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The IASB and FASB convergence process and the need for 'concept-based' accounting teaching[☆]

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ABSTRACT

The increasing globalization of the U.S. economy drives interest in international accounting standards. In this respect, the convergence process between the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) targets the completion of several major projects by 2011. The importance of the projects under consideration as well as the lack of conclusive theoretical solutions around them suggests that the target of a "common set" of accounting standards will be replaced in the short-medium term by a de facto situation of a "slightly different set" of accounting standards. In this paper, we draw on best available practices to make a specific proposal for the introduction of IFRS into the curriculum of institutions of higher learning in the U.S. Our proposal is driven by the idea that accounting education should move from teaching ever temporary rules to emphasize the economic and strategic underpinnings of accounting transactions.

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1. Introduction

The convergence process between the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) targets the completion of several major projects by 2011, and constitutes one of the most ambitious and far reaching efforts in history. Its consequences can hardly be overestimated. As such, the convergence initiative is highly controversial. Nonetheless, it has aligned the agendas of regulators, accounting firms, individual practitioners and academics, who participate in ongoing debates about the optimal nature of standards (rules versus principles), the appropriate standards setting processes and necessary changes to collegiate accounting curriula.

From a U.S. perspective, the increasing globalization of its economy arguably drives interest in international standards. The latest survey of the Bureau of Economic Analysis (BEA) reports that nonbank U.S. multinational companies increased their international operations in 2007 for the fourth consecutive year, as measured by value added, capital expenditures and employment (see Barefoot & Mataloni, 2009). In many if not most of these countries, IFRS is the standard for reporting. Furthermore, IFRS is operating on U.S. soil today; international companies no longer have to reconcile from IFRS to US GAAP to be registered in the U.S. Under these dynamic conditions, this editorial will elaborate on its implications of the convergence process for accounting education. To do so, a focused review of recent events will be helpful.

Recent surveys conducted by KPMG and the American Accounting Association (AAA) highlight the diverse positions of U.S. accounting scholars regarding the introduction of IFRS in the accounting curriculum (AAA-KPMG, 2008, 2009). The first annual survey was conducted in 2008 and gathered responses from 535 professors. Interestingly, just over 20% of respondents expressed a willingness to make changes in their accounting curriculum, to incorporate IFRS, in the following academic year: 2008–2009. A follow-up survey was conducted during the summer of 2009; this second edition of the survey again collected about 500 responses from U.S. accounting academics. In this case, 75% of the respondents indicated that IFRS should immediately be introduced into the accounting curriculum. Despite this apparent significant, a very small percentage of respondents (8%) considered that their university's accounting faculty was prepared to incorporate IFRS into the curriculum.

The question of whether and when to incorporate international accounting standards into the accounting curriculum is not new. In 1978, the European Economic Community (EEC) issued its Fourth Directive on the annual accounts of certain types of companies. Compliance with provisions of the Fourth Directive required changes in the accounting standards of member states during the 1980s. The adoption of IFRS by the EU in 2005 brought about further adaptation by member states of the current European Union (EU), and required changes in the accounting curriculum. Although these adaptation experiences have not been problem free, they do provide a wealth of knowledge that may be

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transferred to other settings, including the U.S. Drawing on best available practices, we shall make a specific proposal for the introduction of IFRS into the curriculum of institutions of higher learning in the U.S.

As shown by the KPMG-AAA surveys, there is a long way to go in order to get consensus around the introduction of IFRS into the accounting curriculum. We are persuaded that there are two major impediments in this regard. At the core of the discussion is the debate on accrual-based financial accounting, which is an ever-present discussion among accounting academics (see Baxter, 1979). This debate, we submit, has a pervasive impact on several of the specific projects of convergence in accounting standards. Importantly for the purposes of this editorial, there also exists a second and highly interrelated debate about the role of accounting standards in accounting education. In the current editorial, we shall draw on the debate on the first item to outline problems that may be obstructing the actual introduction of IFRS into the curriculum of U.S. universities and business schools.

