When you think of the accounting standards-setting process, a horse race doesn’t often come to mind. But as Bob Herz, chairman of the Financial Accounting Standards Board (FASB), has been known to claim, simultaneously improving U.S. Generally Accepted Accounting Principles (GAAP) and converging them with International Financial Reporting Standards (IFRS) can sometimes be like “riding two horses at the same time.” Indeed, on the heels of the economic crises, and with the urging of the G20, the FASB and the IASB seemed to be at full gallop in their joint efforts to develop a single set of global accounting standards for adoption in the U.S. and elsewhere around the world, with 2010 and 2011 slated to see the release of an unprecedented number of major new standards. But the standards-setting Boards recently announced changes in their convergence work plan and timetable to provide constituents with more time to properly review and comment on proposals. All this begs the question of whether

Pursuing the Vision

Interview with
Robert Herz
Chairman of the Financial Accounting Standards Board (FASB)

By Ramona Dzinkowski
and when IFRS might be coming to America.

In this exclusive U.S. interview for *Strategic Finance*, Bob Herz provides an authoritative view on timing and other questions surrounding the convergence path and also talks about some of the hurdles to be jumped along the way.

**RD:** One argument for the global adoption of the International Financial Reporting Standards is that a common framework for financial reporting would increase the transparency and comparability of financial results between companies from different countries, thereby creating a level playing field for capital and ultimately improving capital mobility. To what extent does this apply to the U.S. economy/capital market, which is relatively autarkic?

**BH:** A key potential benefit of IFRS is that it could yield greater comparability across the globe, and if it didn’t reduce the quality and comparability of reporting within the U.S., then you could say on balance it could have net positive benefits to the U.S. That’s a key question the SEC [Securities & Exchange Commission] is looking at: whether IFRS as written and, perhaps even more importantly, as it’s being implemented around the world, results in sufficient quality and comparability or not. A little over a year ago, the FASB and the Trustees at the Financial Accounting Foundation [FAF] engaged two groups of independent researchers to assess the public policy and economic implications of adopting IFRS in the U.S., including the potential cost/benefit issues. They observed that the potential benefits would likely be greater for larger international companies that have many subsidiaries and operations around the world, but, for a domestic-only company, it’s less clear. And the benefits to U.S. investors are also not that clear because, while they have been increasingly investing in foreign securities, the bulk of U.S. investor dollars are still invested domestically. That’s right now. But, in the longer term, if current trends continue where the U.S. share of global GDP and global capital markets is declining and U.S. investment in foreign securities continues to increase, then the cost/benefit equation may start to become clearer.

**RD:** How far off are we in having a common set of standards, and where will they have the most impact?

**BH:** If, in fact, the two sets of standards were substantially converged, then the impact at the point of conversion would be much less, and the cost/benefit issue would be much more a moot point as well. The switch wouldn’t be a big deal. However, as it stands now, there are still some very significant differences. We have very specific industry accounting for insurance, but we’ve been working together with the IASB to try to create a new common standard. They don’t have accounting as of now for extractive industries, including oil and gas, where we have quite specific standards. They don’t have any specific standards for utilities or other rate-regulated enterprises. They’re working on both extractive industries and rate regulation, but it might be a number of years before they have standards in those areas. There are also particular standards that we have in the U.S. that either they don’t have or are different from U.S. standards that may impact certain industries or companies if the difference remains. For example, we allow LIFO [last-in, first-out] accounting for inventory; they don’t. To the extent that manufacturing companies, distribution companies, and retail companies use LIFO, that would be a big issue. Also, for international companies with overseas subsidiaries, we have a very different standard related to unremitted earnings of foreign subsidiaries. So there are a number of differences right now that, unless we work them out in convergence, would have significant impacts on particular companies and particular industries.

**RD:** The G20 has called for convergence of IFRS and U.S. GAAP by 2011, but many companies have asked for a slower pace. What are the costs and benefits of slowing down this process?

