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U.S. Capital Markets and International Accounting Standards: GAAP Versus IFRS

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Summary

Capital markets function most efficiently when investors and creditors have a high degree of trust in the quality of information communicated by firms. Financial reports and disclosures are the primary means by which firms communicate about their performance with investors, creditors, regulators, and the public. Since the creation of the Securities and Exchange Commission (SEC) in 1930s, domestic companies in the United States have used U.S. Generally Accepted Accounting Principles (U.S. GAAP) to issue financial reports.

In 2002, the International Accounting Standards Board (IASB) was established by select countries, including the United States, to develop International Financial Reporting Standards (IFRS), a new global accounting standard. Since the creation of IFRS, more than 100 countries have either fully adopted IFRS or have converged their local accounting standards in varying degrees to more closely resemble IFRS. In addition, there has been an ongoing debate in the United States as to which accounting standard best suits the needs of U.S. capital markets. IFRS by design is a principles-based accounting standard that is subject to each jurisdiction's interpretation and institutional infrastructure. In contrast to IFRS, U.S. GAAP is generally understood to be a rules-based accounting standard that is less subject to interpretation. U.S. GAAP has evolved over 80 years within the U.S. institutional infrastructure to address the specific needs of the world's largest capital market—the United States.

Principles-based accounting standards provide broad flexible guidelines that can be applied to a range of situations, but they can lead to inconsistent interpretation and application. In contrast, rules-based accounting standards require specific guidelines to be followed, but they may not address unforeseen issues that arise in the normal course of business. At issue is whether the United States should adopt or converge with IFRS or remain on U.S. GAAP. Congress has asked the SEC to consult Congress as the SEC contemplates future actions on the issue of convergence.

The SEC was created under the Securities Exchange Act of 1934 (P.L. 73-291) to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. Congress also gave the SEC authority to establish accounting standards for the private sector in the United States; Congress retains its oversight responsibilities over the SEC. The SEC has historically delegated its responsibility for establishing accounting standards to a private entity, the Financial Accounting Standards Board (FASB). To date, the SEC has not given a clear indication as to whether the United States should remain on U.S. GAAP or adopt or converge with IFRS; neither has the SEC taken any concrete steps to adopt or converge with IFRS. In its desire to ensure that capital markets function efficiently, Congress has continued to maintain interest in the IFRS issue through legislation, hearings, and a letter issued to the SEC Chairman. At a March 2015 budget hearing for SEC's FY2016 budget, some Members of Congress voiced concerns over converging with IFRS. Similarly, in 2014, the Congressional Caucus on CPAs and Accountants also raised concerns over issues surrounding convergence with IFRS.

This report briefly explains the different accounting standards and U.S. capital markets. It examines several IFRS policy options Congress might consider and the benefits and challenges of each of those options. One option is to maintain the independence of U.S. GAAP but continue to seek common ground (limited convergence) with IASB. Within the scope of this option, the SEC and FASB could consider developing an international version of U.S. GAAP (I-GAAP). Another option is to adopt IFRS. The last option discussed in this report examines various hybrid methods of allowing U.S. GAAP and IFRS to coexist in the United States.

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Introduction

A firm's financial statements provide investors and creditors with essential financial information to evaluate the firm's performance. Financial statements are also a primary means by which firms communicate with capital markets' stakeholders, including investors, creditors, regulators, and the public. Congress created the Securities and Exchange Commission (SEC) in 1934 to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. However, Congress retains its oversight responsibilities over the SEC.¹ One aspect of the powers Congress gave the SEC is the statutory authority to establish accounting standards for the private sector in the United States. Since the creation of the SEC, domestic companies in the United States have used U.S. Generally Accepted Accounting Principles (U.S. GAAP) to issue financial statements.² Throughout its history, the SEC has relied on the private sector to establish and evolve U.S. GAAP.³ Currently, the SEC recognizes the Financial Accounting Standards Board (FASB) as the designated organization for establishing U.S. GAAP in the United States for the private sector.⁴

Many foreign countries, including the European Union (EU), either require or allow International Financial Reporting Standards (IFRS) for firms in their jurisdiction. The EU also accepts U.S. GAAP as equivalent to IFRS. The SEC and FASB have been considering incorporating IFRS where compatible with U.S. GAAP since the signing of a Memorandum of Understanding (MoU) with the International Accounting Standards Board (IASB) in 2002, known as the Norwalk Agreement. The FASB and IASB committed in the MoU to developing a "high-quality compatible accounting standards for both domestic and cross-border financial reporting."⁵ They also agreed to make existing financial reporting standards fully compatible and to maintain the compatibility between both standards. Since 2002, the SEC has delayed the date of convergence and has changed direction on whether the United States will ultimately adopt or converge with IFRS or maintain and evolve U.S. GAAP independent of IASB.