2. The convergence process: a chronology

The beginning of the IASB and FASB convergence project can be traced back to the 2002 Norfolk agreement, where the two regulatory bodies committed to develop a set of high quality "compatible" standards. As noted above, the EU adopted the IFRS in 2004 and made IFRS compulsory for the consolidated accounts of listed companies as of 2005. In turn, this move brought about an active role by national regulatory boards, which were entrusted to issue standards for private companies and for simple accounts. Consequently, the convergence process did not produce a common set of "European" accounting standards across EU state members but rather the cohabitation between a set of "international" standards and a variety of "national" standards. Although national accounting standards have converged in the recent past to IAS/IFRS, they are still not fully equivalent across countries and European accountants have to adapt to this diversity.

In 2006, the IASB and FASB signed up a "Memorandum of Understanding" (MoU) which enhanced their commitment from a "compatible" to a "common" set of high quality standards.[1] The MoU, which constituted a definite step forward in the convergence process, listed 11 topics that were deemed critical to convergence: business combinations, consolidation, fair value measurement guidance, liabilities and equities distinction, performance reporting, post-retirement benefits, derecognition, financial instruments, revenue recognition, intangible assets, and leases.

In 2007, the Securities and Exchange Commission (SEC) removed the reconciliation requirement for non U.S. companies reporting under IAS/IFRS in order to register in the U.S. In this manner, the SEC effectively recognized IAS/IFRS as a set of high quality accounting standards which satisfied the information needs of U.S. investors. Ultimately, the SEC granted operations of IAS/IFRS in the U.S., even if only for non-U.S. companies. However the incipient financial crisis exerted a definite impact on the convergence process. In particular, it prompted debates on such fundamental issues as (i) how to report information about financial instruments, (ii) the appropriateness of fair values, and (iii) the perimeter of consolidation in cases of "special purpose" business combinations. These three items were already on the list of the fundamental topics considered in MoU of 2006 and the Boards were under pressures to issue accounting standards on these issues. Inevitably, any new standards, however, would be subject to robust criticism by some segment of stakeholders.

In September 2008, at the peak of the current financial crisis, the IASB and the FASB updated the MoU of 2006. In the new document, the two regulatory bodies reaffirmed the list of 11 fundamental topics that would lead to accounting convergence and stated 2011 as deadline. In November 2009, the IASB and FASB issued a Joint Statement that restated the convergence process and confirmed 2011 as a deadline. The Joint Statement comprised a detailed status of the convergence process and identified two particularly controversial topics (i) accounting for financial instruments, and (ii) derecognition of assets and liabilities. These items have attracted a considerable portion of the debate around accounting and the current economic downturn; during the pre-crisis period financial innovations focused on structured finance products (e.g., CDOs and CDSs), whose various forms made it difficult their classification and accounting. Importantly, these financial instruments were often used by Structured Investment Vehicles (SIVs) to finance the "acquisition" of pools of other more primary assets from other financial institutions. Therefore, it remained an issue when selling firms had to derecognize these assets or liabilities as a result of the "transfer" to the SIV. As both the IASB and FASB were under pressure to address these issues, there was awareness that issuing significantly different accounting standards on these controversial items would lessen the credibility of the convergence process. Thus, given the importance of these items, we will focus on them in the next section.

3. Financial instruments and derecognition of assets and liabilities

Differences between the IASB and FASB concerning derecognition focuses on the basis that should support the decision. As far as the FASB, the decision is based on the "legal isolation" concept meaning that a transferor can derecognize a financial asset only if, after the transfer, there is no way for either the transferor or its creditors to get the assets back even in bankruptcy or receivership. Conversely, for the IASB the decision is based on the concept of "transfer of substantial risks and rewards." According to this concept, a transferor can derecognize an asset when it transfers the rights to the contractual cash flows and it does not have any longer involvement on it.

