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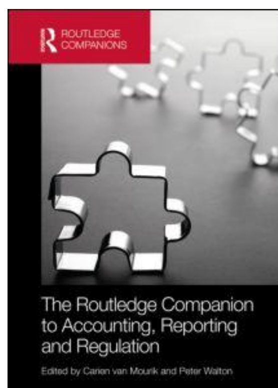

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Global Convergence of Accounting Standards

Alfred Wagenhofer

1. The move to global convergence

Convergence of accounting standards describes the phenomenon that the accounting standards in two or more countries become more aligned or even uniform over time. It comprises harmonization of accounting standards, when standards are made broadly consistent, and standardization, which is the adoption of the same standards in several countries.

Accounting standards have usually been developed within a single country as part of its company and capital markets regulation. These legal institutions differed and continue to differ substantially across countries. The reason is that accounting is intricately embedded in the economic, financial, legal, social, and cultural environment in a country. Accounting evolved jointly with other institutions and its state is a result of the development of these institutions and the historical path they took.[1]

If there was convergence in the past, it was often caused by countries imposing their own legal systems, including the accounting regime, on their colonies and other dependent countries. With the reduction of such dependence, the systems usually began to diverge again. In other cases, there was influence through accounting theories conceived in one country, which were taken up in other countries in shaping their accounting standards. However, there was little need, and thus little effort, to formally converge accounting regimes over a number of countries for a long time. It did not make sense to strive for convergence if countries are relatively self-sustaining and there is not much interdependence among them.

One major undertaking for convergence of accounting standards was the harmonization of accounting in the EU. It began in the late 1960s with an attempt to develop a harmonized framework for financial reports of companies in the EU member states. The underlying principle was to reduce country-specific restrictions on the establishment of companies. The accounting directives were rooted in company law and should create safeguards and minimum legal requirements for financial information to protect members and third parties. The endeavour took many years before the Fourth and Seventh Directives were enacted in 1978 and 1983, respectively. The harmonization achieved by the Directives was moderate, as they include dozens of options for member states or companies directly.

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At about the same time the EU started the work on harmonization, the Accountants' International Study Group (AISG) was founded. It consisted of members from the UK, Canada, and the USA and its main objective was to compare the seemingly similar accounting standards in these countries, only to find out that there were more differences than expected. Its main achievement probably was that it formed the core for the International Accounting Standards Committee (IASC), which was established in 1973 by nine countries.[2] Its original objective was to harmonize financial reporting globally, and it began developing the International Accounting Standards (IAS). The first IASs described the practice of accounting across many countries and were loaded with alternative treatments. Over time, the standards became more stringent as the IASC became more influential. In the mid-1990s some countries granted companies the option to prepare consolidated financial statements according to IAS only, and did not require consolidated statements under national GAAP. Particularly large listed companies took advantage of this option.

In 2001, the IASC was restructured into the IASB.[3] Its objectives are 'to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards', to 'promote the use and rigorous application of those standards', and to 'bring about convergence of national accounting standards and IFRSs to high quality solutions' (Preface to IFRSs, para. 6). Since then convergence has been a major undertaking by the IASB. The focus of the IASB is the use of financial information in the capital markets, although it has more recently turned attention also to non-public, small and medium-sized companies, and emerging economies.

A landmark decision for the IASB was the adoption of IFRS by the EU with the IAS Regulation in 2002. It resulted from a number of legislative steps the EU took to foster the European capital market development. The IAS Regulation requires the consolidated financial statements of listed companies in the EU to be prepared under IFRS as of 2005, and it gives options to member states to extend the applicability of IFRS to non-listed companies and to separate accounts. This Regulation immediately made some 7,000 of the largest EU companies adopters of international accounting standards. Further, it increased the importance and the standing of the IASB as a, or rather *the*, global standard setter.

Meanwhile, IFRS has been adopted or is accepted in more than a hundred countries worldwide. This is indeed evidence of global convergence of accounting standards and an eminent success of the IASB (and its predecessor, the IASC). There are two large countries with powerful capital markets that are not (yet) on the list of countries adopting IFRS: the US and Japan. The US authorities have sent mixed signals as to acceptance of IFRS. In 2007, the SEC abolished the reconciliation requirement for foreign firms listed in the US if they prepare IFRS financial statements. It also proposed a roadmap for the acceptance or adoption of IFRS for US companies and a staff work plan. A final decision whether the US should transition to IFRS is pending. Japan has not made a decision either, but already permits some Japanese companies to prepare financial statements in accordance with IFRS. Other countries, such as China, Malaysia, and India aim to converge with IFRS. Besides the capital market pressure, the World Bank has been instrumental in pushing for convergence with or adoption of IFRS in many countries.

These major steps in the global convergence of accounting standards provide evidence of the apparently large economic benefits of converged standards. This chapter discusses the benefits and costs of convergence mainly in the context of the developments of convergence towards and adoption of IFRS. Presumably the benefits are higher than the costs since otherwise it would be difficult to rationalize the convergence that has been achieved so far. However, convergence does not occur in all accounting areas. Therefore the chapter also examines various dimensions of convergence.

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The adoption of IFRS is clearly a historic event and illustrates many aspects of convergence of accounting standards. However, it should be noted that IFRS are adopted not only because they bring convergence in the sense of standardization, but they are commonly considered to be of higher quality than many local GAAP they substitute. Most of the vast literature studying economic effects of IFRS adoption does not, or cannot, distinguish between these two reasons for adoption. The focus on this chapter is on convergence and less on the quality of standards.[4]

2. Globalization as a main driver for convergence

Whereas early initiatives for harmonization in the EU were driven by minimal financial information requirements in each of the member states (so high quality of financial statements was not the objective), the main impetus for the convergence of accounting standards was the globalization of capital markets. Capital markets have grown due to increased demand of and supply for equity capital.[5] Companies began to make more use of international capital markets to raise capital, and investors began to allocate money globally to reap greater returns and to diversify risk more efficiently. The globalization of capital markets has been facilitated by technological advancements in trading and disseminating information.

