2011

IFRS: A Detailed Look at Progress in the United States

Johnny Ko
Claremont McKenna College

CLAREMONT MCKENNA COLLEGE

IFRS

A DETAILED LOOK AT PROGRESS IN THE UNITED STATES

SUBMITTED TO

PROFESSOR MARC MASSOUD

AND

DEAN GREGORY HESS

BY

JOHNNY KO

FOR SPRING THESIS

SPRING 2011

APRIL 25, 2011

"If we don't change our direction

we're likely to end up where we're

headed."

-- Chinese Proverb

FOREWORD

Being a "third-culture kid" and an international student, I was naturally always interested in international events. I recently learned about the adoption of IFRS in China, where I grew up, and as such decided to look into the progress that the United States has made in terms of trying to adopt IFRS in order to put itself back into the position of a premier international capital market. While researching for this thesis, I came across a lot of literature that talked about convergence between IFRS and U.S. GAAP instead of direct adoption. This paper will examine the history of international accounting that eventually led to the adoption of IFRS in the European Union. It will have an in depth analysis of IFRS and what it may mean for the United States should there be an adoption or a convergence. It will also comment on what needs to be considered in the convergence or adoption process.

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I. INTRODUCTION

The world we know today is very different from what many people know from a decade ago. The advancement in technology has created opportunities for U.S. investors to be exposed to offshore investments at a blink of an eye. Investors and issuers are able to engage in financial transactions all across the globe. U.S. and foreign investors now have access to real-time securities transaction data to help them make informed decisions as they engage in market transactions. The one current problem that investors come across when they start trying to make decisions as they research for their investments is trying to compare the financial statements of companies that currently file under U.S. Generally Accepted Accounting Principles (GAAP) to the companies that currently file their financial statements under International Financial Reporting Standards (IFRS). This problem of comparability has become one of the biggest reasons why investors and issuers around the world are pushing for the adoption of one single set of global standards.

The accounting directives of the European Union back in 1995 were outdated and not suitable for companies wishing to bring their companies to international markets. They also had no common set of accounting standards. In the end, European companies that wanted to expose their companies to international markets started leaning closer towards U.S. GAAP adoption because U.S. GAAP was already broadly known, accepted, and understood in international markets. The European Union feared that there would be a worldwide dominance of U.S. GAAP of which they had no influence and little control over. They soon issued a statement in support of the International Accounting Standards

Committee because they believed that there was “a clear prospect of recognition” on a global scale. However, European companies at that time were not very keen on adopting IASC standards and continued to use U.S. GAAP. (Massoud 2009)

The European Union member states adopted Regulation 1606/2002 in January 2005. It was probably one of the more significant turning points for international accounting, as it required European Union member states to adopt International Financial Reporting Standards (IFRS) for all publicly listed firms. (Massoud 2009)

The United States, despite considering itself the premier investment market of the world, until recently has not been very receptive with the idea of adopting any other accounting standards other than U.S. GAAP. Many have complained about the costs and complications that could be possibly associated with the adoption of IFRS in the U.S. It wasn’t until June of 2007 when the United States Securities and Exchange Commission (SEC) proposed eliminating the “Form 20-F” reconciliation requirement that required foreign registrants that file with IFRS in other countries to reconcile their financial statements and produce a 20-F so that the numbers can be reconciled with U.S. GAAP.

In 2008, the SEC released a statement supporting the move to a single set of high quality global accounting standards:

> “We proudly support the continued move to a single set of high quality global accounting standards, coupled with enhanced international coordination to foster their consistent interpretation and to avoid jurisdictional variants. Further, we encourage the development of a roadmap to identify issues and milestones to

> transition to this end state in the U.S. with sufficient time to minimize disruptions, resource constraints and the complexity arising from such a significant change." (SEC 2008)

The roadmap will require large U.S. companies to start filing under IFRS by 2014, and the rest of the U.S. companies by 2016.

