

Debating the Issue: IFRS or U.S. GAAP

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Abstract

The issue of the United States converting to International Financial Reporting Standards (IFRS) has been a heated debate in the accounting community over the past several years. The quickly approaching decision date set forth in the 2008 Securities and Exchange Roadmap has increased the urgency of this dialogue. In this paper, I present a comparison of the major issues surrounding both sides of the debate. Proponents of the plan believe that worldwide comparability will result from adoption leading to more informed capital allocation decisions. On the other hand, antagonists believe that comparability actually suffered in firms that recently adopted the standards. Early evidence from countries that have adopted IFRS suggests that the implementation of the standard has brought increased comparability of financial reporting. However, despite this perceived success, not all constituents are convinced that a switch to IFRS in the U.S. is warranted. Opponents are concerned about high convergence costs and the move from a rule-based reporting to a more judgment-based accounting.

Introduction

“To be, or not to be, that is the question.” When Shakespeare wrote this infamous line he was completely unaware that one day it would encompass the world of accounting in today’s society. The Securities and Exchange Commission has recently proposed a movement that would eliminate Generally Accepted Accounting Principles and equalize reporting with International Financial Reporting Standards. The SEC’s proposal would allow many multinational companies to report their earnings according to IFRS principles for fiscal years ending on or before December 15, 2009 as early as 2010. An estimated 110 U.S. companies would fall into this reporting category based on their market capitalization and other factors.¹ On November 14, 2008 the SEC proposed a Roadmap outlining that all U.S. companies would abandon U.S. GAAP and report under IFRS beginning in 2014. The SEC was open for comments on the matter, which led to the topic of this paper. The objective of this paper is to set forth an unbiased presentation of both sides of the issue of whether or not the U.S. should move from Generally Accepted Accounting Principles to International Financial Reporting Standards in order to create uniformity with the rest of the world, where financial presentation is concerned. Comparability and effects on investors, previous success, the cost of conversion, SEC proposals and early adoption, education and training, and finally the need for an oversight board will be discussed.

I examine and present a summary of the views expressed in the comment letters to the proposed Roadmap issued by the Securities and Exchange Commission on November 14, 2008. In general, I find that the Big Four accounting firms are supportive of the U.S. movement to adopt IFRS. Their key arguments are that adopting IFRS will bring greater comparability to financial reporting and will make the U.S. more competitive in a global market. On the other hand, I find that there are numerous letters opposing a move towards adopting IFRS. These opposing constituents express frustration that IFRS will bring increased judgment to financial report-

ing, ultimately resulting in a lack of comparability and consistency in accounting.

This paper proceeds as follows: key milestones in the development of IFRS are presented in section 2, arguments in support of IFRS are discussed in section 3, section 4 presents arguments in opposition, and section 5 describes what lies ahead followed by conclusions in the final section.

2. Development of International Financial Reporting Standards

A brief overview of key milestones in the development of IFRS:

- 1973 – The International Accounting Standards Committee (IASC) was formed with hopes these standards would be accepted worldwide.
- 1994 – The International Organization of Securities Commissions (IOSCO) completed and communicated its review of the current IASC standards.
- 1994 – The formation of the IASC Advisory Council was approved in order to provide oversight to the IASC and manage its finances.
- 1995 – The IASC developed its Core Standards Work Program, which led to the creation of a comprehensive set of core standards.
- 1997 – The Standing Interpretations Committee (SIC) was established to provide interpretation of International Accounting Standards (IAS).
- 1999 – The IASC Board approved a restructuring that resulted in the current International Accounting Standards Board (IASB).
- 2000 – The IOSCO recommended that multinational issuers be allowed to use IAS in cross-border offerings and listings.
- 2001 (April) – The IASB assumed the standard setting responsibility from the IASC and adopted the existing IAS standards and SIC Interpretations.
- 2002 (February) – The International Financial Reporting Committee assumed the responsibility for interpreting IFRS.
- 2002 (July) – The European Commission required European Union listed companies to prepare their consolidated financial statements in accordance with IFRS as endorsed by the EC from 2005 forward.

This became the most critically important milestone in the development of IFRS because it was the main driver for the expanded use of IFRS.
- 2002 (September) – The Norwalk Agreement was executed between the FASB and the IASB who agreed to use best efforts to make the existing financial reporting standards fully compatible as soon as was feasible.
- 2004 (December) – The European Commission issued its Transparency Directive, which required non-European Union companies with listings on the EU Exchange to use IFRS.