Global accounting standards enhance the comparability of companies located in different countries. They reduce the costs investors incur to understand, analyse and compare financial statements and they increase the information investors are able to use to interpret companies' financial position and the risks involved to evaluate their prospects. This leads to more efficient global resource allocation and capital formation, and to increased competition among stock exchanges, which again should lower the cost of capital, increase market liquidity, and eventually boost economic growth.[6] Indeed, one of the main breakthroughs of IFRS internationally was the endorsement of the (then) IAS by the International Organization of Securities Commissions (IOSCO) in 2000 for multinational issuers of capital in cross-border offerings and listings. Cross-listing came into vogue for companies to improve raising capital, and they even prepared IFRS financial statements voluntarily, thereby incurring significant costs of preparation and auditing. The SEC also acknowledges comparability as the main driver for convergence of US GAAP with IFRS, up to adopting IFRS in the longer run.[7]

Besides the capital market effects, convergence of accounting standards facilitates transactions and relationships with other parties in global business. It improves effective communication with stakeholders regardless of where they are located, because all parties know the underlying standards according to which the financial information is prepared. So, financial statements are readily interpretable. For example, lending decisions can be based on financial information that is readily understood. Suppliers and customers can better assess the economic situation of the firm if they are familiar with the accounting standards under which the firm reports. Information that is useful for acquisitions of firms, the formation of joint ventures, and other investments becomes easier to collect and understand. These effects facilitate cooperation and trade globally.

Global standards are also useful for contracting purposes. It becomes easier to write contracts that include covenants based on accounting numbers if parties are familiar with accounting standards that are used to prepare the accounting numbers. They are in a better position to understand and forecast the numbers and, thus, the outcome of contracts will be less risky and better enforceable.

Other benefits of global standards arise on the firm level, particularly in multinational firms. If the subsidiaries report under the same accounting standards, consolidation becomes less costly, timelier, and more accurate. It also reduces the cost of preparation, communication, and analysis

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of management reports within the group. Internal control systems become better aligned. For example, a survey of CFOs by PricewaterhouseCoopers (2002) reveals that the adoption of IFRS benefits internal reporting systems, risk management, accounting processes, and increases trust in reported numbers.

Global standards also provide benefits from a regulatory point of view. Companies may be inclined to exploit differences in national regulation regimes and cherry-pick favourable regulatory provisions in designing its organization. Firms can structure transactions so as to target gaps in different accounting standards. This holds for industrial firms and also for banks and insurance companies, which are subject to regulatory supervision. Such actions reduce the effectiveness of supervision and oversight in capital markets and other markets and are significantly reduced if the regulatory regimes are standardized. Regulation and enforcement have become more international, and an international standard improves the coordination of such efforts.

3. Comparability of financial statements

3.1 Institutions and incentives

Accounting practice is determined not only by accounting standards, but also by institutions and incentives. Institutions include the legal systems, capital market regulation, product market competition, company law, enforcement, and firm-level incentives, such as ownership structures, financing, corporate governance, and compensation practices. Institutions, together with tradition and education, shape incentives. This has two consequences:

- convergence of accounting standards does not necessarily imply convergence of financial reporting practice;[8] and
- it is unlikely that a single set of standards works best in all institutional environments.[9]

The same standard can lead to diverse practice across countries if it allows different accounting policies, either explicitly or implicitly. For example, Kvaal and Nobes (2010, 2012) analyse accounting policy choices of companies after the adoption of IFRS in five large countries. They have found evidence that companies attempted to continue with accounting practices they complied with before adopting IFRS, thus leading to diversity in practice despite a common standard. They also found that companies in France and Spain changed their accounting policies in the years after the transition, suggesting they learnt to use options provided in IFRS that were new relative to their local GAAP.

Application of the same standards may differ even if it includes no options. For example, cultural differences across countries, such as basic risk attitude and tradition, can sustain diversity in practice. Schultz and Lopez (2001) report on an experiment with experienced auditors who work in the offices of the same global audit firm in France, Germany, and the US. They received the same information about a firm that had introduced a new product and had to estimate a provision for guarantees under IFRS. The amount of the provision differed significantly, being highest in France, then Germany, and finally the US. This finding suggests that cultural differences influence judgement in subtle ways.

Selection among options and discretionary choices are strongly affected by incentives. There are countries in which financial accounting is the basis for determining income tax payments, whereas there are other countries in which this is not the case. The direct link between financial and taxable income affects management's incentives for earnings management,

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and even if the same accounting standards apply, their application is likely to differ significantly. Management compensation that is heavily tied to particular earnings numbers or stock price increases incentives for earnings management, which can reduce the usefulness of financial statements. Typical management compensation packages differ across countries, and, hence, the incentives for earnings management and the comparability of financial reports differ.

A major implementation issue is the fit of new accounting standards with the legal system in a country. It has an important effect on the interpretation and application of standards. The IFRS are developed based on the legal environment of Anglo-American countries, and their form is similar to the accounting standards in these countries. The legal systems in Anglo-American countries are based on common law, whereas other countries follow very different legal traditions.[10] Applying IFRS in other countries can lead to difficulties in the application of the standards, as different legal methodologies may lead to different interpretations particularly in situations in which several views may be appropriate. IAS 8 provides guidance for the interpretation of the IFRSs, but does not describe a self-contained legal system for interpretation.[11]

Implementation of accounting concepts that are common in one country but uncommon in another may also create diversity. For example, the Fourth Directive includes a true-and-fair-view principle, which is a familiar concept in the UK, but alien to many other European countries, so it is likely that it is applied differently. Further, the Directive – and following that also IAS 1 – requires an override in the rare circumstances that a true and fair view is not achieved by following the standards, again a concept uncommon in many countries.

Translation of accounting standards into another language is another source for divergence. IFRSs are written in the original English language and then translated into many languages used around the world. Some translations are prepared by the IASB itself with the help of local institutions, and the EU endorsement process (see also below) requires translations into the EU's official languages. Translations may be of differing quality and may lead to different interpretations if there is no equivalent expression in the respective language or if the expression is associated with a term that is already used in local GAAP.[12] Curiously, Portugal and Brazil apparently use two different Portuguese translations of IFRS.

