Convergence of the Conceptual Framework

Introduction

The idea of forming a single set of accounting standards (a concept known as convergence) that provides quality financial information has been growing in importance on a global basis as cross border trading in capital markets has increased. With the increase in cross border trading, the need for comparability and transparency has grown (Gornik-Tomaszewski, & Showerman, 2010).

The International Accounting Standards Board (IASB), created in 2001 as successor to the International Accounting Standards Committee (IASC), is composed of 15 full-time people with the responsibility to develop accounting standards on an international basis. Power is given to it by the European Union and the European Parliament. As of the end of 2010, there were more than 12,000 public companies in over 100 countries following IASB accounting standards with Canada and India converting in 2011 (Gornik-Tomaszewski & Showerman, 2010). The Financial Accounting Standards Board (FASB), created in 1973, is the accounting standard setter for the United States, is composed of 7 full time individuals, and receives its authorization for existence from the U.S. Security and Exchange Commission (SEC). All U.S. publicly traded companies are required to follow FASB accounting standards however the SEC has allowed foreign companies following IASB accounting standards to trade on U.S. stock exchanges.

The SEC has supported a single set of worldwide accounting standards since 2002 and in 2008 prepared a plan that provided various milestones to convergence to international accounting standards (Gornik-Tomaszewski & Showerman, 2010). In 2010, the SEC revised that plan with focus on the impact of international accounting standards on the U.S. financial reporting system noting the need to continue the efforts of convergence but indicating concerns about reduction in quality and transparency of financial information (Gornik-Tomaszewski & Showerman, 2010).

The development of consistent standards relies on a framework that is understandable and is followed by the standard setters. Additionally, the composition of the standard setting organization will change over time. These changes in decision makers will result in inconsistent development efforts if no accepted guide exists (McGregor & Street, 2007). Accordingly, agreement must be reached on a conceptual framework if the goal of a worldwide set of accounting standards is to be realized.

History and Convergence

The FASB began its development of a conceptual framework in the 1970’s and completed the process in 2000 when it issued seven pronouncements titled Statements of Financial Accounting Concepts (SFAC). The IASC issued its conceptual framework in 1989 titled the Framework for the Preparation and Presentation of Financial Statements. As one would imagine, there are both differences and similarities between the two conceptual frameworks (Kaminski & Carpenter, 2011).

Most informed individuals accept the need for a set of common accounting standards. The SEC continually presents the importance of comparability of financial
reports to the investing public (Gornik-Tomaszewski & Showerman, 2010). The FASB and the IASB also support the idea of a single set of accounting standards. In various announcements, both boards have agreed that the first step in establishing a single set of standards is to develop a conceptual framework. Since both boards have developed their own conceptual framework, the boards decided to embark on a project to develop a single conceptual framework. The objective of the conceptual framework project was to remove any differences between the two conceptual frameworks, address any areas that needed to be expanded, and make any improvements where necessary (Whittington, 2008). The boards believed initially that the process would take several years to complete.

The effort to converge U.S. and international accounting standards began with the Norwalk Agreement signed in 2002. The agreement announced the commitment of both the FASB and the IASB to develop quality and compatible accounting standards for domestic and cross border reporting of financial results (Gornik-Tomaszewski & Showerman, 2010). The project to rewrite the two conceptual frameworks was broken into eight phases:

1. Phase A: objectives and qualitative characteristics
2. Phase B: definitions of elements, recognition, and derecognition
3. Phase C: measurement
4. Phase D: reporting entity concept
5. Phase E: boundaries of financial reporting, presentation, and disclosure
6. Phase F: purpose and status of the framework
7. Phase G: application of the framework for not-for-profit entities
8. Phase H: remaining issues

From 2004 until 2010 the two boards worked on chapters 1 and 2 of the conceptual framework and issued the results in September 2010 which are now part of each Board’s conceptual framework (Orrell & Streaser, 2013). In their efforts, some significant conclusions were reached by the boards (Kaminski & Carpenter, 2011)

- The objective of financial reporting should be broad so that financial information includes information in addition to the financial statements.
- Financial information should address the needs of a wide selection of interested parties such as creditors, stockholders, employees, management, and regulators.
- Information should be provided that assesses the stewardship of management.
- Financial information must be useful. To be useful, financial information must be relevant and faithfully represented.
- Neutrality is an important concept that negates the convention of conservatism. The intentional understatement of net assets and net income is in contradiction of the philosophy of freedom from bias.
- Comparability follows relevance and faithful representation.
- Understandability is a qualitative characteristic.
- Materiality is a concept of relevance and represents a constraint on financial reporting; however, it is entity specific and, consequently, does not affect the decisions of the standard setters.
- There is a need to standardize terminology and definitions.
As the process ensued, issues began to arise that necessitated a change in approach. In 2008, the boards decided that rather than try to eliminate differences in standards, they would begin working on development of new accounting standards jointly. At their 2008 meeting the two boards established a list of joint projects (Gornik-Tomaszewski & Showerman, 2010):

1. Financial statement presentation
2. Revenue recognition
3. Leases
4. Financial instruments
5. Liabilities and equity distinctions
6. Consolidation policy and procedures
7. Fair value measurement
8. Derecognition
9. Post-employment benefits including pensions

The Boards also decided after the publication of the first two chapters of the revised conceptual framework to discontinue their efforts on development of a joint conceptual framework and focus on the individual joint projects (Orrell & Streaser, 2013). In 2012, the IASB returned to the conceptual framework project as a response to requests from public stakeholders and expects to issue a final revised framework by 2015. The FASB has not reopened the project (Orrell & Streaser, 2013). Without a coordinated effort by both boards, this author believes that a joint conceptual framework will not be created.

The coordination problems that come with any transition combined with the need to control the process will be significant. Along with these two factors, differences in culture between the U.S. and the international community create a unique condition that contributes to a very difficult task (Whittington, 2008). Focusing on only accounting culture and ignoring the overall impact of general cultural differences, there exist different views as to what should be reported in the financial statements (Whittington, 2008). These differences have to be identified, understood, and then resolved before international standards can be adopted. For example, stewardship is just one of several issues. FASB has deleted the concept of stewardship as an independent objective from its conceptual framework generally because the U.S. capital markets perform the disciplinary actions on improper management decisions. However, in Europe corporate governance is more through the rule of law and voting rights rather than market reactions (Whittington, 2008).

Conclusion

As the process of convergence continues, more cultural differences will be identified that will need to be addressed before full integration and acceptance of a worldwide accounting standard setting process is achieved. In addition, the conceptual framework must be designed in a way to allow for evolution. Without flexibility, transactions that will be normal in the future but unknown today will be difficult to account for in a consistent manner (McGregor & Street, 2007).
Results have shown that both boards can achieve success and accomplish a coordinated effort by developing a single standard. The energetic discussions and the notable compromises that have been made on both sides of the issue are indications of a strong and healthy social debate (O'Brien, 2009). This author encourages the two boards resume their joint efforts in developing a conceptual framework for the creation of accounting standards. Until a complete conceptual framework is jointly developed, the risk of a disjointed and inconsistent standard setting process will exist. And this will cause delays and inefficient use of resources in the development of accounting standards and disruption in corporate operations in implementing those standards for the foreseeable future.
References


November 15th, 2013