- 2005 (April) – The SEC published the first Roadmap. This Roadmap discussed the possible elimination of the U.S. GAAP reconciliation for foreign private issuers that use IFRS. It also laid out a series of milestones that if achieved would result in the elimination of the U.S. GAAP reconciliation by 2009 at the latest.
- 2006 (February) – The FASB and IASB published a Memorandum of Understanding. This memorandum reaffirmed the Boards' shared objective to develop high quality, common accounting standards for use in the world's capital markets. The Boards decided to proceed along two tracks for convergence: 1) a series of short term standard setting projects designed to eliminate major differences in certain focus areas, and 2) the development of new common standards, since accounting practices under both directives are regarded as candidates for improvement.
- 2006 (August) – The CESR and the SEC together published a work plan identifying areas of IFRS and U.S. GAAP that raise questions in terms of high quality and consistent application.
- 2007 (November) – The SEC eliminated the U.S. GAAP reconciliation for private issuers after determining that the 2005 Roadmap has been sufficiently met.
- 2007-2008 – The SEC explored future use of IFRS by U.S. companies.

In August of 2007 the SEC issued a Concept Release asking the public to comment on the possible use of IFRS by U.S. domestic registrants. Also, in August 2008 the SEC approved an updated Roadmap for public issuance on November 14, 2008, which anticipated mandatory reporting under IFRS beginning in 2014, 2015, or 2016 depending on the size of the company.

• **Pressing Onward**

The momentum to converge to a single set of global uniform accounting standards, with IFRS as the chosen proponent is continuing to build, and is a very active topic on the SEC's agenda. The updated Roadmap proposed milestones to be considered in determining whether reporting under IFRS should be mandated for U.S. companies and states that further assessment by the SEC must be conducted in order to declare a definitive statement on the matter in 2011.²

3. Support for International Financial Reporting Standards

3.1 Comments from the Big Four

Each of the Big Four accounting firms: PricewaterhouseCoopers, KPMG, Deloitte & Touche, and Ernst & Young, strongly support the decision to implement IFRS in the United States. Each firm has recognized the interconnectivity of the capital markets and highlights the need for increased transparency and worldwide comparability due to the recent financial crisis. They believe that a single-set of high quality accounting standards will allow investors to make better capital allocation decisions. With more than 110 countries currently operating under these standards, IFRS is deemed to be the best solution. It has also been recognized that IFRS will make it easier for U.S. and worldwide regulatory bodies to monitor systematic risks in the global capital markets and to achieve the objectives of the Group of Twenty.^{3,4,5,6}

3.2 Comparability and Effects on the Investor

The most common characteristic of IFRS that lends itself to wide-spread support in the U.S. and countries abroad is the aspect of a single set of accounting standards that can lead to worldwide comparability. In recent years, IFRS has gained increasing acceptance in capital markets worldwide and is anticipated to be adopted in more countries in the near future. This has led many to believe that IFRS has the highest potential to become the set of accounting standards that best provides a common platform for companies to report and investors to compare financial data.⁷

Investors and issuers in capital markets are of utmost concern with the current economic downfall. Due in large part to the technological advancements that have graced society, cross-border trading and investing have reached a global peak. U.S. investors have the ability to access real-time security transaction data from security markets around the world and to trade on global exchanges through access to the Internet. With the increase in global trading and investing, it goes without saying that investors need to have access to fair and accurate disclosures that enable the comparison of financial information. With the ease of cross-border investing and trading it is necessary that investors have the tools to compare their investment opportunities with global markets.⁷ Former Chairman Christopher Cox commented in a speech to the International Organization of Securities Commission that both the IASB and its governing body, the IASC Foundation, are doing their best to make sure that investor's interests are the primary concern in the continuing development of IFRS.⁸

Much like comparing apples to apples, investors must be able to compare U.S. financial statements with those of countries that report under IFRS. The current differing accounting principles and presentations of financial statements make it hard for even the savviest of investors to compare financial statements prepared under U.S. GAAP with those prepared under IFRS. According to the SEC, U.S. investors would be able to make better-informed investment decisions if they could obtain high quality financial information from U.S. companies that are comparable to the information from foreign companies operating in the same industry. Capital formation and investor understanding would be enhanced if the world's major capital markets all operate under a single set of accounting standards that generate comparable, high quality financial information from public companies.⁷