Quality assurance of financial reports varies across countries. Auditing, corporate governance, and enforcement differ significantly. In some countries, for example Japan and the Netherlands, qualified audit reports are highly uncommon, which does not mean that auditing is of low quality, but rather that there are other means for auditors to influence financial statement quality. Similarly, enforcement results differ across countries. For example, the percentage of erroneous financial statements in Denmark, Germany, and Portugal is around 25 per cent, compared with some 2 per cent in the UK and Spain.[13] It is unlikely that these large differences are attributable only to differences in the quality of financial reports in these countries; rather they suggest differences in the organization and effectiveness of enforcement. Christensen *et al.* (2013) even suggest that the enforcement is the main driver for economic effects of IFRS adoption.

Financial reports that are subject to strong quality assurance are of higher quality than financial reports prepared under the same standards but subject to lax assurance. Such differences may even affect the desirability of specific accounting measurement rules. For example, an accounting standard that requires measurement of many assets at fair value estimates may result in highly useful information if it is applied in a country with strong quality assurance in place. In another country with lax assurance the same measurement rule can result in financial numbers that are not trustworthy and therefore useless. In such a country, an accounting standard that avoids such estimates may provide a more informative and comparable view of the financial situation of companies. Another interaction between accounting standards and enforcement occurs in

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countries with a highly litigious environment. Preparers and auditors strongly demand rules in lieu of principles because rules reduce or eliminate judgement, which lowers the risk of being found guilty of not correctly applying the standard.

The importance of the institutional environment has been acknowledged by the IASB, but apparently it does not guide the development of its standards, which are developed with the presumption that they are enforced effectively. Rather, the IASB calls for improvements in the institutional environment to effectively enforce its standards. There are several initiatives underway to improve quality assurance which aim to increase convergence of financial reporting practices in the long run.[14] For example, the International Standards on Auditing (ISA) provide a global basis for providing assurance services, and several countries operate audit oversight bodies. Convergence of corporate governance is more difficult because company laws differ substantially across countries. Harmonization occurs on a higher level; for example, the OECD issued principles of corporate governance in 1999.

Enforcement and litigation are also difficult to harmonize as they are fundamentally embedded in national legislation. Decisions by enforcement agencies or courts affect the application of a standard in a particular country, and it is not obvious whether there is a mechanism that could be established in which decisions on global accounting standards made in one country extend to other countries. It is also likely that different enforcement agencies and courts can come to differing conclusions about similar underlying facts. Therefore, global accounting standards can lead to increasing divergence in accounting practice over time, as more conflicting legal decisions are made. In the EU, the European Enforcers Coordination Sessions (EECS) have been established under the European Securities and Markets Authority (ESMA) as a forum to exchange information regarding the enforcement of IFRS. It maintains a database of enforcement decisions to coordinate application in the member states.[15] However, it is difficult to see whether a similar mechanism to coordinate global enforcement could be established.

3.2 Comparability and IFRS adoption

The adoption of IFRS in the EU and in many other countries provides an interesting setting to study whether adopting a single set of accounting standards in fact increases comparability. Comparability requires that similar transactions and events are recorded similarly, and dissimilar transactions and events are recorded differently. This means that adopting the same accounting standards can *reduce* comparability in practice if they do not sufficiently take account of institutional differences, with the result that dissimilar events are reported similarly and users of financial statements cannot discern the different economics. Indeed, Stecher and Suijs (2012) suggest that if users across countries are heterogeneous, a single global accounting standard may become a lowest common denominator and that a reconciliation requirement may be preferable.

Recent empirical literature addresses this issue based on data around the mandatory adoption of IFRS by companies in several countries. There are several ways to measure comparability. Input-based measures are based on accounting policy choices, whereas output-based measures capture the similarity of accounting numbers resulting from similar economic events. Input-based measures indicate an increase in comparability if IFRS includes fewer options than the sum of local GAAP that were applied before the transition to IFRS. As mentioned earlier, a caveat is that discretion may still be exercised differently. In general, such analyses suggest that comparability has increased.

Output-based measures capture both the standards and the incentives effects on comparability. A common measure is based on De Franco *et al.* (2011), which essentially maps economic events into earnings. Comparability between two companies' accounting systems is considered

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higher if they produce more similar financial statements for a given set of economic events. They use stock returns as the proxy for similar economic events; an alternative proxy is cash flow from operations.

Empirical studies provide mixed evidence. For example, Yip and Young (2012) use a sample of companies in 17 European countries and find that the IFRS adoption increases cross-country comparability by making the mapping of similar events more similar, without making dissimilar events more similar. Lang *et al.* (2010) construct a sample from 47 countries, including IFRS adopting and non-adopting countries. They find that IFRS adoption increased earnings co-movement, which is that earnings variations are related regardless of whether the underlying economic events are similar or not. However, they also find that cross-country comparability based on the mapping of returns into earnings did not increase relative to a control sample of non-adopting firms. Barth *et al.* (2012) find that the application of IFRSs in countries previously using local GAAP enhanced financial reporting comparability with US firms, even though some differences remain. Cascino and Gassen (2011) specifically study German and Italian companies and find that the overall comparability increase is limited. However, comparability increases for firms with high compliance incentives. On the other hand, Brochet *et al.* (2012) studied companies in the UK, where the transition to IFRS did not significantly change accounting quality as UK standards were relatively close to IFRS, so any effects of IFRS adoption could be attributed to an increase in comparability. They find that IFRS adoption increases comparability and improves capital market information.

Kim, Kraft, and Ryan (2012) suggest an alternative measure of comparability, which is the variability of the adjustments that Moody's makes to better compare financial reports of companies in peer industries. They find that greater comparability is associated with lower bid-ask spreads for corporate bonds, among others. An indirect measure of comparability is the change in investment strategies. Since comparability improves the information about companies in different countries, investors are more likely to invest in foreign firms. Khurana and Michas (2011) find indeed that US investors increase the weight of stocks in countries that adopt IFRS.