With respect to accounting for financial instruments, the IASB issued a new standard in November 2009 (IFRS 9). This new standard modified extant rules to accounting for financial instruments as *assets*, whereas it leaves financial instruments as *liabilities* under the scope of the old IAS 39. The FASB also reached an agreement about many specifics of a new standard on financial instruments although the new standard has not been issued as yet at the time of writing this editorial.[2]

Both Boards moved from a three-category classification model (Held-To-Maturity; Marketable Securities; Available For Sale Securities) to a two-category classification model. In their new framework both Boards used full fair value accounting with changes in the income statement as the default accounting model for securities. They also agreed about allowing debt type securities to be treated differently. However, the Boards disagreed about the accounting model to impose on debt type securities. In IFRS 9 the IASB stated that these securities had to be accounted for at amortized cost with no adjustment to fair value unless in case of impairment for credit losses. Conversely, the FASB advocated fair value adjustments for debt type securities, but with changes in fair value reported in Other Comprehensive Income and not in the Income Statement. Moreover, some other differences between the Boards referred to the calculation of credit losses and accounting treatment for hybrid instruments (see FASB, 2009).[3]

The discussion on the appropriate model to account for financial instruments did not emerge with the current economic downturn. In 2005, the EU endorsed IAS 32 and IAS 39, which became the latest international standards receiving EU support before the official adoption of IAS/IFRS. The promulgation of IAS 32 and IAS 39 was

[1] As noted by some commentators, the adoption of IAS/IFRS by the EU put them in a good position to become a "global" set of standards, and this in turn may have driven this shift in the convergence process (see Whittington, 2005).

[2] A summary of the decisions already reached with respect to the future new standard have been made public in a recent document released by the FASB (2010).

[3] Cf. FASB (2009).

preceded by discussions about the extent to which fair value with changes reported in the Income Statement was the right way to go for such financial instruments as derivatives. However, this solution faced the opposition of many financial institutions, which argued that the recognition of unrealized gains and losses on derivatives into the Income Statement would bring about “artificial” volatility in the reported earnings. Importantly, extant accounting research has not reached conclusive results on this matter. Plantin, Sapra and Shin (2008) and Allen and Carletti (2008) suggested that, under certain conditions, the use of fair value can increase the volatility or the instability of financial markets, with a resultant loss in terms of social welfare. Glavan and Trombetta (2010) examined the choice between fair value and historical cost in the context of a dynamic optimal portfolio choice; they found that historical cost may induce a riskier portfolio choice but it can also generate a higher level of ex-ante expected utility with respect of fair value. In turn, these results concur with empirical research conducted by Zhang (2009) and Lins, Servaes and Tamayo (2009), who found that the introduction of fair value for derivatives instruments induced firms to use a more conservative approach to risk management. On the other hand, Bleck and Liu (2007) highlighted the superior incentive properties of fair value regime with respect to historical cost.

Some of these controversies stem from the Boards' reliance on an accrual-based representation of original cash flows. In the case of adopting a cash flow approach, changes in the fair value of a financial instrument without subsequent trading does not result in cash flows and, hence, no gain or loss would be recognized. Overall, issues listed on the MoU of 2006 and subsequent update were already critical in the first half of the 20th century when accounting regulation started to adopt its current status. These issues were critical many years go; they are still critical and will likely be considered critical in future discussions about accounting regulation. Ultimately, this is the outcome of having neither value-free nor assumption-free ways to determine the superiority of accrual-based accounting treatments over its alternatives. Consequently, the inability to definitively resolve the question of the ultimate superiority of FV over HC, or vice-versa, reflects the more general, inconclusive debate on the superiority of an accrual-based model over its alternatives. This conceptual impossibility of devising “first-best” accounting standards is timely when assessing progress by regulatory bodies on specific and historically determined processes such as the IASB/FASB convergence project.

4. Convergence as a regulatory objective

There exist several notions (or interpretations) of convergence in accounting standards. From a strict viewpoint, “convergence” refers to the enforcement of a single set of accepted standards by several regulatory bodies, while a soft notion of “convergence” refers to diminishing differences among accounting standards issued by several regulators. In-between notions of “convergence” relate to the extent to which two or more jurisdictions may agree on a core set of common standards but allow varying approaches and interpretations regarding non-core issues.

