets.

iii. **Reduction of Financial Reporting Costs:** convergence would reduce financial reporting costs for companies that seek to list their shares on foreign stock exchanges. Cross-listing of securities would allow companies to gain access to less expensive capital in other countries and would make it easier for foreign investors to acquire the company's stock.

iv. **Investors' Confidence:** national differences in corporate reporting cause loss of investor confidence, which affects the availability and cost of capital. Investors often build in a premium to the required return on their investment if there is any uncertainty or lack of comparability about the figures—such premiums can be as large as 40 percent.

v. **Cost Reduction of Preparing Consolidated Financial Statements:** one set of universally accepted accounting standards would reduce the cost of preparing worldwide consolidated financial statements, and the auditing of these statements also would be simplified.

vi. **International Mobility of Labour:** multinational companies would find it easier to transfer accounting staff to other countries. This would be true for the international auditing firms as well.

vii. **Improvement in information Credibility:** convergence would help raise the quality level of accounting practices internationally, thereby increasing the credibility of financial information. In relation to this argument, some point out that as a result of convergence, developing countries would be able to adopt a ready-made set of high-quality standards with minimum cost and effort.

Arguments against Convergence

The following arguments have been raised against convergence:

i. **Cost of Eliminating Existing Differences:** The greatest obstacle to convergence is the magnitude of the differences that exist between countries and the fact that the political cost of eliminating those differences would be enormous.

ii. **Nationalism**: One of the main obstacles is nationalism. Whether out of deep-seated tradition, indifference born of economic power, or resistance to intrusion of foreign influence, some say that national entities will not bow to any international body.

iii. **Almost Impossible to achieve**: Arriving at principles that satisfy all of the parties involved throughout the world seems an almost impossible task. Not only is convergence difficult to achieve, but the need for such standards is not universally accepted.

iv. **Uniform Accounting Standards are not necessary**: A well-developed global capital market exists already. It has evolved without uniform accounting standards. Opponents of convergence argue that it is unnecessary to force all companies worldwide to follow a common set of rules.

v. **Standards Overload**: They also point out that this would lead to a situation of "standards overload" as a result of requiring some enterprises to comply with a set of standards not relevant to them. The international capital market will force those companies that can benefit from accessing the market to provide the required accounting information without convergence.

vi. **Importance of Diversity**: Yet another argument against convergence is that because of different environmental influences, differences in accounting across countries might be appropriate and necessary. For example, countries that are at different stages of economic development or that rely on different sources of financing perhaps should have differently oriented accounting systems. Professor Frederick Choi refers to this as the dilemma of global harmonization: "The thesis of environmentally stimulated and justified differences in accounting runs directly counter to efforts at the worldwide harmonization of accounting. Hence, the dilemma." This applies equally to the idea of convergence.

*IASB (See Note on IASB and its Framework)

INTERNATIONAL CONVERGENCE TOWARD IFRS

The IASB has earned a great deal of goodwill from many interested parties. Its new approach clearly reflects a change of role from a harmonizer to a global standard-setter. According to its chairman, the IASB's strategy is to identify the best in standards around the world and build a body of accounting standards that constitute the "highest common denominator" of financial reporting. The IASB has adopted a principles-based approach to standard setting and has obtained the support of U.S. regulators (even though U.S. standard-setters historically have taken a rules-based approach). On the other hand, the IASB's structure is similar to that of the U.S. standard-setter recognizing that the FASB has the best institutional structure for developing accounting standards.

In 2002, the six largest public accounting firms worldwide conducted a survey of national efforts in 54 countries to promote and achieve convergence with IFRS. Almost all the countries surveyed intend to converge with IFRS, indicating that the IASB is the appropriate body to develop a global accounting language. Countries indicating a plan to achieve convergence included members of the European Union, the six countries of the Western Hemisphere with the largest economies (Argentina, Brazil, Canada, Chile, Mexico, and the United States), and China, India, Malaysia, New Zealand, South Korea, and Thailand. The survey identified three different **convergence strategies**:

i. Replacing national GAAP with IFRS (supplemented for issues not addressed by IFRS).
ii. Adopting IFRS as national GAAP on a standard-by-standard basis.
iii. Eliminating differences between national GAAP and IFRS when possible and practicable.

The major concerns in achieving IFRS convergence as expressed by respondents to the 2002 survey included:

- The complicated nature of particular standards, especially those related to financial instruments and fair value accounting (51 percent of countries)
- The tax-driven nature of the national accounting regime; using IFRS as the basis for taxation is seen as a problem (47 percent of countries).
- Disagreement with certain significant IFRS, especially those related to financial statements and fair value accounting (39 percent of countries).
- Insufficient guidance on first-time application of IFRS (35 percent of countries).
- Limited capital markets, and therefore little benefit to be derived from using IFRS (30 percent of countries).

- Satisfaction with national accounting standards among investors/users (21 percent of countries).
- IFRS language translation difficulties (18 percent of countries).

The IASB has taken initiatives to facilitate and enhance its role as a global standard-setter. The issuance of IFRS 1 is one such initiative. IFRS 1 was issued in response to the concern about a lack of guidance on first-time application of IFRS. The official language of the IASB is English and IFRS are written in this language. The IASB has attempted to address the translation issue by permitting national accountancy bodies to translate IFRS into more than 30 languages including Chinese, French, German, Japanese, Portuguese, and Spanish. In addition to the problem that IFRS have not yet been translated into very many languages, research has shown that translation can be problematic as some terms in English have no direct equivalent in other languages.

With the increasing trend in many countries including Australia and the EU member nations to adopt IFRS, a large number of companies (over 7,000 listed companies in Europe alone) now use IFRS in preparing their financial statements. The IASB's decision to hold a series of public roundtable forums to provide opportunities for those who have commented on an exposure draft to discuss their views on the proposals with members of the IASB is another important initiative. Seven of the 14 board members of IASB have direct liaison responsibility with national standards setters. As a result, unlike its predecessor, the IASB now is formally linked to national standard-setters in at least some countries, and the liaison board members are able to coordinate agendas and ensure that the IASB and those national bodies are working toward convergence. I FAC supports the IASB's objective of convergence. At its July 2003 meeting, held in Quebec, Canada, IFAC approved a Compliance Program designed to provide clear benchmarks to current and potential member organizations in ensuring high-quality performance by accountants worldwide. This program requires member bodies to implement, with appropriate investigation and disciplinary regulations, both IFAC standards and IFRS. IFAC's Auditing and Assurance Standards Board (IAASB) also has issued new guidance clarifying when financial statements are in full compliance with IFRS. In its 2007 annual report, the IFAC highlights, among other things, the progress in achieving international convergence through IFRS. The main objective of the IASB is to achieve international convergence with IFRS. However, Zeff (2002) points out that some obstacles to comparability are likely to arise in areas of the business and financial culture, the accounting culture, the auditing culture, and the regulatory culture. Regardless of the arguments against harmonization, substantial efforts to reduce differences in accounting practice have been ongoing for several decades. The question is no longer whether harmonization should be strived for, but going a step further, it is to ask how to achieve convergence.

THE ADOPTION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS

There are a number of different ways in which a country might adopt IFRS, including requiring (or permitting) IFRS to be used by the following:

1. All companies; in effect, IFRS replace national GAAP.
2. Parent companies in preparing consolidated financial statements; national GAAP is used in parent company-only financial statements.
3. Stock exchange listed companies in preparing consolidated financial statements. Non-listed companies use national GAAP.

4. Foreign companies listing on domestic stock exchanges. Domestic companies use national GAAP.
5. Domestic companies that list on foreign stock exchanges. Other domestic companies use national GAAP.