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) signed a memorandum of understanding (M.O.U) on September 18, 2002, with the mutual understanding and hope that IFRS and U.S. GAAP will eventually converge together. (Massoud 2009)

II. HISTORY OF INTERNATIONAL ACCOUNTING

International accounting standards really started back in 1966 when the American Institute of Certified Public Accountants (AICPA), the Institute of Chartered Accountants of England and Wales (ICAEW), and the Canadian Institute of Chartered Accountants (CICA) jointly proposed to establish an International Study Group. In 1967, the Accountants International Study Group (AISG) was established and started to publish papers. In 1972, the issue of diversity in accounting standards around the world was brought up, and the International Accounting Standards Committee (IASC) was established. The International Organization of Securities Commissions (IOSCO) was the worldwide association of national securities regulatory commissions, consisting of members like the SEC, the London Stock Exchange. In 1995, the IOSCO and the IASC reached an understanding where if the IASC were able to have standards at an acceptable level, the IOSCO would consider endorsing the IASC's standards for reporting by foreign companies seeking stock exchange listings worldwide. In March 2001, the International Accounting Standards Board (IASB) assumed the accounting standards setting responsibilities from the IASC. (Massoud 2009)

III. IFRS DETAILED

Oversight

The initial purpose of establishing the International Accounting Standards Board (IASB) was to develop global standards for financial reporting. The IASB is overseen by the International Financial Reporting Standards Foundation (IFRSF), which is responsible for the activities of the IASB and other work that centers on IFRS. These activities "include initiatives related to translation of IFRS from the English language, and education about IFRS." (SEC 2010)

In the spirit of enhancing the public accountability of the IFRS Foundation, the Trustees "amended the IFRS Foundation's Constitution to establish a connection between the IFRS Foundation and a Monitoring Board" that composed of "public capital market authorities charged with the adoption or recognition of accounting standards used in their respective jurisdictions." The SEC study noted that recent events "demonstrated the significant pressure that can be exerted on a standard setter and acknowledged that the establishment of the Monitoring Board was an important step in improving the public accountability of the IFRS Foundation." However, having a satisfactory structure for the Monitoring Board is still being debated. The study suggested "improvements to the Monitoring Board and urged that the Monitoring Board should include representatives from the investment community, analysts, auditors, and preparers, as well as national and regional regulators." (SEC 2010)

It has also been suggested that "additional time is needed to determine the effect that the Monitoring Board will have on the public accountability of the IFRS Foundation and the IASB," and that "effective oversight is critical to any decision to incorporate IFRS into the financial reporting system for U.S. issuers." (SEC 2010)

Completeness

There has been a sentiment amongst many people in the industry that U.S. GAAP has gone through tests of history, and that through all the patching and legislation that has been passed throughout its time, we have managed to put together a system that works and has been tested through time. On the other hand, IFRS is relatively new compared to U.S. GAAP. IFRS adoption only started to pick up speed because of the adoption by the European Union. The SEC report outlines the concerns with regards to dropping U.S. GAAP for IFRS:

> "We are concerned about quality and maturity of IFRS in comparison to U.S. GAAP. U.S. GAAP has a long history and has been tested and refined through multiple and complex economic events and developments. Many of the standards in U.S. GAAP have emerged as a direct result of circumstances and events that demonstrated the need for better and more transparent financial reporting (for example, the rise of derivative instruments and recent financial scandals such as the collapse of Enron)" (SEC 2010)

The SEC report believes that IFRS is limited in two areas. Firstly, in "certain topical areas, such as accounting for certain common control transactions, recapitalization transactions, reorganizations, acquisitions of minority shares not resulting in a change of control and similar transactions, and the push down of a new accounting basis in an entity's separate financial statements." Secondly, "certain industries, such as those related to utilities, insurance, extractive activities, and investment companies," and lastly, "disclosures in order to provide better transparency regarding the application of accounting principles." (SEC 2010)

