Taking Account: Convergence with International Accounting Standards

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Taking Account: Convergence with International Accounting Standards

General Background Slides
“The rapid development of global financial markets has greatly reinforced the desirability of – indeed now demands – international consistency in accounting standards and auditing approaches.”

Paul Volcker
Chairman of the Trustees of the IASC Foundation
June 2001
Differences in global standards

• **Recognition and measurement of:**
  – Financial assets and derivative financial instruments
  – Impairment losses
  – Provisions
  – Employee benefit liabilities
  – Income taxes

• **Disclosure of:**
  – Related party transactions
  – Segment information

• **Accounting for business combinations**

*Source: www.ifad.net.*
<table>
<thead>
<tr>
<th>Question</th>
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<tbody>
<tr>
<td>Are the country's accounting standards on recognition and measurement in accordance with International Accounting Standards?</td>
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<td>Are the country’s accounting standards on disclosure in accordance with International Accounting Standards?</td>
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<td>Must firms account for financial assets at fair market value?</td>
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<td>Are large shareholders (5%) required to disclose share of ownership?</td>
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<td>Does the stock exchange maintain a set of corporate governance guidelines?</td>
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<td>Are annual reports available to shareholders or the public on demand?</td>
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<td>Are public corporations’ financial statements required to be reviewed by an external auditor?</td>
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<td>Have exchanges established disclosure requirements?</td>
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<td>Are banks required to have an independent audit?</td>
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<td>Are there annual banking inspections?</td>
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<td><strong>Strength of auditing and reporting standards</strong></td>
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</tbody>
</table>

*Source: Milken Institute.*
Opacity Index, 2007-2008

Accounting/disclosure standards

Higher scores denote more opacity

Source: Milken Institute.
Opacity Index, 2007-2008

Maximum = 100

Source: Milken Institute.
Taking Account: Convergence with International Accounting Standards

Robert Herz’s Slides
International Convergence and the Possible Use of International Financial Reporting Standards (IFRS) in the U.S.

Robert H. Herz
Chairman, FASB
April 28, 2008

The views expressed in this presentation are my own and do not necessarily represent official positions of the Financial Accounting Standards Board. Official positions of the FASB Board are arrived at only after extensive due process and deliberations.
Why international convergence?

- Continuing globalization of investing, M & A, trade, major corporations
- Different accounting languages add costs and complexity
  - For companies
  - For investors
- “Pax Americana” unlikely; growing use and acceptance of IFRS
- But to be truly “international,” must include the United States
Possible paths to a single set of global accounting standards

• By fiat, i.e., governments/securities regulators mandate one set of standards
• Through competition among standard setters (let the market decide)
• Through a structured convergence process
The progress of convergence

- Pre-2001: Old IASC, “Harmonization Efforts”
- 2001: Establishment of IASB with support of FASB and SEC
- 2002: Norwalk Agreement between FASB and IASB
- Official support from SEC, Congress, others
- 2005: SEC staff roadmap for eliminating the reconciliation for IFRS filers
- 2006: FASB/IASB memorandum of understanding
- 2007: SEC eliminates reconciliation requirement for “full IFRS” foreign filers and explores allowing U.S. registrants to choose IFRS
- 2008: FASB and IASB update memorandum of understanding
  SEC issues proposing release on IFRS option/moving to IFRS in the U.S.?
- Currently more than 100 countries require or permit IFRS, with others planning to do so.
Key aspects of FASB – IASB convergence process

- Agenda alignment
- Joint projects on major topics
  - Full joint
  - “Modified joint”
- “Short-term” projects on narrower areas of difference
- Conduct of projects
- Not just convergence for the sake of convergence, but also improvement
Some challenges to convergence

- Starting from different places
- Differences in institutional, regulatory, business, and Cultural environments
- Potential agenda misalignment
- Getting boards to agree/resolve differences
- Resistance to change from certain constituents
- Politics
- U.S. demand for detailed guidance and special industry standards
- IASB funding, governance, and staffing
- Inconsistent application of IFRS
  - “As adopted” versions
  - National flavors due to inconsistent application
Progress to date

• **Major areas**
  – Share-based payments
  – Business combinations
  – Income taxes
  – Segment reporting

• **Narrower areas**
  – Changes in IFRS to U.S. GAAP
  – Changes in U.S. GAAP to IFRS
Current convergence agenda (per MOU)

• **Major projects**
  – Conceptual framework
  – Financial instruments
  – Financial statement presentation
  – Lease accounting
  – Revenue recognition

• **Modified Joint Projects**
  – Consolidations
  – Fair value measurement
  – Insurance
  – Liability vs. equity
  – Pensions and OPEBs

• **Continuing projects on narrower areas, for example, earnings per share**
So what’s needed to achieve a global reporting system?