In a related vein, there exist three fundamental approaches towards the policy implications of the “convergence” process. For example, we can aim at merging all standard setting bodies into a unified “global” body or, alternatively, keeping each of the existing standard setting bodies as the sole authorities in their respective jurisdictions. The intermediate position would refer to a national standard setting body coexisting with international coordination bodies.

From a theoretical point of view the unified solution of a single international setting body and no national setting bodies has been advanced as optimal. Dye and Sridhar (2008), however, argue there exists a dearth of research to either support or refute this position. A considerable number of academic papers[4] deal with the ex-post empirical analysis of the effects of accounting standards. However, very few papers address the issue of an optimal regulatory regime from an ex-ante theoretical perspective and even less from an international perspective. A full review of even this sparse literature is beyond the scope of this editorial; but it is important to note that it is inconclusive. We will highlight some timely messages suggested by this strand of theoretical literature.

The first message states that discretion and flexibility in accounting standards can be theoretically more desirable than uniformity and rigidity. Dye and Verrecchia (1995) analyze the optimal design of standards by focusing on the existing agency problem between shareholders and management. When the incentive consequences of accounting standards are taken into consideration, then discretion can be superior to uniformity. Dye and Sridhar (2008) reiterate the possible superiority of flexibility in accounting standards when the investment effects of accounting standards are taken into consideration. Consequently there is no clear case for uniform and rigid accounting standard. The intuition is simple, uniform and rigid accounting standards do not provide sufficient, powerful incentives and have problems to adapt to complex situations in which there is a high level of variation in the transactions described by the accounting system.

At an international level Trombetta (2001, 2003) and Stecher and Suijs (2007) show that mutual recognition of different standards can be superior to full harmonisation. In a mutual recognition regime, standards set by one body are recognized by the other body and vice-versa. From an informational point of view, it is difficult to support the superiority of a single codification of the message space and it is relatively easy to build examples where a richer choice of messages conducts to a more informative communication process.

The joint documents produced by the IASB and the FASB adopt a strict sense of convergence as shown by their aim to “achieve a single set of high quality standards.”[5] In pursuing this objective, the two regulatory bodies are aligned with the recommendations made by the leaders of the Group of the 20 (G20). In the conclusions of the Pittsburgh meeting, the G20 supported the goal of a single set of high quality global standards. Thus, not surprisingly politicians advance a politically expedient solution, albeit perhaps a naïve solution. In a related vein, the SEC recently expressed its belief in a single set of high quality and globally accepted standards, which would benefit U.S. investors.[6] The tension between the political perspective and the academic perspective has been highlighted by the Financial Reporting Committee of the AAA.[7] Nonetheless, and despite the official objective of converging to a single set of standards, both the previous EU experience and the current state of the convergence process outlined above suggests that two or more sets of slightly different standards will coexist in the short-medium term and arguably should exist in the long run. If this is the case, then accounting education needs to be ready to such multicenter environment.

5. Implication for education: from rule-based teaching to concept-based teaching

As noted above, some surveys have addressed the eventual introduction of IFRS as generally accepted accounting standards in the U.S. (see also Muntor & Reckers, 2009). Despite some progress towards convergence, there exists great uncertainty among U.S. accounting educators over the possible “arrival” of IFRS. Many U.S. academics consider that neither accounting faculty nor their

[4] For a survey of this literature cf. Leuz and Wysocki (2008) and Hail, Leuz and Wysocki (2009).

[5] Cf. IASB and FASB (2009) Joint statement, November.

[6] Cf. SEC (2010).

[7] Cf. AAA Financial Reporting Committee (2009). This document provides comments on the SEC proposed roadmap to adoption of IAS/IFRS for US companies. The committee focuses only on some of the issues raised by this roadmap.

institutions are ready for this event and they perceive an insufficient, motivation or collective effort to attain this goal.

Germane to many educators are the historically and culturally determined regulatory solutions given to accounting problems. In this case, in the U.S., some accounting educators follow a "rule-based" model to accounting education. Within this mode of education, accounting exercises have "right" and "wrong" solutions. There exist a "correct" way to account for a certain transaction and it has to be spotted in every possible business situation. The emphasis is on the outcome and a much lesser importance is placed on the fundamentals of the accounting model.