The IASB has also often decided to provide less guidance and details with IFRS compared to U.S. GAAP. The report shows that "views were mixed as to whether the lesser degree of detailed guidance under IFRS, as compared to U.S. GAAP, is indicative of a higher quality set of accounting standards." It also states that people who "preferred U.S. GAAP's approach expressed that IFRS relies too much on management discretion, thereby increasing the potential for opportunistic accounting." While some people have argued that even though "IFRS provides financial statement preparers more discretion in application than U.S. GAAP, such additional discretion may not result in major differences in the application of IFRS by U.S. companies because the U.S institutional framework plays a major role in shaping how companies would apply the discretion." (SEC 2010)

Comparability

The advantages of a global set of accounting standards to U.S. investors is really about the comparability across investment options, and that would only hold true if IFRS is, "in fact, consistent across companies, industries and countries." (Massoud 2009)

The SEC report cautioned against a "U.S. version of IFRS" by saying that they do not "believe the [SEC] should supplement any missing accounting or disclosure requirements or the financial statements would not be considered to be prepared in accordance with IFRS as issued by the IASB. [They] believe any additional disclosures the Commission would consider requiring should be included outside of the audited financial statements." (SEC 2010)

There are currently only a few countries in the world that uses IFRS as issued by the IASB. Most of the countries that currently use IFRS have their own variations, mostly arising because of the difference between various cultures. (Massoud 2009) This is best outlined by the SEC report:

> "More than 100 countries require or allow the use of IFRS. At the same time, there is a real possibility of jurisdictional variations, which could undermine comparability. Jurisdictional variations may arise from both authoritative and informal application guidance, changes made to the standards for purpose of use within a jurisdiction, and variations in the times it may take separate jurisdictions to complete their respective processes to enact into law or otherwise adopt new or amended standards. Historical approaches and cultural differences also may give rise to jurisdictional variations. Commenters frequently cited concerns regarding the existence of and future potential for jurisdictional variations of IFRS. The extent to which IFRS is adopted and applied in foreign jurisdictions as issued by the IASB or as jurisdictional variations of IFRS may influence the degree to

> which comparability may be achieved through widespread adoption of IFRS." (SEC 2010)

There is also a high likelihood that in the field of auditing, each firm may develop their own interpretation of IFRS, which would result in a reduced comparability across companies that used different auditors. Differing regulation and enforcement structures and practice on a global basis may undermine the comparability of financial statements prepared under IFRS. It should be noted that securities regulators have "developed and continue to improve infrastructure to foster the consistent and faithful application and enforcement of IFRS around the world." (SEC 2010)

Composition of the IFRS Foundation and the IASB

The IFRS Foundation is "governed by 22 trustees with geographically diverse backgrounds and trustees are appointed for a term of three years that is renewable once." The IASB is "currently composed of 15 full-time members who serve five-year terms subject to one re-appointment." Full-time members are "required to sever all employment relationships and positions that may give rise to economic incentives that might compromise a member's independent judgment in setting accounting standards." Trustees must "seek an appropriate mix of auditors, investors, and preparers, such that the IASB is not dominated by any particular constituency." (SEC 2010)

There have been people who have argued that "all IASB members should be full time in order to avoid potential conflicts of interest with their outside employers." Greater representation from investors has also been raised as a concern as they are the primary consumer of financial reports. (SEC 2010)

Auditability and Enforceability

The principle-based ideology that IFRS fosters, that comes with less detailed and prescriptive guidance, could potentially have an effect on its auditability and enforceability. IFRS may make litigation or enforcement outcomes more difficult to predict. The report suggests that

> "Investors need greater assurance regarding the divergence of application within the principles-based standards of IFRS prior to adoption. Conversion to more principles-based standards that are applied inconsistently in different regulatory environments, auditing regimes and cultures may not be beneficial to investors."