This report first provides a brief explanation of the different accounting standards and U.S. capital markets. U.S. capital markets are discussed in the context of how converging or remaining on U.S. GAAP may affect investors and firms. It then examines congressional interest in convergence issues, including recent statements by SEC's senior leadership on this issue. In conclusion, the report discusses a number of policy options facing Congress in the U.S. GAAP versus IFRS debate.

¹ CRS Report IF10032, *Introduction to Financial Services: The Securities and Exchange Commission (SEC)*, by Gary Shorter.

² The Securities and Exchange Commission (SEC) issued a rule in 2007 that allows foreign issuers of financial statements to file with the SEC using International Financial Reporting Standards (IFRS) without having to reconcile to U.S. Generally Accepted Accounting Principles (U.S. GAAP). Stephen A. Zeff, "How the U.S. Accounting Profession Got Where It Is Today: Part 1," *Accounting Horizons*, vol. 17, no. 3 (September 2003), pp. 191-193.

³ Financial Accounting Standards Board (FASB), "Facts About FASB," <http://www.fasb.org/facts/>.

⁴ The FASB's parent organization, the Financial Accounting Foundation (FAF), is a non-stock Delaware corporation. Neither FASB nor FAF is a government agency, even though the SEC does have oversight of the budget for FASB and the accounting standards as promulgated by FASB. FAF, "Facts About FAF," <http://www.accountingfoundation.org/jsp/Foundation/Page/FAFSectionPage&cid=1176157790151>.

⁵ FASB, *Memorandum of Understanding - "The Norwalk Agreement,"* September 18, 2002, p. 1, <http://www.fasb.org/resources/ccurl/443/883/memorandum.pdf>.

Appendixes of key definitions for certain concepts and terminology and acronyms used in this report are provided.

Accounting Standards

In simple terms, accounting standards are agreements among practitioners (i.e., accountants, auditors, and regulators) on how each line item on the financial statement should be valued and reported. The rules and guidelines in aggregate comprise U.S. GAAP or IFRS.⁶ U.S. GAAP is widely considered to be rules-based accounting that relies on specific guidance and a list of detailed rules on how accounting principles should be applied to economic events. As the name indicates, accounting standards in the United States are described as U.S. Generally Accepted Accounting *Principles*; arguably, it can be asserted the rules-based accounting framework in the United States is guided by a set of accounting principles.⁷ Over the decades, however, U.S. GAAP has become more rules based as practitioners have sought clarity from regulators on how best to implement the accounting standards as prescribed by U.S. GAAP and through the judicial process.

In contrast to U.S. GAAP, IFRS is considered principles based. Rules-based standards with their specificity may not address all unforeseen situations, whereas principles-based standards provide a framework for decisionmaking (the spirit of how rules should be interpreted and followed) but do not provide specific guidance or a list of detailed rules as with U.S. GAAP. If a practitioner is in doubt about how to apply the principles, IFRS directs the practitioner back to the principles.⁸ Whether IFRS will evolve into a rules-based standard, similar to U.S. GAAP, may not be known until it has weathered significant scrutiny from practitioners and the judicial system.

U.S. GAAP

Since its creation in 1934, the SEC has had the authority to establish financial accounting and reporting standards for private-sector firms.⁹ However, throughout its history, the SEC has relied on the private sector to establish such standards. The SEC recognizes U.S. GAAP, the accounting standards promulgated by FASB, to be the authoritative accounting standards for the private sector in the United States.¹⁰ The FASB is an independent entity that functions under the oversight of the private, nonprofit Financial Accounting Foundation (FAF). Both FASB and FAF are headquartered in the United States (Norwalk, CT). Since enactment of the Sarbanes-Oxley Act of 2002 (SOX),¹¹ FASB has been funded by fees collected from issuers of publicly traded securities. In 2014, FASB received \$24 million in accounting support fees from issuers.¹² It also made a

⁶ IFRS is used interchangeably throughout this report to refer to a single accounting standard or the aggregate of all accounting standards issued by the International Accounting Standards Board (IASB).