- Internationally?
- In the U.S.?
What’s needed internationally?

- **Address national/regional endorsement mechanisms** that produce “as adopted” versions of IFRS
- **More consistent application** of IFRS to avoid “national flavors”
- **IASB to fill in major gaps** in IFRS (e.g., insurance, extractive industries, rate regulation)
- **Improvements in major areas** (e.g., per FASB – IASB MOU)
- **Strengthening IASB as a global standard setter**
  - Funding (ongoing efforts by IASC Foundation Trustees)
  - Staffing
  - Governance/oversight (proposed regulatory “monitoring body”)
  - Structure (e.g., having multiple locations)
What’s needed internationally? (cont’d)

- Converge and standardize other elements of corporate reporting package (disclosures, MD&A)
- Improve and converge global auditing standards and practices and oversight of auditors
- Improve coordination of global regulatory review and enforcement
So what’s needed in the U.S.?

• **Decide where we want to go:**
  – Much of the rest of the world has declared for IFRS
  – End game in U.S. not clear right now. Could be:
    1. “Mutual recognition” for foreign filers only
       a. with continued convergence over many years
       b. without convergence (perhaps competition between standards)
    2. Two-GAAP system for the U.S. registrants
       a. With continued convergence over many years
       b. Without convergence (perhaps competition between standards)
    3. A single set of high-quality international accounting standards

• **Each path has very different implications for standard setters, preparers, auditors, investors, regulators, educators and on overall system costs and complexity**
So what’s needed in the U.S?

Would some U.S. companies choose to use IFRS?

• **Probably, if perceived benefits exceed perceived costs**
• **This might be so for U.S. companies:**
  – With a majority of operations in countries that require IFRS
  – Whose principal competitors use IFRS
  – That are U.S. subsidiary of foreign parent that uses IFRS
  – That prefer the IFRS treatment(s) in key area(s)

**BUT**

• **A two-GAAP system for U.S. registrants would:**
  – Add complexity and reduce comparability for many users
  – Add to overall cost and complexity of our (already complex) U.S. reporting system

**Note that convergence can obviate or reduce these added costs and complexity.**
If we are to either broadly permit and/or eventually require IFRS in the United States, we need a national plan with a “blueprint.”

– Other countries develop plans before moving to IFRS.

– U.S. plan needs to specify required action steps and related milestones and target dates.
So what’s needed in the U.S.? (cont’d)

- **Action steps would cover such things as:**
  - Continued convergence between and improvement in U.S. GAAP and IFRS (e.g., all or some of the projects in FASB – IASB MOU)
  - If to a single set of standards, how to eliminate other areas of difference between U.S. GAAP and IFRS
  - Changes in education, training, CPA exam, etc.

- **Changes in contracts, regulatory requirements and state laws tied to U.S. GAAP**
  - Systems changes, 404 control changes, and data gathering by companies
  - Evaluating related SEC accounting and disclosure requirements (including what’s in financials vs. other parts of filings)
  - Dealing with “special issues” like LIFO
So what’s needed in the U.S.? (cont’d)

- Assessing impact on and approach to reporting by private companies and not-for-profit entities (different GAAP or “vertically integrated”?)
- Impact on XBRL development and use
- Cultural, behavioral, and structural changes in the U.S. to better handle a more “principles-based” system with less detailed guidance
- Determining role of FASB and SEC in a global system
- Target date or date(s) for adoption of IFRS
  - Perhaps staggered to allow for learning and capacity issues
  - Should early adoption be permitted (and, if so, by any registrant or qualified)
- And many more issues . . .
FASB and FAF support moving to a single set of high-quality international standards

• Preferred by investors: enhances comparability, reduces analytical complexity
• Consistent with continuing globalization of capital markets
• Would bring the U.S. into alignment with most other international capital markets
• We advocate a well planned “improve and adopt” approach to transitioning the U.S. to IFRS
  – Improvement through continued joint projects between IASB and FASB in major areas
  – Directly adopt other parts of IFRS
• Helps avoid/reduce added costs and complexity of having a two-GAAP system for an extended period
Implications for individual companies and boards of directors