The implication from these studies is that it is not necessarily the case that the adoption of the same accounting standards increases comparability. Since many countries that adopt IFRS also change their institutional environment, for example auditing, governance, and enforcement, this result is even more intriguing as one would strongly expect comparability to increase. It should be noted that the notion of comparability is different from that of quality of financial reporting, but it is difficult to separate them empirically. Thus, there may be beneficial effects of IFRS adoption that are a consequence of an increase in the quality of financial reporting rather than of higher comparability.

4. Quality of converged accounting standards

4.1 Format of the standards

Transactions and events may vary considerably across countries due to different forms of trade, different contracts, differences in legislation, and the like. Therefore, accounting standards that are globally used must encompass such differences. The IASB attempts to do this by formulating accounting principles based on the economic substance of transactions but not describing them in detail. An alternative is to add standards ('rules') for every conceivable form of transaction, something that US GAAP had followed before the convergence with the IASB. Stating principles only leaves much discretion with companies and leads to diversity in practice. Adding rules may become messy and may incorporate exceptions that contradict the main principles.

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To illustrate this concern with current IFRSs, consider the situation in some countries where it is prohibited to buy land and the common way to possess land is to rent it for, say, 99 years. According to IAS 17 such a transaction is accounted for as an operating lease. IAS 40 offers a fair value model for measuring investment property, but this option does not extend to operating leases. To extend the application of the fair value model to such specific situations, IAS 40 includes an exemption for investment property that overrides the accounting principle. Another example is the classification of financial instruments as equity or liability under IAS 32. There are countries in which certain kinds of owners' equity contributions are subject to a legal redemption provision. According to the principle in IAS 32, such instruments are classified as liability, which contrasts with the view in these countries. IAS 32 has been amended to include a highly specific and detailed exemption for such capital, which contradicts the principle. Tax regulations provide another example for the need to adjust accounting standards to accommodate country-specific tax rules. For example, in some countries holding gains are taxed differently from operating gains. IAS 12 has recently been amended to include a rebuttable assumption for the applicable tax rate of the recovery of investment property.

A different kind of challenge is the inclusion of specific forms of ownership and financing. For example, the *keiretsu* in Japan offers substantial influence and coordination among companies; the *Hausbank* financing system in Germany provides a bank with insider information and influence on companies; and Islamic finance is difficult to compare with forms of financing in Western countries. The question then is whether such transactions are economically similar to the concepts underlying the development of global standards or if they should be covered by separate standards. That is, errors would occur either if different transactions are recorded similarly or if they are indeed similar but recorded differently. Moreover, it may be difficult to clearly define the economic substance without having an unintended impact on other transactions, such as generating structuring opportunities.

4.2 Efficiency of standard setting

A major potential benefit of global accounting standards lies in the broad knowledge, experience, and expertise that can be considered and used in the process of developing standards. Setting global standards involves people from many different countries and it pulls together ideas and views from constituents worldwide. If standards are developed in a joint convergence effort, for example by the IASB and the FASB, the expertise of both large standard setters is brought to the table. Ideally, the resulting standards should then be of higher quality. The discussion of technical issues is facilitated by organizations such as the International Forum of Accounting Standard Setters (IFASS), which replaced the National Standard Setters (NSS) forum, and the Consultative Forum of Standard Setters (CFSS) that is organized within the European Financial Reporting Group (EFRAG).

Joint standard setting reduces the total cost of standard setting in the economy because of economies of scale. It avoids parallel efforts to develop standards and allows standard setters to build on expertise from others. Standards that have proved effective can be adopted and standards that did not work very well can be avoided or improved. Despite this broader set of expertise, converged standards tend to persist, as it is difficult to innovate, experiment, or simply change standards that are widely applied in practice. It is clearly not desirable to use a large part of the world as 'beta testers' of new standards; hence, changing converged standards significantly has a high cost and slows down change.

Given the existence of a global standard setter, incentives for countries to maintain their own national accounting standard setters decrease because it is costly, but the marginal benefit

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diminishes. The IASB emphasizes potential benefits of national standard setters to avoid undermining their existence. It argues that their contribution can be to bring to the IASB's attention specific issues that it should consider, to ensure consistent interpretation and application of standards, to provide feedback on implementation issues, and many more. The IASB also cooperates with individual national standard setters on particular projects.

Diminishing influence of a single national standard setter has led to the establishment of regional groups of standard setters. In the EU, the EFRAG assumes an important role in the formal endorsement process of IFRS. In addition, it undertakes pro-active projects to provide input into conceptual accounting issues. More recently, the Asian-Oceanian Standard-Setters Group (AOSSG) and the Group of Latin-American Standard-Setters (GLASS) were formed. The IASB regards these groups as the main channels of cooperation with national standard setters, as it becomes increasingly difficult for the IASB to talk to each standard setter separately. It remains to be seen how this hierarchical system of aggregating communication to the IASB will work in practice.

4.3 Politics of standard setting

Involvement of many people and different organizations in standard setting also has disadvantages. Accounting is not a technical discipline in a sense that there is a 'true' accounting, which must only be discovered; accounting is driven by objectives and requires trade-offs in achieving the objectives. Therefore, constituents may have very different views on issues: they vary in their background and experience; they may have a hidden political agenda (including perhaps to preserve the status quo); and the like. Moreover, the political power and influence of constituents may vary across countries.

Attempting to listen to all constituents is likely to slow down or paralyse standard setting because the groups of people whose views are not supported oppose the standard.[16] The quality of accounting standards can even decrease if a global standard setter avoids generating opposition to a standard and tries to please everyone by adopting lax or ambivalent standards. Alternatively, a global standard setter may be induced to consider every aspect in a new standard, which can make it difficult to discern the principle or can lead to complex and rules-based standards. Consequently, the objective of providing global high-quality standards may be compromised.