⁷ Linda A. MacDonald, project manager, FASB Simplification and Codification Project, “Principles-Based Approach to Standard Setting,” FASB newsletter, November 27, 2002, http://www.fasb.org/project/principles-based_approach.shtml.

⁸ Rebecca Toppe Shortridge, PhD, CPA, and Mark Myring, PhD, “Defining Principles-Based Accounting Standards,” *The CPA Journal Online*, 2009, <http://www.nysscpa.org/cpajournal/2004/804/essentials/p34.htm>.

⁹ 15 U.S.C. §77s.

¹⁰ FASB, “Facts About FASB,” <http://www.fasb.org/facts/>.

¹¹ P.L. 107-204.

¹² FAF, *Building a Better GAAP - 2014 Annual Report*, May 18, 2015, <http://www.accountingfoundation.org/cs/> (continued...)

non-recurring contribution of \$3.0 million to IASB. The support fees for FASB are subject to SEC review.¹³ In 2007, the chief accountant of the SEC reportedly refused to authorize the budget for FASB until the FASB chairman signed a MoU between the SEC and FASB. The MoU reportedly gave the SEC the power to nominate and interview FASB members and FAF trustees.¹⁴

U.S. GAAP consists of concepts, principles, and rules for communicating financial information for profit and nonprofit sectors within the United States.¹⁵ U.S. GAAP gives guidance on what should be reported on financial statements, how figures should be calculated; and what other management discussion and analyses are required for an investor to make an informed decision about a firm's performance. In many respects, U.S. GAAP is described as the "gold standard," because it has evolved since the 1930s within the U.S. institutional infrastructure through decades of due process that is uniquely sensitive to the needs of U.S. investors and capital markets.¹⁶ Accounting practitioners also perceive U.S. GAAP to adhere closer to the *conservatism principle*¹⁷ than IFRS.¹⁸ Even after certain countries have adopted IFRS (e.g., EU member countries), U.S. GAAP is still accepted in those countries, arguably strengthening the credibility of U.S. GAAP.

IFRS

In 1973, the American Institute of Certified Public Accountants (AICPA) and its counterparts in other countries established the predecessor organization to the IASB, the International Accounting Standards Committee (IASC).¹⁹ The IASC (unlike FASB and IASB) was essentially a nonbinding agreement rather than a formal body. It was created to establish basic global accounting standards in response to increased economic integration and cross-border capital transactions. Only a few countries that lacked the resources to create their own accounting standards used the IASC standards until IASB began issuing IFRS in 2003.²⁰ In 2005, the EU

(...continued)

ContentServer?c=Document_C&pagename=Foundation%2FDocument_C%2FFAFDocumentPage&cid=1176166022212. In 2013, 7,681 companies paid a total of \$25.5 million in fees to support FASB. See FASB, "How We're Funded," <http://www.accountingfoundation.org/jsp/Foundation/Page/FAFSectionPage&cid=1351027545591>.

¹³ 15 U.S.C. §7219.

¹⁴ Alan Rappeport and Marie Leone, "SEC Used Budget to Strong-arm FASB," *CFO.com*, April 3, 2007, <http://ww2.cfo.com/accounting-tax/2007/04/sec-used-budget-to-strong-arm-fasb/>.

¹⁵ The FASAB develops GAAP for federal government entities. Similar to FASB, the Governmental Accounting Standards Board (GASB) develops GAAP for state and local governments under the oversight of the private, nonprofit FAF.

¹⁶ Chris Cox, "How America's Participation in International Financial Reporting Standards Was Lost," Keynote Address, Pasadena, CA, June 5, 2014, p. 8, <http://www.aba.com/Tools/Function/Acct/Documents/KeynoteAddressToSECandFinancialReportingInstituteChrisCox060514.pdf>.

¹⁷ In accounting, under the conservatism principle, if the probability of loss in value of an asset is high, then the loss should be recognized. Conversely, if the likelihood of a gain is low, then the gain should not be recognized. Similar application is required for recognizing estimates and profit (loss).

¹⁸ John Briginshaw, "What Will the International Financial Reporting Standards (IFRS) Mean to Businesses and Investors?" *Graziadio Business Review*, vol. 11, no. 4 (January 2008).

¹⁹ The American Institute of Certified Public Accountants (AICPA) plays an integral part in creating accounting and auditing standards through its various activities, including developing and grading the Uniform CPA Examination and enforcing compliance with technical and ethical standards for its 400,000 members. AICPA, "About the AICPA," <http://www.aicpa.org/ABOUT/Pages/About.aspx>.