3.2 Previous Success

The European Union, Canada, and Australia have recently converted to IFRS and have had much success with their adoption. Prior to this conversion, each Member State of the European Union had individually established its own accounting principles. Each state had allowed the use of other jurisdiction accounting standards along with its own. It was very evident that the European Union was in desperate need of a single set of high quality accounting standards under which all Member States could report. They chose to adopt IFRS and have been pleased with the results overall. With the increasing globalization of capital markets, Canada recently decided to converge Canadian GAAP with IFRS over a transitional period in order to establish a single set of high quality accounting standards. Australia has also recognized the need for comparability and consistency across global financial markets and chose to adopt IFRS as well.⁷

4. Opposition to International Financial Reporting Standards

4.1 Comparability and Effects on the Investor

While there is much support for the idea of increased comparability of financial statements under IFRS, there is also extensive opposition to the matter. Moody's Investors Service conducted a study

into the financial statements of thirty, large European companies to understand how their reporting changed when they switched to IFRS under the European Union adoption in 2005. Generally, it was determined that profits rose, balance sheets deteriorated and comparability suffered.⁹ While Ernst & Young as a whole is in clear support of IFRS, David Lindsell, the head of Ernst & Young's global IFRS practice comments that even though IFRS has been successfully implemented in a timely manner, there is still a long way to go before consistency and comparability are improved.¹⁰

Ernst & Young also reports that there are four issues explaining a lack of consistency and comparability. The first is that IFRS reports have a strong national identity, but the main focus has been on how companies recognize, measure, and disclose items. There has been a significant lack of focus on the presentation of the results. Because of this, companies have been preparing their financial statements by adopting approaches that are most similar to their previous national standards, inherently, reducing the ability to compare across industries. Second, is that there is no specific guidance for industries. Consequently, IFRS implementation has required a significant amount of judgment to be used in selecting and applying IFRS accounting treatments throughout industries. Third, some companies are not confident that their performance is communicated to the market appropriately under IFRS. Finally, IFRS financial statements are much more complex than financial statements prepared under U.S. GAAP. There are concerns that the preparation of financial reports will become a technical compliance issue instead of a mechanism for communicating performance and the financial position of many companies.¹⁰

The director of investor protection for the Consumer Federation of America, Barbara Roper, is worried about comparability under a principles-based accounting rulebook like IFRS. She believes that the flexibility allowable under IFRS is likely to be taken advantage of by executives painting their companies' financial statements in the most positive light. She also notes that IFRS is not consistently applied from country to country let alone company to company.⁹

The Moody's Investors Service report provides several examples of where comparability is currently suffering. Among the thirty companies that Moody's investigated, it found that these companies use ten different ways to report dividends, interest, and taxes in the Statement of Cash Flows. There are multiple views on whether cash flows should be classified as operating, investing, or financing under IFRS, unlike the specific rules under U.S. GAAP. Therefore, IFRS allows companies to decide for themselves how to classify cash flows. The Vice President and accounting specialist for Moody's, Trevor Pijper, states, "The layout of the cash flow statement reflects a lot of theoretical differences on the board of IASB. You can scatter items all over the statement, as long as you report in a way that allows people to put it together in a way that suits them." He also adds that this is something that the IASB is not planning to correct immediately.⁹

Another area of decreasing comparability is inconsistent interpretation and application of accounting policies. Reporting on this significant concern is Danita Ostling, a partner at Ernst & Young and the firm's IFRS leader in America. She says the nature of the principles-based IFRS compared to the rules-based U.S. GAAP places the responsibility on companies to establish clear accounting policies. According to Ostling, companies should consider the substance of the transactions that they are entering into and decide how the principles of IFRS should be applied. Ostling's solution to inconsistently applied accounting policies is for companies that report under IFRS to create a comprehensive accounting policy manual which will

make sure that IFRS principles are consistently applied throughout the company and its subsidiaries. In her opinion, this policy manual will give investors visibility into a company's accounting policies and will ultimately lead to increased comparability. She believes that investors will be able to see if there are differences and where these differences are coming from through policy visibility.⁹ Ostling's idea is something that should be well considered. Requiring accounting policies, which are now consistently interpreted differently across global markets, to have uniform application is a good start. However, policy manuals will not correct the lack of comparability within industries. Her solution also seems to send the message that the company can decide how they want to report certain aspects in order to shed a better light on their company, as long as they note their decision in the policy manual.