The potential problems when it comes to auditability and enforceability include "risk of opportunistic accounting, potential for accounting conclusions of preparers to be unfairly criticized by auditors, regulators, and investors, and diminished comparability are all issues that have been raised." (SEC 2010)

It is well known that IFRS is more flexible than U.S. GAAP due to the principle based accounting system, as confirmed by the SEC report:

> "The international standards (IFRS) are widely viewed as less specific and providing less prescriptive guidance than U.S. GAAP (i.e., IFRS are more principles based), as well as more subjective primarily due to more use of fair

> value measurements. The downgrading of verifiability as a key concept guiding accounting standard settings and the resulting focus on fair value measurement significantly impairs the ability of an auditor to limit opportunistic actions of management and improve financial reporting." (SEC 2010)

This may result in "standards being less auditable and enforceable, which would not be in the public's interest. (SEC 2010)

In the litigious environment of the United States, IFRS's less detailed and prescriptive guidance could potentially cause companies to have "increased claims by shareholders and other seeking to challenge its application." This is stated by the SEC report:

> "We believe that the existence of a strong and consistently applied enforcement mechanism is a necessary component to the success of an objectives-oriented system. Preparers and auditors have expressed concern that those charged with enforcement in a principles-based environment will question reasonable judgments made in good faith. In fact, some have asked whether the Commission staff would be willing to accept reasonable views and interpretations by preparers and auditors in the application of accounting principles." (SEC 2010)

However, on the other side, some people have said:

> "We believe… that the concern over litigation uncertainty is sometimes overstated… If preparers and auditors maintain contemporaneous documentation that demonstrates that they properly determined the substance of a covered transaction or event, applied the proper body of literature to it, had a sound basis

for their conclusions-particularly those involving the exercise of judgment-and ensured through disclosure that their method was transparent, their exposure to litigation may be reduced." (SEC 2010)

Funding

Until 2008, the IFRS Foundation "financed IASB operations largely through voluntary contributions from a wide range of market participants from across the world's capital markets, including from a number of firms in the accounting profession, companies, international organizations, central banks, and governments." (SEC 2010) FASB Chairman specifically told the SEC that he currently does not "believe the current funding levels and staffing mechanisms of the IASB are adequate [enough] for the tasks it will face if the improved version of IFRS becomes the single set of global accounting [standards]." (Massoud 2009) Since 2008, efforts to change the financing basis of the IFRS Foundation have continued. Most funds are now "obtained on a national basis from national standard setters and national capital market authorities." (SEC 2010)

The IASC on the other hand is having a difficult time getting financial backing because of the international nature of the organization. It must rely on cash that comes from countries all over the world that has or will adopt IFRS in the future. The amount of contribution per country is largely determined by the size of their GDP. (Massoud 2009)

The SEC pointed out that they would only require use of IFRS for all U.S. companies if the IASC Foundation found a way to secure a stable funding mechanism that would allow the IASB to function independently. (Massoud 2009)

IV. CONVERGENCE

Authority

Usually, national accounting standard setters have been accountable to a national securities regulator or other government authority. Currently, the SEC has oversight of the FASB. The FASB in their 2004 report however states that "under an objectives-oriented regime, there cannot be a proliferation of standard setters" and specifically stated that there "would be one standard setter (FASB)." (FASB 2004) This specifically points to the fact that FASB would potentially have problems with giving up its current status as the standard setter for the United States to an organization like the IASB. If the IASB were designated as the U.S. standard setter, it is also currently unclear how the SEC would exercise oversight of the IASB. (SEC 2010)

There is also a potential problem when it comes to reacting to crisis situations, as currently there is no framework that is in place to "protect U.S investors if the IASB did not address U.S. specific issues in a timely manner". (SEC 2010)

Effects on Tax Liability

Currently, IFRS does not allow for the use of last-in, first-out (LIFO) method of inventory accounting. This would mean that a company that reports in accordance with IFRS would be required to use a method of accounting for inventory that is acceptable under IFRS, for example the first-in, first-out, or FIFO method. U.S. issuers changing to FIFO for financial reporting purposes may experience a change in taxable income based on the difference between inventory valued on a LIFO basis and on a FIFO basis." (SEC 2010)

If the current tax codes were maintained, companies may experience "a significant increase in the number of book-tax differences they would be required to track upon incorporation of IFRS into the financial reporting system for U.S. issuers." It has been pointed out that "because of the high cost that otherwise would be incurred in maintaining two sets of records, the U.S. Internal Revenue Code, as well as state and local tax codes and related regulations, would need to be modified." And when they are modified, "companies may experience significant changes to their expected tax liabilities." The SEC should "work with the Internal Revenue Service and other tax authorities to mitigate the LIFO transitional issue, as well as the transfer pricing arrangements and franchise tax considerations that may be affected in the transition." (SEC 2010)