Accounting standard setting has traditionally been a target for political influence. The main reason is that accounting redistributes wealth and a new accounting standard may benefit some stakeholders at the cost of others. Political influence can be exerted by governance mechanisms imposed on the standard setter, such as monitoring boards, degree of delegation, veto power, and more subtly, financing the standard setter, particularly if it is a private body. Public lobbying and lobbying behind closed doors are other means to influence standard setters' decisions. As a result, accounting standards can include compromises and exceptions, which contradict the conceptual basis. Examples for political interference in the recent past are the recognition of changes in the fair value of financial instruments in income or directly in equity (other comprehensive income); the expensing of management stock options in income or only disclosure; and the smoothing of pension liabilities with a device known as the corridor approach.

Political pressure increases with the importance of the IASB's standards. Countries may want to gain more influence in the IFRS Foundation (IFRSF) and the IASB.[17] For example, a report to the European Parliament argues that the decision to adopt IFRS in the EU has turned IASB into a quasi-regulator and this fact would require several measures to change the governance structure of the IFRSF.[18] The IFRSF reacted with a review of the constitution

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that eventually established a monitoring group with representatives of public authorities and international organizations as a second oversight body besides the trustees. Recognizing the fact that political influence is increasingly important, the new chairman of the IASB as of 2011 was a former politician.

It is an open issue if standards developed by a global standard setter are more or less susceptible to political influence than those of national standard setters. One may argue that lobbying effectiveness reduces for at least two reasons:

- the likelihood that lobbying succeeds in affecting a standard is reduced if there are many divergent interests globally, so that there will be less lobbying impact. For example, it becomes more difficult to have an effect on standard setting if the issue arises only in one or few jurisdictions; and
- the de facto power of the global standard setter increases with increasing acceptance worldwide, so pressure by national political powers is less effective.

However, a global standard setter is vulnerable to political pressure by a major country (or group of countries) that threatens to withdraw support and perhaps develops its own accounting standards or derivatives of the global standard. For example, the EU as the 'prime' consumer of IFRS through its mandatory IFRS adoption influenced standards heavily, particularly when it comes to standards that lean more to US GAAP. In 2006, the IASB proposed the adoption of SFAS 131 on operating segments essentially word by word. After little resistance, the draft was enacted as IFRS 8 in the same year. However, the endorsement by the EU was controversial as members of the European Parliament resisted an 'Americanization' of IFRS and finally accepted it only under the provision that it be reviewed within two years after becoming effective. Indeed, the IASB is currently undertaking a post-implementation review of IFRS 8. As another example, in the wake of the financial crisis 2008, the EU threatened to write its own standard on financial instruments to facilitate reclassification out of categories that require fair value measurement into cost-based measurement, arguing that European banks should not be subject to stricter rules than US banks. The IASB reacted with a hasty amendment to IAS 39 that was passed within three or so days ignoring the due process, and the EU endorsed the amendment within another three days.

The final result of a convergence process depends on the willingness of countries to give up some of their sovereignty with respect to setting accounting standards and on the power of other countries. For example, Simmons (2001) argues that accounting standards for cross-listing pose low negative externalities to a large country such as the US, but induce high incentives for others to follow them. This would suggest little movement by the US to adopt international accounting standards. On the other hand, Posner (2010) describes a path dependency of institutional configurations and regulatory capacities that eventually made IFRS rather than US GAAP *the* international accounting standard. Véron (2007) calls the move of the EU the 'global accounting experiment', as the full consequences are not yet known.

5. Dimensions of convergence

Convergence describes the process of bringing closer together accounting standards across countries. It comprises a broad spectrum ranging from harmonization of standards to standardization by employing uniform standards. From an economic point of view, convergence is desirable if the benefits are greater than the costs in the long run. Therefore, one would expect

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convergence (to a certain degree) to occur in some settings, but not in others. It is difficult to quantify many of the benefits and costs, although it is possible to make statements on changes in net benefits and trends. For example, it is well known that the benefits of standardization increase with the adoption of the standards due to network benefits.[19] Switching costs of firms and institutions in a country are important, but are a one-time effect that needs to be traded off against the long-term net benefits of a change. In this section, I review the degree and the potential scope of convergence and discuss mandatory or voluntary adoption options.

5.1 Degree of convergence

There are several aspects that affect the degree of convergence of standards. One aspect is the flexibility of the converged standard. The harmonization in the EU was shaped by accounting directives that included dozens of options, which were essentially taken from local GAAP in case countries could not find a compromise.[20] Therefore, the success of the harmonization was low, as countries were usually able to continue with the standards with which they were accustomed prior to the directives. This example shows that it is possible to formally converge to a common standard, as long as it is flexible enough. Flexibility can occur through explicit options or principles that are sufficiently high-level so as to allow various interpretations. However, in this way formal convergence happens without bringing convergence of financial reporting practice, which also illustrates that convergence and quality are different, and sometimes countervailing, concepts. The IASB follows a different strategy: IFRS includes high-quality, tight standards with relatively few options. Converging with IFRS, therefore, implies significant change in the reporting practice and makes it harder to achieve.[21]

There are several ways to converge with IFRS.[22] The most natural way is that a country simply incorporates IFRS without any qualification. The main problem with this route is that for most countries it is not feasible to give away authority to set accounting standards to a foreign private body such as the IASB. The solution is the establishment of a formal endorsement mechanism, which includes a review of the standards and an approval decision.

Some countries incorporate IFRS within their local standards. For example, Australia adopts IFRS as part of Australian Accounting Standards. The Australian standard setter makes sure that complying with Australian Accounting Standards ensures compliance with IFRS. Again, the reference in financial reports is to Australian standards rather than to IFRS directly. The EU's endorsement process requires amending the EU regulation. This process is lengthy, not least because of the translation of the standard into the official EU languages. It involves several European bodies besides the European Commission: three committees, one technical, one political, and one that overviews the process; further, it requires votes in the European Parliament and the Council. The involvement of many different institutions increases the likelihood that a standard is not endorsed, which then creates a local version of IFRS. The EU, indeed, has carved out a specific hedge accounting rule so that the European IFRSs are not compliant with the full IFRSs.[23] Financial reports in the EU refer to 'IFRSs as endorsed by the EU'. An endorsement process allows inclusion of country-specific amendments and modifications, but hinders full convergence with IFRS and may induce confusion among users of financial statements, thus reducing the potential benefits of global standards. Moreover, an endorsement process is time-consuming and can cause a delay in the incorporation of a new standard. The SEC staff proposed a further endorsement process, labelled 'condorsement' (SEC 2011), which involves a lengthy transition period over which US GAAP would converge to IFRS before IFRS is fully incorporated.