**BH:** Last year the G20 called upon us to “redouble” our joint efforts to get our Memorandum of Understanding program done by mid-2011. In response, we greatly intensified our joint efforts. But we got to a point where it became clear that, in order to meet mid-2011, we would have to issue somewhere between seven and 10 exposure drafts around mid-2010. In our view, that just wasn’t in the cards. A very important part of our ability to issue quality standards is to make sure that constituents have the ability to properly review, digest, and comment on our proposals. Putting out seven, eight, nine, 10 proposals simultaneously wasn’t reasonable in that regard. We’re trying to work as expeditiously as pos-
sible, but, at the same time, it's imperative that we maintain proper due process and that there's quality in both the process and the end product. So we've revised the work plan, both in terms of the timing of issuing proposals and finalization of new standards and in terms of the scope and approach to certain projects. A natural consequence is that there will be fewer converged standards in the near term.

**RD:** To what extent has the current economic environment impacted the convergence process, and when is the right time to adopt IFRS?

**BH:** Many companies in the U.S. are dealing with business issues emanating from the recession, with cash management, and with risk management, and they've recently come off their SOX 404 implementation projects a couple years back. We're certainly cognizant of these factors, as is the Securities & Exchange Commission. That's why we were pretty adamant about reworking the MOU work plan. We're also planning to come out with a document this year that talks about the issues associated with implementation. How much time is needed to implement the various new standards? Should different changes be batched? Should it be done on a staged basis? So we're going to probe all these issues with companies, with auditors, and with the investment community. The first step is to issue good standards. The second question is how long it takes to properly implement them and how best to do it. U.S. issuers have consistently said they will need a number of years of lead time in order to do it properly. It will require identifying areas of differences, systems changes, changes in contracts, etc. The larger public companies will have to put new 404 controls in and a number of other things. So I don't think a broad mandatory switch to IFRS is likely to occur in the next few years. What could happen is that if the SEC makes a decision in 2011 or 2012 that we'll move to IFRS at some point in the future, they might allow for early adoption for those companies that wanted to do so and were prepared.

**RD:** We see some major standards coming down the pipe soon. Can you provide some high-level insight into the main issues/impacts on U.S. financial reporting as well as potential economic/industry impacts surrounding the emerging converged standards?

**BH:** Let me first deal with accounting for financial instruments. That is a key subject, particularly to financial institutions, because it deals with how to measure and report their main assets and liabilities financial instruments. Our plan is that once we have both received comments and other input on our respective proposals to see if we [FASB and IASB] can come to a converged answer. That will probably start in the fall and require fairly intensive joint deliberations into the winter and next spring. It's a very challenging area. The instruments and transactions are often complicated, and a key issue is where to use fair value vs. amortized cost or both. Leases is another area that could have a big impact. If you're a retailer and you lease most of your stores, it could have a big impact. If you're a manufacturer and you lease most of your big-ticket equipment, it could have a big impact. There is another major project on financial statement presentation, which has the potential to significantly alter the look, feel, and organization of the basic financial statements. That includes potential changes to the cash flow statement, moving from the indirect method, which is what almost everybody does now, to the direct method. That has potentially significant implications on companies' accounting systems, and with that comes the potential for incurring additional costs. We are carefully looking at all these issues.

**RD:** Some suggest that “mark to market” has been one of the principal culprits leading to the failure of some of the large U.S. financial institutions. How do you respond to this view?