Effects on Auditing

There has been question on whether the move to a global accounting standard should be "coupled with a move to global auditing standards in the United States, for example, through convergence of PCAOB standards with or adoption of auditing standards issued by the International Accounting and Assurances Standards Board." As we stand today, "PCAOB auditing standards may require better alignment with IFRS." The general concern is that there would be a "mismatch between the less prescriptive standards in IFRS and U.S. auditing standards." And the potential effects it may have on the outcome of the auditing environment as they move towards a less prescriptive standard system away from the stringent auditing standards that they used to have. (SEC 2010)

However, some people have argued that if U.S. GAAP were a principles based system like IFRS, the accounting scandals that the U.S. has experienced may have been less likely to happen. (Massoud 2009)

Cultural Change

When we look at the U.S. legal system, and the fact that to a larger extent it relies mostly on "guidance, rules, and bright lines", it is very likely that "ultimately it will drive IFRS to evolve, similar to U.S GAAP, into a rules-based set of standards." Hence, there should be a "framework established for accounting and auditing judgment so that issuers can be assured that they will not be penalized for use of reasonable judgment in the application of IFRS." (SEC 2010)

It has also been suggested that if professional judgment were to be established, there may have to be a cultural change in the U.S environment, starting with: "(1) a reduction in the tendency to ask questions like where does the literature say I cannot do this, (2) a reduction in an audit checklist mentality, (3) an improvement in accounting professional's understanding of the economic substance of a transaction, and (4) an improvement in the transparency of disclosures." (SEC 2010)

V. CONCLUSION

IFRS has become the financial reporting standard for a significant amount of countries around the world. However, out of all the countries, only a particular handful actually fully adopts IFRS as issued by the IASB. For the most part, investors who went in believing that IFRS would mean 100% comparability between all the countries using it may actually be misled. The SEC currently also accepts IFRS as a reporting basis for foreign private issuers without the previous requirement of reconciling to U.S. GAAP, so in a sense, one could say that is progress by itself.

With all the accounting scandals that have circled the United States over the past few decades, it seems like U.S. GAAP has still been able to hold up the status of the U.S. market in the world. Despite all the scandals, each and every one of them has made U.S. GAAP better and stronger because rules and regulations are often passed or created after each scandal to hopefully prevent future abuse of the same situation. With that in mind, the same cannot be said for IFRS, as it has not stand by the test of time. Despite what people may say about the negative effects of “rules-based” accounting, we do not know what could happen in the future with “principles-based” accounting.

The ultimate goal of comparability is probably something that all the countries in the world strive to achieve. However, it should be important to note that quality should not be sacrificed in the process. If the goal were not for comparability, than the adoption of IFRS in lieu of U.S. GAAP would actually be pointless, if not harmful to the current U.S. environment.

The IASB also needs to find a way to become independent of political pressures from around the world, and it would need to secure funding from sources that will provide reliable and sustainable income. The FASB will also need to find its place in the new hierarchy of international standard setting organizations, as it currently seems to struggle to find where it may fit into the system.

The U.S. also needs to figure out how to properly fit the IFRS and IASB working structure into the U.S. system so that it has enough influence in order to make sure that it is attentive to U.S. crisis situations, and can react fast enough to resolve problems.

Current tax codes should be looked into and amended if necessary to adopt the new principle-based accounting.

The culture of the U.S. accounting and regulatory environment needs to change. The general mindset of the people in the U.S. also needs to change. It should no longer be acceptable to say that as long as there's no rule about it, it can be done.

IFRS and U.S. GAAP should continue to converge, but with the current state of affairs, global adoption of true IFRS is still a long way away. U.S convergence into IFRS is also a work in progress that, though may be slow, is something that needs to be considered carefully at every step to make sure that in the end, everybody will benefit from the adoption of a global set of accounting standards.

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