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Convergence can also bring different sets of standards closer together. Indeed, this is probably the original use of the term 'convergence' – albeit without achieving full compliance. The IASB works to persuade countries to adopt IFRS as they are. There are some large countries that have not endorsed IFRS yet. With two of them, the US and Japan, the IASB has set up long-term convergence projects. In a Memorandum of Understanding (MoU) in 2002, known as the Norwalk Agreement, the IASB and the FASB agreed to make their standards fully compatible and to coordinate the future development of standards. The Memorandum does not explicitly talk about 'convergence'; however, in the MoU 2006 the boards reaffirmed their commitment to IFRS and US GAAP convergence, thus using the term 'convergence'. The MoU shaped much of the work programme of the IASB over the last few years, including the development of new standards on major themes such as financial instruments, leases, and revenue recognition. The FASB has been highly successful (perhaps too successful for some observers) in shaping new standards and gearing them towards its own thinking.

The history of the convergence project also reveals difficulties that the two boards have with achieving full convergence. One example is the development of a new standard on financial instruments. Probably influenced by the EU, the IASB hurried to develop a new standard, IFRS 9, as response to the financial crisis in 2008, and organized the project in a piecemeal approach. In contrast, the FASB took longer, but offered a full-fledged draft of a new standard. Despite the overall convergence objective, the draft standards differ substantially, particularly on the impairment for financial instruments carried at cost. Another example is the development of a new standard on business combinations. Here, the two boards were successful in agreeing to a common standard but, nevertheless, the IASB introduced a new option for the measurement of goodwill of non-controlling interests into IFRS 3 that is not available under US GAAP. The reason arguably was that several IASB members were uncomfortable with the full goodwill approach.

In 2007, the IASB and the Accounting Standards Board of Japan (ASBJ) signed the Tokyo Agreement, in which both boards 'share the belief that convergence towards high quality accounting standards will greatly benefit capital markets around the world' and seek to eliminate major differences in their standards. Japan has less influence on the resulting, converged standards than the US, which is evident from the work programme of the IASB that contains several joint projects with the FASB, but none with the AJSB. Therefore, convergence of IFRS and Japanese GAAP is more of a one-way street where Japan, similar to other national standard setters, influences the development of IFRS more indirectly through other channels.

The IASB is working with other large countries to reform their local accounting standards in a direction that is in compliance with IFRS. For example, China follows a 'continuous convergence process'[24] to reduce differences between Chinese standards and IFRS.

Countries can converge to IFRS in a one-sided effort. This is particularly likely if the global standards incorporate a standard on an accounting issue that is deemed of higher quality than the local standard. In contrast to 'official' convergence projects, convergence occurs on a non-systematic basis. For example, German GAAP was amended significantly in 2009 by enactment of the *Bilanzrechtsmodernisierungsgesetz* (BilMoG). Many of the new rules were influenced by IFRS, for example the recognition of development costs (which, however, are only optional), the discounting of long-term provisions, and the application of the temporary concept for deferred taxes. Earlier proposals for inclusion of the fair value measurement for certain financial instruments were so controversial that they were not included in the final law.

Finally, a minimal form of convergence is achieved by keeping local GAAP but providing additional disclosures that help users to assess how the financial statements would look like if the

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company had adopted IFRS. Reconciliation is a common means of additional disclosures, but it is costly to companies that then have to prepare their financial statements under two different accounting standards. A broad description of differences between local GAAP and IFRS without providing figures can give international users a sense of which items in the financial statements would be affected by applying different standards. Additional disclosures offer only limited benefits of convergence, but can be a starting point towards stronger forms of convergence.

5.2 Scope of convergence

Figure 13.1 depicts different categories of companies, for which benefits and costs of convergence of accounting standards towards IFRS are likely to be different. Convergence has occurred for listed companies, driven by the globalization of capital markets. Multinational companies are another group that is likely to benefit most from convergence. Indeed, IFRS focuses on capital market participants, and the EU requires IFRS for listed firms only (but with the option for other firms to report under IFRS). Listed companies and multinational companies overlap to a great extent, and they are usually also large companies.

The next category includes private companies that have a strong international orientation, such as private equity funding or trade relationships internationally. They benefit from convergence, but to a lower extent than listed companies. Finally, locally oriented companies do not reap benefits from convergence of accounting standards across countries, but incur potential costs, for example due to a misfit of the global standard with their country-specific institutional and economic setting. In particular, small and medium-sized companies (SMEs) are unlikely to benefit strongly from global standards.

This statement does not contradict the fact that the IASB developed IFRS for SMEs in 2009. This is a self-contained standard based on full IFRS. Compared with full IFRS it is less complex and tries to adjust to the needs of smaller companies. For example, IFRS for SMEs do not cover certain issues deemed irrelevant for SMEs; they contain fewer and simpler options, including some deviations from full IFRS; and they require significantly less disclosures. Interestingly, IFRS for