**BH:** I think it’s somewhat disingenuous for people to blame fair value accounting. A number of independent studies of the failure of financial institutions and of the financial crisis point to other causal factors. After all, our standard didn’t make lenders extend poorly underwritten or fraudulent loans or require that they then be packaged into ridiculously complex securities, and it didn’t make lenders write mountains of derivatives on top of them and turn a blind eye to the underlying risks in these “toxic” investments. And we’re certainly not responsible for the lack of a proper market infrastructure for derivatives and asset-backed securities. All this had nothing to do with accounting. It had to do with other forces and incentives in the system—or lack of them. It had to do with a lack of proper risk management, lack of controls, too much easy money. That’s point one. Second, where fair value was used, many believe that it gave an early warning sign of problems that managements weren’t acknowledging and that weren’t being properly captured by historical cost accounting. And in that regard, the idea of writing down assets in economic downturns, including lower of cost or market principles, is hardly a new one. If there was any
legitimate blame, it wasn’t fair value but the continued use of off-balance-sheet vehicles for securitization and structured investment vehicles. Clearly the prevalence of off-balance-sheet accounting that kept things out of sight, out of mind, and, in substance, increased your leverage and risk was a real problem. But part of the problem seemed to involve stretching and abuse of the rules. So we had to step in very forcefully and change and tighten the standards.

**RD:** What happens when these assets are back on the balance sheet from a reserve capital requirement, for example? Should there be two values, one for regulatory capital purposes and the other one for accounting purposes?

**BH:** In an ideal world, there would be the same accounting for tax, for financial reporting, and for regulatory reporting. But the three have somewhat different objectives, so in the real world they cannot always be the same. While we work very hard with the regulators to come up with common answers, it’s not always possible. Where appropriate, they need to make sure that their views on regulatory capital are not hamstrung or constrained by what we view as proper financial reporting or vice versa. We both have very important but different roles to play in the financial system.

**RD:** What role does accounting, and by extension the FASB and the IASB, have to play in restoring economic growth in the U.S. and around the world, if any?

**BH:** Accounting did not cause an economic downturn, and changes in accounting did not end it. However, what I can say is that good reporting and transparency are very important elements of the operation of sound capital markets. If people start to question that, it can have very devastating impacts on companies and industries and more broadly on the overall financial system. That was clearly the case back with Enron and WorldCom. People lost confidence in financial reporting, and that had very severe effects. The important thing is that our standards—and the implementation and enforcement of those standards—provide an overall sound basis of reporting and transparency and that there’s public confidence in that. Without that, it can really have negative impacts on the economy.

**RD:** Under what circumstances do you see U.S. issuers accepting principles-based standards with little or no guidance? Are there other options?

**BH:** Without there being significant cultural, institutional, and behavioral changes in the U.S., it’s a real challenge. It’s a very complicated issue in our environment. Clearly we have much more regulatory review in the United States than in other parts of the world. There’s also much more enforcement, and, of course, there’s litigation. All of those factors prompt people to ask for specific guidance so they don’t have to second-guess themselves and for fear of second-guessing by others. A lot of people would say that’s a very good attribute of our system; others say it’s not. In my view, good accounting standards contain both clear objectives and principles and sufficient explanation and guidance needed to foster sound and consistent implementation.

**RD:** Many other countries around the world that are adopting IFRS have significantly different business and legal environments from Europe or North America. What are some of the elements that can get in the way of the vision of one common set of accounting standards being used by all?

**BH:** There are important business, cultural, and institutional differences between countries, and I think the IASB has been conscious of those and has tried to address those within their standards. In China, for example, a key issue is the extent of state-run enterprises that are partially privatized. That’s a big issue in terms of related-party transactions between those entities and the government. There are other emerging economies where they may not have the resources and expertise to implement aspects of new standards. There are certain practices in the Islamic world that are different and stem in part from the Koran. There are also issues in the emerging world of high inflation and foreign currency translation. And beyond accounting standards, there are differences in auditing practices, in regulatory review and enforcement, and in the legal frameworks around financial reporting. So while we press on with our agenda for convergence, many issues remain that will continue to challenge the vision of one set of high-quality standards uniformly implemented around the world. No one said this would be easy. But I feel that there has been a lot of progress and that, despite the continuing challenges, it’s a vision that must continue to be actively pursued.

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