4.2 Cost of Conversion

One of the largest corporate concerns of IFRS is the cost of implementation. Many companies are worried that the costs will be more than they can handle. The SEC estimates that the cost of each company to transition from U.S. GAAP to IFRS will be approximately \$32 million over the first three years of filing 10-K forms under IFRS.¹¹ With a minimum of approximately 110 issuers eligible for adoption, costs are estimated to be nearly \$3.5 billion.⁷ The SEC expects that the majority of the costs incurred will be in the first year of adoption. There are many costs that are included in the approximate \$32 million of transition costs. These include: expenses incurred in determining the effects of adopting IFRS, changes to systems needed to support IFRS reporting, the higher costs of accounting personnel, outside consultants, and auditors who are familiar with IFRS. The costs of acquiring an audit firm with the proper experience in IFRS reporting is also a major necessity that companies must consider.¹¹ The SEC claims that costs will decline by nearly seventy-five percent in companies' second year filings but the initial cost is still hard for companies to swallow.¹²

5. Looking Ahead

5.1 SEC Proposals and Early Adoption

The SEC outlined two proposals in the 2008 Roadmap that address the disclosure of U.S. GAAP by U.S. issuers that elect to report financial statements under IFRS in their Commission filings. Proposal A would make issuers provide a single reconciliation from certain U.S. GAAP financial statements to IFRS, in a footnote to its audited financial statements as required by IFRS 1. IFRS 1 also requires that entities explain how the transition from U.S. GAAP to IFRS has affected their financial position, financial performance, and cash flows. This information would help users of the financial statements understand the differences between financial statements prepared under U.S. GAAP and those prepared under IFRS.⁷

In Proposal B, U.S. issuers that elect to report under IFRS would also provide a reconciliation from IFRS to U.S. GAAP as required under IFRS 1, and would disclose, on an annual basis, certain unaudited supplemental financial information covering a three-year period. The unaudited financial information would be disclosed yearly in the issuer's report on Form 10-K. The SEC argues that this proposal would increase comparability in multiple ways. An example is the comparison of the most recent three-year period compared to the earlier three-year period, shown on a consistent basis under IFRS and U.S. GAAP. This would also allow investors to understand the differences between U.S. GAAP and IFRS as well as current trends. This proposal would increase the likelihood that issuers would maintain U.S. GAAP controls, procedures, and records after they elect to report under IFRS. Reverting from IFRS back to U.S. GAAP would also be possible through Proposal B.⁷

The SEC strongly promotes early adoption of IFRS for issuers based on certain criteria. The extent to which the issuer has experience with IFRS reporting is one example of these criteria. The SEC proposes that this offer be applicable for filings of fiscal years ending on or after December 15, 2009.⁷ The Commission also asserts that there are two key benefits with early adoption. The first benefit being that early adoption in global industries will likely benefit investors by increasing comparability. The second benefit is that experiences of companies that choose early adoption will increase the effectiveness and efficiency of conversions, which will also lower transition costs. The Commission also plans to consider early adoption experiences in the final decision set to be made in 2011.⁷

Grant Thornton LLP, Deloitte & Touche LLP, Ernst & Young LLP, PricewaterhouseCoopers LLP, and KPMG LLP all strongly support early adoption. However, each firm agrees that the early adoption criteria should be expanded to include a larger population of issuers. In reading the comment letters of each of the above listed companies, there is much consistency in opinions on Proposal A and Proposal B. Each firm supports the idea of comparability of IFRS and U.S. GAAP for a certain period of time, allowing investors to understand the differences; because of this there is overwhelming support for Proposal A over Proposal B. A common consensus is that Proposal B would place a cumbersome burden on companies to maintain two accounting standards. Adding to the dislike of Proposal B is that it discourages companies from considering early adoption because it eliminates the benefits that early adoption provides. None of the firms see the need to keep the possibility of reverting back to U.S. GAAP open and feel that Proposal A eliminates this possibility.⁷