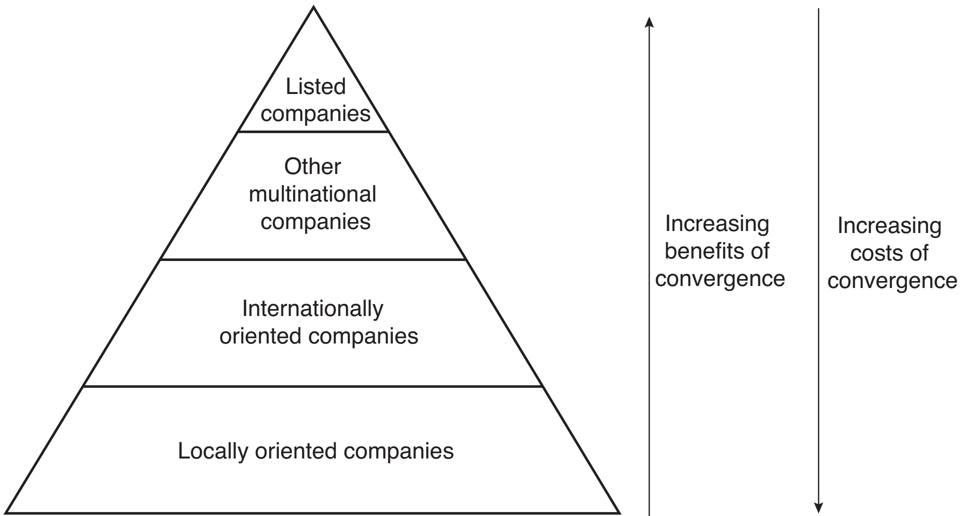

Figure 13.1 Benefits and costs of convergence for categories of companies

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SMEs derive from the same conceptual framework as full IFRS, despite the fact that the uses of financial statements are starkly different for listed companies and SMEs, particularly the weight associated with informing investors and stewardship uses of accounting information. However, the main reason for developing IFRS for SMEs has not been to bring convergence across countries, but to offer less-developed countries a set of high-quality accounting standards, which they can adopt.

A similar observation holds for public sector accounting, where the International Public Sector Accounting Standards Board (IPSASB) develops IPSAS for use in public sector entities. IPSAS are based on IFRS, but adjust them to such entities and usually lag the development of IFRS somewhat. The IPSASB has the strategic goal of converging IPSAS with IFRS. Again, the demand for IPSAS arises because there do not exist many well-developed and high-quality standards for public sector entities.

Convergence differs according to the kind of financial information. IFRS is generally applicable to consolidated (group) financial statements,[25] because they are considered the primary financial information for investors. However, most jurisdictions require other financial information in addition to consolidated statements. These include:

- separate financial statements – these often serve as a basis for dividend distribution restrictions, equity capital requirements, bankruptcy indication, and other company law and governance triggers. For example, EU regulation requires companies in the EU to prepare separate financial statements in compliance with (harmonized) local GAAP, and offers member states the option to require or allow separate statements according to IFRS. Around half of the member states give companies that option, the rest do not.
- tax reporting – determination of income taxes is based on financial statements, which can either use IFRS, local GAAP, or be based on specific tax rules that are detached from GAAP. Interestingly, the EU has been working on a common tax base since 2001 and issued a proposal for a directive on a Common Consolidated Corporate Tax Base (CCCTB) in 2011. It aims at introducing a single system for computing taxable income in the EU and its allocation to the member states, but does not address the corporate tax rate. This should alleviate the fiscal impediments of over-taxation and double taxation and should reduce administrative and compliance costs. Since the proposal has strong implications for the tax revenue raised in the member states, it has been controversial, and the proposed CCCTB is optional and not compulsory for corporations.
- regulatory financial reports – financial statements are also used as a basis for capital adequacy requirements for banks and insurance companies. The Basel framework by the Bank of International Settlement and Solvency directives by the EU are attempts to bring convergence of these requirements. Here, the main driver for convergence is globalization of the banking and insurance industry, particularly regarding competition and possible contagion effects, as witnessed in the recent financial crises. In regulated industries it is common to base rate regulation on financial information, which often requires companies to follow specific rules.
- management accounting – companies have full discretion to design their management accounting and internal reporting systems. While they usually use the financial accounting system as a basis, they often make adjustments to determine key numbers to support management decisions. The demand for converged management accounting systems is low – a benefit can derive from rolling out the management reporting system to subsidiaries in different countries.

If, and to the extent that, companies need to prepare several kinds of financial information, they incur the cost of maintaining them. Convergence between them within a company can

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reduce this cost significantly. Therefore, companies may have incentives to select among options that are useful for more than one purpose or minimize the number of adjustments they make to the information systems.

5.3 Mandatory or voluntary adoption

The analysis of benefits and costs of convergence does not differentiate whether adoption of converged standards is mandatory in a country or voluntary. Comparability is highest if companies that are in the same group (e.g. listing, industry, analyst peer group) use the same standards. Mandatory adoption is clearly preferable in this sense, but it does not take into account benefits and costs on the firm level. There may be firms that incur a net cost of applying converged standards. From a welfare perspective, mandatory adoption is preferable if the total benefits of comparability are higher than the total costs. Presumably the result of this trade-off depends on the size and the institutions in each country.

The IASB seeks acceptance of IFRS in countries worldwide. Acceptance can mean mandatory compliance with IFRS or companies being allowed to choose whether to comply with IFRS. For example, the regulation that adopted IFRS in the EU requires listed companies to report under IFRS in their consolidated statements and provides an option for member states to require or allow other companies to use IFRS in their consolidated statements or to use IFRS in separate financial statements. The options enacted in the member states vary significantly,[26] providing evidence of different net benefits of a convergence with IFRS on the level below that of listed firms.

Convergence can occur on the country level, which has the advantage that the standards can be mandated and enforced by the institutions in the respective country. To avoid the legal system, a company would have to move its headquarters or incorporation into another country that has a different legal system. An alternative is convergence on the stock exchanges level. In this case, exchanges require IFRS within their contractual listing requirements. Companies can choose to be listed on a particular stock exchange or market segment. At the other end of the spectrum is the firm level: companies can decide to prepare financial statements in accordance with IFRS, with the caveat that they may be required to prepare a second set of financial statements to conform with the local law, which is a costly undertaking. Indeed, voluntary adoption was the driver for several countries accepting IFRS consolidated statements to replace consolidated statements under local GAAP. Leuz (2010) proposes the creation of a global player segment, which would comprise companies that apply the same accounting standards (IFRS) and are subject to the same enforcement mechanisms and have similar reporting incentives. This institutional environment should be provided by a supra-national body, such as, for example, IOSCO or ESMA. This proposal does not require countries' institutional settings to converge in order to generate a measurable benefit of converged accounting standards. Companies would be able to self-select into this superior institutional environment and reap the economic benefits associated with global financial reporting.