²⁰ FASB, *Comparability in International Accounting Standards—A Brief History*, Projects, <http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176156304264>.

member countries switched from their local GAAP to IFRS. Since 2003, more than 100 countries at varying degrees have either adopted or converged with IFRS.²¹ The IASB is a member of the IFRS Foundation based in the United Kingdom. Unlike the designated authority granted by the SEC to FASB to set the accounting standards in the United States, the IASB is an international body tasked with the responsibility (but not the designated authority) to establish IFRS.²²

The IASB seeks to promote unified accounting standards through IFRS by broadly defining the principles of specific accounting concepts. Individual countries have two main ways of incorporating IFRS:

1. Adoption—One approach is to accept IFRS without any modification as set by IASB (e.g., EU member countries).
2. Convergence—Another approach is to converge, where a jurisdiction would closely align some or all of its local GAAP with IFRS. Convergence can be achieved by either incorporating specific standards from IFRS or modifying the local GAAP to more closely resemble IFRS. For example, in China, IFRS is neither required nor permitted but the Chinese Accounting Standards (CAS) has substantially converged with IFRS. To a significant degree, IFRS was customized to a more easily understandable format for the Chinese markets.²³

Similar to FASB, the AICPA, IASB, IASC, and other nongovernmental organizations create and promote accounting and auditing rules and guidelines, but they do not have authority to enforce their compliance for the private industry in the United States.

Issues for Congress

Financial statements provide economy-wide benefits to firms and investors through the dissemination of accurate information. One way these benefits are realized is through the efficient allocation of capital between investors and firms. Investors rely on financial statements to make informed decisions on how best to invest their savings. This section of the report first discusses congressional interest in SEC actions on the issue of which standard, U.S. GAAP or IFRS, best serves the interest of the U.S. capital markets. Next, it discusses the implications of remaining on U.S. GAAP or adopting IFRS from investor and firm perspectives.

Congressional Interest in SEC Actions on Convergence

One aspect of the powers Congress gave the SEC is the authority to establish accounting standards for the private sector in the United States.²⁴ Although the SEC has the Office of the Chief Accountant, whose primary mission is to establish and enforce accounting and auditing

²¹ IFRS, “Jurisdiction Profiles,” September 25, 2014, <http://www.ifrs.org/use-around-the-world/Pages/Jurisdiction-profiles.aspx>.

²² SEC, *Reaffirming the Status of the FASB as the Designated Private-Sector Standard Setter*, policy statement, April 25, 2003, <https://www.sec.gov/rules/policy/33-8221.htm>.

²³ PricewaterhouseCoopers (PwC), “China,” in *IFRS Adoption by Country*, ed., <http://www.pwc.com/us/en/issues/ifrs-reporting/publications/ifrs-status-country.jhtml> (DE: PricewaterhouseCoopers, 2014), p. 159.

²⁴ CRS Report IF10032, *Introduction to Financial Services: The Securities and Exchange Commission (SEC)*, by Gary Shorter.

policy to ensure that financial statements improve investment decisions, the SEC has relied on the private sector to establish accounting standards in the United States. As previously discussed, FASB and its predecessor organizations have promulgated U.S. GAAP with the SEC largely assuming an oversight role except on the issue of establishing global accounting standards.²⁵ If the SEC chooses to switch from U.S. GAAP to IFRS, it might have major implications for U.S. firms and investors, which could be of interest to Congress in its oversight capacity of the SEC.

Congressional interest in accounting convergence has manifested itself in several ways, including hearings, letters to the SEC, and earlier enacted legislation. Most recently, Congress expressed interest on the convergence of accounting standards at a March 2015 hearing on the SEC's FY2016 Budget Request held by the House Committee on Financial Services.²⁶ In June 2014, the bipartisan joint Congressional Caucus on CPAs and Accountants wrote a letter to the SEC Chairman on the issue of convergence. In both instances, some Members of Congress voiced their concerns over "further incorporation of IFRS into the U.S. financial reporting system" and the existence of a "two-GAAP environment, enabling accounting arbitrage; investor confusion arising from differences in accounting treatments; and possible legal challenges."²⁷ Some Members of Congress have also expressed similar concerns publicly.²⁸