- **Monitor continuing developments**
- **Evaluate overall impact on company:**
  - Will early adoption of IFRS be available?
  - If so, evaluate pros and cons, costs and benefits
  - When will mandatory adoption be required? Will we be ready?
- **Develop a plan for identifying and addressing conversion issues, including:**
  - Ability to handle more “principles-based” reporting
  - Impacts on accounting policies, practices, disclosures, systems, 404 controls
  - Whether additional expertise is needed at company and board levels and/or via external service providers
Implications for individual companies and boards of directors

- Potential impacts on employee and executive compensation arrangements, loan and financing agreements, contractual arrangements, regulatory requirements, and taxes (e.g., use of LIFO)
- Communicating with internal and external stakeholders (investors, analysts, etc.) re: plans and expected impacts

- **In summary, this needs to be treated as a major implementation project:**
  - Well planned and resourced
  - Appropriate oversight and involvement of senior management, board and relevant committees (e.g., audit, finance, compensation committees)
  - Timely internal and external communication
Some final thoughts

• A threshold issue for U.S. reporting system
• Companies and directors should closely monitor developments and begin evaluating implications
Taking Account: Convergence with International Accounting Standards

Neri Bukspan’s Slides
Accounting and financial reporting standards are in a great state of flux. Globalization and recent market trends raise fundamental questions relative to:

- The role of the U.S. GAAP/FASB;
- The role of the IFRS/IASB;
- The role of global securities regulators;
- The role of auditors;
- The dividing lines between accounting and financial reporting;
- Big GAAP vs. Small GAAP; and
- The role of technology (XBRL) in financial reporting.

Given the complexity of the business environment and transactions, financial reporting in its current state is not adequate to meet the information needs of analysts.
State of financial reporting – analyst’s perspective

- Too many fundamental accounting standards and issues are in play:
  - The FASB and IASB are “rethinking” their conceptual frameworks;
  - Format and structure of income statement and performance reporting;
  - Consolidations;
  - Liabilities & equity definition;
  - Business combinations;
  - Leases;
  - Derivatives accounting and disclosures; and
  - Financial instruments...

To name only a few.
State of financial reporting – analyst’s perspective

• In addition, the SEC…
  – Formed an advisory committee on Improvements to financial reporting;
  – Eliminated the foreign issuers’ reconciliation to U.S. GAAP (commencing in 2008); and
  – Is exploring how to allow U.S. registrants to adopt IFRS.
State of financial reporting – analyst’s perspective

• We must adopt to the constant rate of change.
• Difficult to compare financial information – consistency is lacking:
  – Between periods;
  – Between countries;
  – Within countries; and
  – In some cases, even within the same company.
• Accounting is predominantly “backward-looking” – more retrospective than prospective.
• Mixed attributes persist.
• Disclosures are incomplete, hard to navigate, and often in dire need of a translation to plain English.
• Aggressive accounting and structuring further muddy the picture.

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Challenges of financial reporting in a global economy

• **International Financial Reporting Standards (IFRS)**
  – Are principles-based, permitting greater flexibility to tailor attributes to company-specific experience; and
  – Comparability and subjectivity of assumptions and consistency of methodology across peers.

• **U.S. Generally Accepted Accounting Principles (GAAP)**
  – Are rules-based, encouraging more comparability and consistency; and
  – Rules without an overarching philosophical context have encouraged varying practical interpretations and necessitated restatements.

• **IFRS, being principles-based, allows for more flexibility, but in its current state may not resolve analytic issues around complexity and transparency.**

• **The SEC’s decision to permit foreign-based companies to file without a reconciliation to GAAP and its proposal to permit U.S. companies to use IFRS heightens comparability concerns.**

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International Financial Reporting Standards

- **What are the potential benefits?**
  - Reporting transparency and efficiency – more universally understandable financial statements prepared under a single global system;
  - Increased market liquidity and lower cost of capital;
  - The recognition that a principles-based approach better captures the economics of highly complex transactions and business environment; and
  - Large multinationals likely will benefit the most.

- **Will the benefits be universally recognized?**
  - This important question speaks to fundamental success of convergence;
  - The answer, unequivocally, is NO.
  - Small/medium sized entities? Non-public?
  - It will also not ensure consistent enforcement, interpretations, and auditing.

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Some potential issues

• Structural issues abound:
• Resource availability (accountants, companies, universities, etc.);
• Changes to educational curriculum;
• Systems changes;
• Responsibility for standard setting – would countries let go of control over accounting-standard setting?
• Adequate representation in standard setting bodies;
• Political pushback – carve-outs, local applications;
• Adequacy of IASB resources and funding – users’ representation; and
• The impact on regulations tied to U.S. GAAP (e.g., banking, utilities, insurance).