An alternative approach to teaching focuses on conceptual issues and situational analysis. .Following this approach, accounting teachers first present their audience with the economic essence of a certain transaction and then delve into theoretical aspects involved in choosing, say, an accrual-based representation for such transaction. Once a proper understanding of fundamentals is achieved, educators address possible alternative solutions to the specific accounting problem and identify which is/are consistent with current regulatory guidance. . In this respect, we submit, the sequence of addressing first the conceptual and theoretical structure of the accounting issue followed by the solutions established by each regulator follow naturally. We can call this alternative model of accounting teaching as "concept-based." By making this proposal towards a "concept-based" approach to accounting teaching we do not claim the superiority of any given teaching pedagogy over the other under all circumstances. In this respect, we contend that the "rule-based" approach fits in settings featuring a single set of accounting standards, especially if such standards are inspired by rules rather than principles (Carmona & Trombetta, 2008). Conversely, in settings featuring the coexistence of different sets of standards, the "concept-based" approach enhances the strategic and economic fundamentals of transactions and drives to a better understanding of the solutions proposed by each regulation. Considering the current prospects for the coexistence of several accounting regulators, there is a case for a "concept-approach," which would result in a major turnaround in accounting education. Within this framework no regulatory change should be seen as daunting because it does not require a full makeover of our teaching practice. It does requires periodic updating of our classes when we come to the presentation of the generally accepted solutions to the general issue.

Furthermore, this "concept-based" approach will add value to participants in accounting programs and will depart accounting from teaching modes in use in a vocational training school. In particular, "concept-based" accounting teaching has two important implications for the accounting profession. First, it needs to be accompanied by a solid economics and business administration curriculum. It is absolutely impossible to be able to account for a structured finance product without first having grasped proper understanding of the economics of the instrument. Similarly it is impossible to account properly for a business combination without reaching an understanding of the strategic and organizational implications of the combination. Second, the development of "professional judgment" becomes a fundamental part of accountants and auditors' jobs. In contexts suited to "concept-based" teaching, the mechanical application of rules and diligent completion of a list of box ticking may be replaced by careful analysis of the economics and strategic underpinnings of the transaction.

6. Concluding remarks

The current trend towards globalization suggests that U.S. firms will steadily proceed with the current process towards internationalization, involving investments abroad and the set up of subsidiaries in other countries. Given that more than 100 countries are already on IAS/IFRS, U.S. accountants will likely have to consolidate financial accounts of subsidiaries that are prepared under accounting standards different from the U.S. GAAP. Consequently, this will require from U.S. accountants an understanding of IAS/IFRS. Arguably, this awareness of IAS/IFRS could be unnecessary should the current convergence process between the IASB and FASB results in the dominance of the latter over the former. However, the importance of the projects under consideration as well as the lack of conclusive theoretical solutions around them suggest that the target of a "common set" of accounting standards will become in the short-medium term a "slightly different set" of accounting standards.

In turn, this likely setting has implications on the introduction of IAS/IFRS in the curriculum of U.S. institutions of higher learning. Overall, we cannot expect standardization resolving our dilemmas as accounting educators. As noted by Baxter some thirty years ago:

> "Standards are a godsend to the feebler type of writer and teacher who finds it easier to recite a creed than to analyze facts and to engage in argument. If an official answer is available to a problem, why should a teacher confuse examination candidates with rival views? Thus learning by rote replaces reason; the good student of today is he who can parrot most rules. On this spare diet, accounting students are not likely to develop the habits of reasoning and skepticism that education should instill" (Baxter, 1979).

Consequently, a setting featuring the coexistence of different accounting standards provides good opportunities to enhance our service to business practice and the society at large. Accounting education in these settings should move from teaching ever temporary rules to emphasize the economic and strategic underpinnings of accounting transactions, which will ultimately let participants in accounting programs cope with IAS/IFRS adoption and any other future regulatory environment.

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