Previous congressional interest in IFRS has also manifested itself in enacted legislation that required the SEC to study the issue. For example, Section 108(d)²⁹ of the Sarbanes-Oxley Act of 2002 required the SEC to "conduct a study on the adoption by the United States financial reporting system of a principles-based accounting system." The SEC concluded the study as required by SOX in 2003, recommending that U.S. standards should be more principles based, although the study recognized the benefits and limitations of both rules-based and principles-based standards.³⁰

Section 509 of the National Securities Markets Improvement Act of 1996³¹ required the SEC to report to Congress on the development of international accounting standards. The study stated in 1997 that the international accounting standards, developed by the International Accounting Standards Committee (IASC), needed to be improved before acceptance could be considered in

²⁵ Since the creation of the SEC, domestic companies in the United States have used U.S. Generally Accepted Accounting Principles (U.S. GAAP) to issue financial statements. Stephen A. Zeff, "How the U.S. Accounting Profession Got Where It Is Today: Part 1," *Accounting Horizons*, vol. 17, no. 3 (September 2003), pp. 191-193.

²⁶ U.S. Congress, House Committee on Financial Services, *Examining the SEC's Agenda, Operations, and FY2016 Budget Request*, Hearing, 114th Cong., 1st sess., March 24, 2015. On October 24, 2007, the Senate Committee on Banking, Housing and Urban Affairs (110th Congress) held a hearing on convergence of U.S. GAAP. U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs Subcommittee on Securities, Insurance, and Investment, *International Accounting Standards: Opportunities, Challenges, and Global Convergence Issues*, 110th Cong., 2nd sess., October 24, 2007, S.Hrg. 110-951 (Washington: GPO, 2007).

²⁷ Adrienne Gonzalez, "Bipartisan Congressional CPA Caucus Warns SEC Against Taking IFRS Too Fast," *goingconcern*, July 23, 2014, <http://goingconcern.com/post/bipartisan-congressional-cpa-caucus-warns-sec-against-taking-ifrs-too-fast>. For the discussion of these concerns, see "Hybrid Methods" section below.

²⁸ Brad Sherman and Peter King, "A Sure-Fire Way to Harm the Economy: A proposal to count leases as liabilities would cost 3.3 million jobs and add \$2 trillion to company balance sheets," *Wall Street Journal*, November 9, 2014, <http://www.wsj.com/articles/brad-sherman-and-peter-king-a-sure-fire-way-to-harm-the-economy-1415574014>.

²⁹ 15 U.S.C. §7218.

³⁰ SEC, Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting, July 25, 2003, <https://www.sec.gov/news/studies/principlesbasedstand.htm>.

³¹ P.L. 104-290.

the United States.³² The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act³³ addressed many reforms to the financial industry, but did not specifically address accounting convergence issues. While SEC reports to Congress in 2003 and 1997 stated the pursuit of a unified global accounting standard might be in the interest of the United States, a later report by the SEC in 2012 did not make any specific policy recommendations on incorporating IFRS.³⁴

The future direction of how accounting standards evolve in the United States could be decided by Congress, the SEC, or FASB. To date, Congress has not enacted legislation on incorporating IFRS. However, if Congress chooses to directly address the issue, it could pass legislation. Alternatively, it can continue to defer to the regulators as it has since the creation of IFRS in 2003. Although the SEC has the statutory authority for establishing accounting standards in the United States, it has delegated the responsibility to FASB to continue to find common ground with IASB on specific standards. At this point, Congress is seen as unlikely to act unless the SEC were to change the status quo.

To date, current senior leadership within the SEC has proposed three different approaches to incorporating IFRS within the United States without achieving consensus. The first approach, according to SEC Chairman Mary Jo White at the aforementioned March 2015 hearing, is the establishment of a single set of high-quality global accounting standards.

A second approach was proposed by SEC Commissioner Kara M. Stein in a March 2015 speech. In her speech, she stated that a single set of globally recognized, high-quality accounting standards is a “wonderful vision,” but with a myriad of shortcomings, and the “debate between dueling standards needs to move on.” She also stated that she was not convinced of a need to abandon U.S. GAAP in favor of IFRS. She proposed an alternate approach of developing accounting standards that are responsive to the interconnected digital world, which can minimize the differences and maximize global investment and access to capital.³⁵

A third approach was proposed by SEC Chief Accountant James Schnurr, who proposed that financial statements based on IFRS should be allowed as supplementary information to U.S. GAAP statements. In December 2014, he stated that international regulatory and accounting constituents continue to want clarity on what action, if any, the SEC will take regarding incorporating IFRS into U.S. GAAP.³⁶ The text box below highlights the key events toward convergence between 2002 and 2015.