5.2 Education and Training

Another big concern with the adoption of IFRS is the issue of education and training. A survey conducted by KPMG LLP and the American Accounting Association concluded that professors believe that their students will be at a major disadvantage if the U.S. does not adopt a set of globally accepted accounting standards and if colleges and universities do not incorporate IFRS into their curriculum *immediately*. In polling 500 professors, it was found that seven out of nine conclude that the hardest part about incorporating IFRS is finding room for it in the curriculum, but seventy percent of these professors indicated that they have already taken steps to incorporate it. Manny Fernandez, KPMG's National Managing Partner, states that, University professors realize that teaching IFRS is critical to the preparation of students to succeed in the professional environment, but they also realize that finding space in the curriculum is a challenge. Given the state of the current regulatory environment, seventy-nine percent of the polled faculty thinks that U.S. GAAP should continue to be taught for the next three to five years, while increasingly incorporating more IFRS concepts on a compare and contrast basis as the conversion date approaches. Fifty-nine percent of the faculty believes that the CPA exam will include significant content on IFRS by 2012 and 2013. Fifty-four percent believe that comprehensive coverage will occur in intermediate accounting books by 2011 and 2012.¹³

One of the seven milestones proposed by the Commission is education and training as it relates to IFRS. In the SEC comment letters there are differences in opinions on education and training from the Big Four. However, all four believe that the Commission must set forth a decision to require the adoption of IFRS before the extensive investment in education and training will be made. Deloitte & Touche LLP has formed the IFRS University Consortium to help provide colleges and universities with teaching material, making it the only one of the Big Four to take such active steps for higher education.¹⁴

Nevertheless, Ernst & Young is following closely behind by announcing a million-dollar investment in the creation of a new Academic Resource Center to provide university faculty with real-time curricula to meet the fast changing needs of the global financial market.²

5.3 Oversight Board

With the inherent nature of IFRS, much more judgment is required and less reliance on clear-cut 'rules' is necessary. This creates the need for a global regulatory body to facilitate the consistent application of IFRS worldwide. The final matter of concern for the U.S. is to determine who has the ultimate authority over International Financial Reporting Standards because the U.S. wants more accountability. As seen in the timeline presented in section 2, the International Accounting Standards Board, based in London, is currently the accounting standard setting body established to develop global standards for reporting. The IASB is overseen by the International Accounting Standards Committee Foundation, which is also London based. Twenty-two trustees, with diverse backgrounds, govern the IASC Foundation. The IASC Foundation is responsible for the activities of the IASB as well as other IFRS initiatives including education of IFRS.⁷

To improve the public accountability of the IASC Foundation, the trustees have proposed amendments to its Constitution to establish a connection with a Monitoring Group consisting of securities authorities. The Monitoring Group will participate in voting and approve nominations for IASC Foundation trustees, review funding arrangements of the IASC Foundation for adequacy and appropriateness, and address matters that the IASC Foundation trustees are responsible for such as oversight of the IASB. The SEC is convinced that the accountability of the IASC Foundation will be improved with the interaction of securities authorities and the trustees created by the Monitoring Group. Effective oversight is critical to mandating that U.S. issuers prepare financial statements in accordance with IFRS.⁷

6. Conclusion

Clearly, there has been a recent explosion of International Financial Reporting Standards in the United States. Adopting a set of accounting standards that have been deemed as "high quality" by over three-quarters of the world creates an enticing proposition, especially with the current state of the economy. Inarguably, regaining investor confidence in capital markets is a goal of high importance for the U.S. and is much more achievable when financial statements foster comparability. With 113 countries reporting under IFRS, it is logical that IFRS is the chosen proponent to allow the U.S. to achieve this goal. Former Chairman, Christopher Cox, strongly endorsed the movement of incorporating IFRS; while the new appointee of the Securities and Exchange Commission, Mary Schapiro, would like to take a step backward and review the matter. There is much concern about moving from the rules based U.S. GAAP to the principals based IFRS because of increased interpretation, lack of industry guidance, and high costs of conversion. The SEC will make the final decision in 2011, but the Roadmap allowed nearly 110 companies to report earnings in accordance with IFRS principles in 2010. With the final decision date quickly approaching, there is much debate on whether this movement is in the best interest of the U.S., its companies, and its investors. With the avid support of the Big Four constituents and belief that future competition of the U.S. largely depends on the adoption of IFRS, it seems that this question becomes more of a matter of "when" than a matter of "if." However, we have consistently been taught that there is always room for improvement. IFRS, U.S. GAAP, and the accounting profession in general are certainly no exception.

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