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Accounting and ratings

• Accounting does not drive ratings.
• Rather, it reflects a fundamental difference between accounting and analysis; the accountant necessarily must find one number to use in presenting financial data: The analyst, by definition, picks apart the numbers.
• Good analysis looks at multiple perspectives and uses adjustments (as well as other data – e.g., sensitivity analyses) as an analytical technique to depict a situation differently for a specific purpose, or to gain another vantage point(s).
• Understanding the underlying accounting methodology and its implications is an integral component of Standard & Poor’s “fundamental analysis” (part of our assessment of management capability and its financial policies).
• We strive to adjust reported figures for comparability where there are material differences (period-over-period and peer group – including on a global scale).
Accounting and ratings

• Generally, we would not expect transition to have a significant ratings impact.
  – The analytical approach already adjusts to reach ‘economic’ presentation;
  – New information may come to light which may drive ratings actions, but we would not expect this to be widespread;
  – Adverse/favorable market effects; and
  – Regulatory, covenants, and existing contractual provisions.
Our wish list for financial reporting

- **We strongly support global convergence and consistency.**
  - It enhances cross-border comparability and analysis, supporting globalization of capital markets; and
  - Our ultimate goal is to have a single set of globally accepted accounting standards that are consistently applied and audited.

- **Eliminate mixed attributes: some assets/liabilities reported on historical (accrual) cost or fair value basis (with better disclosures).**

- **Provide forward-looking information of projecting future performance (with sensitivity analysis to major assumptions).**

- **Enhance the usefulness of the balance sheet, income statement, and cash flows statement: ensure that these better match economic reality.**

- **Greater linkage between accounting and how the business is being run is needed.**

- **We believe a comprehensive holistic approach is necessary, because the quick-fix approach did not serve analysts well in the past.**
Taking Account: Convergence with International Accounting Standards

Jerry de St. Paer’s Slides
• Financial Accounting Standards Advisory Council
• Meets four times a year
• Considers items to be put on the FASB Agenda
• Makes standards recommendations to FASB
• Became a member of FASAC in March 2008
• I don’t speak for the FASAC or the FASB

BUT

FASAC encourages its members to speak on the public issues being considered by the FASB
• Senior Vice President – Finance
• Today, I will not be speaking for AIG
Group of North American Insurance Enterprises (GNAIE)

- Executive chairman of a 16-person board
- GNAIE originally formed by the chief financial officers of some of the largest life and p/c insurers in America
- Pro-active effort to assist and work with accounting and regulatory standard setters in creating high-quality international accounting standards
- Don’t speak for them, but my comments will be generally consistent with their views
Preparing for 21st Century Accounting

Jerry.deStPaer@GNAIE.net
What we stand for

• GNAIE supports the development of a single set of high-quality, robust international accounting standards for the insurance industry that are principles-based.

• The standards must show current and past financial results, financial health, future performance, and cash flows.

• To be acceptable, the standard must address the real different business models of the life and property-and-casualty insurance companies.

• GNAIE believes that IFRS can be the appropriate framework for arriving at such standards.

• GNAIE is committed to proactively provide input into the IFRS process.
“Being an accountant gives him that extra aura of danger.”
Insurance contracts

- When do you recognize revenue?
- How do you present your performance?
- What is an asset? When is it no longer your asset? How do you measure that?
- What is a liability? When is the liability over?
- How do you record changes in assets?
- How do you record changes in liabilities?
- (Notice I haven’t said the word “insurance”)
- (That’s because these issues apply to everyone.)
Insurance is the window to high-quality international accounting standards.

And it’s a two-way window, since the major issues of the IASB are windows to successfully completing the insurance project.
## Connectors

<table>
<thead>
<tr>
<th>Joint projects</th>
<th>Insurance contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conceptual framework:</td>
<td></td>
</tr>
<tr>
<td>• Definitions of assets and liabilities</td>
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<td>• Recognition and measurement</td>
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<tr>
<td>Revenue recognition</td>
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<tr>
<td>Financial statement presentation</td>
<td></td>
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<tr>
<td>Liabilities and equities</td>
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<td>Financial instruments accounting</td>
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<td>IASB review of fair value measurement</td>
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<td>Insurance liability</td>
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<td>Insurance asset</td>
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<td>Contract measurement?</td>
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<td>Contract fulfillment value</td>
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<tr>
<td>Calibrating to no gain at issuance</td>
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<tr>
<td>Participating contracts</td>
<td></td>
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<tr>
<td>Definition of insurance</td>
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<tr>
<td>Reality of level 3 accounting</td>
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Insurance is precedential