The voluntary adoption model is not restricted to a single global standard. Alternatively, it can allow for competition among global standards. Competition among standards offers some benefits over a standard setting monopoly, but also some costs.[27] To realize benefits of competition among standards the candidate standards should be sufficiently different; competition among converged standards is pointless. Benefits stem from the fact that there are several competing accounting theories that lead to stark differences in financial reporting, such as the prevalence of the asset–liability or

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the revenue–expense approach or different measurement concepts. Mixing them in a single set of standards may lead to a result worse than having companies choose which concept fits their needs better. Competition is likely to increase innovation in accounting standard setting and to reduce the susceptibility of the standard setters to capture by political influence. Moreover, the market shares of the standards can indicate the quality of the standards. Disadvantages relative to a single standard are the lower comparability across companies and reduced benefits from standardization; moreover, standard setting is more costly. Ray (2011) identifies economic settings in which uniform standards or a choice among few standards is preferable. Bertomeu and Cheynel (2013) show that having two standard setters can improve welfare due to more company information being available in the capital market. This result also suggests that competition among standards does not inevitably lead to a race to the bottom, but can go to the top.[28]

6. Conclusions

'The creation of a truly global set of accounting standards is a long-held dream for many. … a global accounting language is likely to end up with some distinctly different national dialects' (Reilly 2011, p. 873). This chapter has examined benefits and costs of convergence of accounting standards, mainly using the historic case of the convergence with, and adoption of, IFRS. This case also illustrates the abundance of dimensions convergence can take and the importance of institutions and incentives to achieve convergence of financial reporting in practice. It also provides insights into the politics of accounting standards.

It is remarkable how successful the IASB has been in promoting IFRS globally in a relatively short period. Unsurprisingly, it has not achieved full convergence, and will perhaps never do so. Also, research has documented mixed results on the economic effects. But it has shown that more emphasis should be put on convergence of institutions relating to accounting if convergence should be achieved. Indeed, there are many efforts underway to harmonize auditing, corporate governance, and enforcement. On the other hand, it is clear that convergence to IFRS benefits a small segment of companies that are internationally oriented, so there are limits to convergence.

Finally, the analysis should remind us that there is no 'correct' accounting per se, but accounting is driven by the objectives of financial reporting and has economic effects. There are many different ways of accounting for transactions and events and of providing information to users of financial statements. Therefore, whether and how much convergence is really desirable is a challenging question.

Notes

Helpful comments by Christian Groß are gratefully acknowledged.

1 See, e.g., Nobes and Parker (2010).
2 For a detailed account of the history of the IASC and IASB respectively see Camfferman and Zeff (2007) and Zeff (2012).
3 In the 1990s, the G4+1 Group of standard setters (Australia, Canada, New Zealand, the UK, and the USA) worked on a convergence of accounting standards at least for Anglo-American countries. It disbanded in 2001 with the establishment of the IASB.
4 This does not suggest that convergence is more important than quality; in fact, it is probably the opposite (see Jamal *et al.* 2010).
5 See, e.g., Benston *et al.* (2006), pp. 6–14.
6 See, e.g., SEC (2003) and Hail *et al.* (2010a).
7 See SEC (2008), pp. 11–18.
8 See, e.g., Ball *et al.* (2003) and Daske *et al.* (2008).

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9 See, e.g., Walker (2010).
10 For example, La Porta *et al.* (2000) describe the influence of legal families on investor protection. See also Leuz (2010) for a clustering of institutional variables.
11 Schipper (2005) predicts an increasing demand for implementation guidance. Interestingly, global audit firms provide voluminous commentary books with their views of the application of IFRSs.
12 Dahlgren and Nilsson (2012) provide several examples of the difficulties of translating IFRS into European languages.
13 See Berger (2010), pp. 28–9.
14 For more background information see Benston *et al.* (2006), pp. 243–54.
15 Only excerpts from this database are publicly available.
16 In contrast, Perry and Nölke (2006) argue that the IASB was able to rapidly promote and introduce fair value measurement because it is a transnational private authority and did not require as much political process.
17 The IFRSF also has incentives to grow and increase influence. See Wagenhofer (2009).
18 See Committee on Economic and Monetary Affairs (2008).
19 Ramanna and Sletten (2012) find that perceived network benefits explain the staggered adoption of IFRS around the world and also find that network benefits are more important for smaller countries. See also Wähirsch (2001) for an analysis of network effects.
20 The Fourth Directive (separate accounts) includes some 60 and the Seventh Directive (consolidated accounts) some 50 options. See Benston *et al.* (2006), pp. 136, 141–5.
21 However, Daske *et al.* (2013) show that even within the group of IFRS adopters some firms make few changes and adopt IFRSs more as a label rather than increasing their commitment to transparency.
22 See, e.g., SEC (2011), Hail *et al.* (2010b).
23 The significance of this carve-out is marginal. A study by ICAEW (2007, p. 78) identified eight banks in the EU that have used it.
24 See Michel Prada, Chairman of the IFRS Foundation Trustees, in a speech delivered in Frankfurt on 27 June 2012 (www.ifrs.org/Alerts/Conference/MP+Frankfurt+speech+June+2012).
25 IAS 27 and IAS 28 contain few standards for separate financial statements; and the discussion about the definition of a reporting entity in the conceptual framework clearly shows that separate financial statements are not in the focus of the IASB.
26 See the Implementation of the IAS Regulation (1606/2002) in the EU and EEA provided by the EU as of July 2010 (http://ec.europa.eu/internal_market/accounting/docs/ias/ias-use-of-options2010_en.pdf).
27 See, e.g., Dye and Sunder (2001), Sunder (2002, 2009), Benston *et al* (2003, 2006), Walker (2010).
28 See also Huddart *et al.* (1999) for the case of exchange level competition.

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