- Extractive industries: gas, coal, oil, diamonds
- Leasing
- Pensions
- Financial instruments
- Government contracts
- Subscriptions
- Promises of future benefits (e.g., airline miles)
Choices

Multiple GAAP systems, country by country
Double GAAP
FASB Adopts US GAAP --------- IASB Adopts IFRS

Pick one – easy
Pick one per country – hard
MAJOR LEGACY HEADACHE AND NO INTERNATIONAL BENEFIT

WORST CASE – PICK U.S. GAAP – LIVE WITH IT
IT’S GONE - YOU’RE IN IFRS
Credit turmoil

• Institute of International Finance
  – The banks report

• Financial stability forum
  – The central banks and regulators report
  – IASB sets its agenda
  – European commission sets hearings
  – Insurance supervisors call meetings
  – All within 7 days. Sounds like a plan
Not just banks

- Major U.S. businesses affected
- Institutional investors
  - Pension funds
  - U.S. insurers– $3.8 trillion worldwide
  - Mutual funds
  - Monoline bond insurance companies
  - Financial guarantee insurers
  - Others
Worst accounting idea

• Recognizing you can’t transfer a liability to another person; you create exit value that uses a hypothetical subjective calculation, based on mythological assumptions open to manipulation and inconsistent application.

• Choose your slogan: Mark to Model, Mark to Myth, Mark to Meltdown, Mark to Mystery, Mark to Muse, Mark to Mirage...

• Every day a new description of a bad idea.
Second worst idea

Recognize gain at issuance of a contract

ENRON-style accounting
Third worse idea

Reduce reserves and capital as the company gets weaker

Own credit risk
From those wonderful folks who brought you fair value
Must work for preparers

• GNAIE believes that decisions on the best accounting standards for insurance contracts can be made only after:
  
  – 1) the main concerns raised by GNAIE and others are considered;
  – 2) impact assessments are conducted and the results analyzed;
  – 3) more thought is given to the relationships between the insurance contracts projects and other projects on the IASB and FASB agendas;
  – 4) discussion with the FASB on whether the insurance contracts standards should be pursued as a joint project by the two boards.

• Impact assessment of the results of such standards is particularly critical before the standards are implemented.
• It will be much easier to correct problems before a standard goes into effect.
Why FASB should join the Insurance Contracts Accounting Standards Project

• The development of a single global set of high-quality insurance contracts accounting standards is necessary given the global nature of the insurance industry today, and the need for globally efficient capital markets.

• The process by which such standards are developed should be as inclusive as possible, and reflect input from key standards setters from Asia and North America, including FASB.

• FASB’s participation will ensure that such standards are in line with the realities of the U.S. insurance market, and assist in a smooth transition for the industry to a global standard.

• Failure on FASB’s part to join the project could result in either a “multiple recognition” system under which “dueling” and often inconsistent standards are used throughout the world…or a situation in which the U.S. is “left out” of a set of standards adopted by the rest of the world. Both outcomes would place U.S. insurance companies at a disadvantage.
• “You almost never hear companies complain about squishy valuations that result in large gains. Make them report huge losses, though, and there's no end to the corporate whine-a-thon about fair-value accounting.”

AIG, BIA Show Whinning Back in Vogue
Jonathan Weil, March 5, 2008

• Isn’t it the accounting forcing the writedowns of the securities to what they are worth that is causing all the market turmoil?
“If only we didn't know how badly off the banks are, then maybe we could save the financial system as we used to know it.”

• “Myth No. 1: The rules known as Financial Accounting Standard No. 157 are to blame.

• Myth No. 2: Mark-to-market accounting is new.

• Myth No. 3: Companies aren't allowed to explain their mark-to-market values.

• Myth No. 4: Eliminating mark-to-market accounting will prevent margin calls.

• Myth No. 5: The public would be better off without mark-to-market accounting.”

Don't Blame Mark-to-Market for Banks' Problems
Jonathan Weil, March 17, 2008
“Financial firms plagued by massive write-downs on their mortgage-related debt are trying to convince investors their fortunes aren’t as desperate as they seem.”

Companies try to steer investors’ view on mark-to-market accounting