³² SEC, Pursuant to Section 509(5) of the National Securities Markets Improvement Act of 1996 - Report on Promoting Global Preeminence of American Securities Markets, October 1997, <http://www.sec.gov/news/studies/acctgsp.htm#sec1>.

³³ P.L. 111-203.

³⁴ SEC, Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers - Final Staff Report, July 13, 2012, <https://www.sec.gov/spotlight/globalaccountingstandards/ifrs-work-plan-final-report.pdf>.

³⁵ Commissioner Kara M. Stein, *International Cooperation in a New Data-Driven World*, Securities and Exchange Commission, speech, Washington, DC, March 26, 2015, <http://www.sec.gov/news/speech/2015-spch032615kms.html#.VRXQeOGAlsQ>.

³⁶ Ken Tysiac, “SEC Will Seek Comments on New Possibility for Voluntary IFRS Adoption,” *Journal of Accountancy*, December 8, 2014, <http://journalofaccountancy.com/news/2014/dec/ifrs-voluntary-adoption-201411476.html>.

Key Events in the U.S. GAAP and IFRS Convergence Timeline, 2002-2015

2002—The Sarbanes-Oxley Act of 2002, enacted on July 30, 2002, instructs the SEC to conduct an investigation into the adoption of a principles-based system in the United States. In September 2002, FASB and IASB signed a Memorandum of Understanding (MoU), the Norwalk Agreement. The MoU states that FASB and IASB would work jointly to develop high-quality compatible accounting standards that could be used for both domestic and cross-border financial reporting.

2007—The SEC issues a rule that allows foreign issuers to file financial statements with the SEC using IFRS without having to reconcile to U.S. GAAP. Until 2007, foreign companies that filed with the SEC were required to reconcile their financial statements to U.S. GAAP.

2008—The SEC releases a proposal that would require all U.S. registrants to use IFRS by 2014.

2010—In early 2010, the SEC proposes 2015 as the new deadline. The Work Plan for the Consideration of Incorporating IFRS into the Financial Reporting System for U.S. Issuers is published by the SEC.³⁷

2012—The final Staff Report of the 2010 Work Plan is issued by the SEC. The Staff Report did not make any specific policy recommendations on whether IFRS should be incorporated into the U.S. financial system.

2014—December 2014, the Chief Accountant of the SEC, James Schnurr, states at the AICPA conference that financial statements under IFRS should be allowed as supplementary information for SEC filings.³⁸

2015—SEC Chairman Mary Jo White testified at a March 24 hearing, held by the House Financial Services Committee, that there should be a single set of high-quality global accounting standards.³⁹ On March 25 at a breakfast roundtable SEC Commissioner Kara Stein states the “debate on dueling standards needs to move on” and U.S. regulators should focus on how best to address the needs of investors in a data-driven world.⁴⁰

GAAP Versus IFRS: Implications for U.S. Investors and Firms

A high-quality uniform global accounting standard, IFRS or another internationally accepted standard, might provide economy-wide benefits for the United States. Firms might benefit from easier access to global capital markets, because a uniform accounting standard may make it easier for investors to compare firms’ performance under one standard than under different standards. The easier access to global capital markets could potentially benefit U.S. firms in three main ways:

1. Improved capital allocation—Adoption of IFRS could potentially provide overseas investors with comparable and familiar financial statements that might be similar to the ones they use in their own countries. This, in turn, could result in increased investments in U.S. firms.
2. Lower cost of capital—Increased foreign demand for debt or stocks issued by U.S. firms could lower the costs for U.S. firms to issue debt or raise equity. A lower cost of capital would, all else equal, lead firms to increase physical investment, thereby stimulating economic growth in the United States.

³⁷ AICPA, *International Financial Reporting Standards - An AICPA Background*, 2011, p. 11, http://www.ifrs.com/pdf/ifrsupdate_v8.pdf.

³⁸ Financial Accounting Foundation, “FAF/FASB Statement on Remarks of SEC Chief Accountant James Schnurr at AICPA Conference”, news release, December 8, 2014, http://www.accountingfoundation.org/cs/ContentServer?c=FAFContent_C&pagename=Foundation%2FFAFContent_C%2FFAFNewsPage&cid=1176164627729.

³⁹ U.S. Congress, House Committee on Financial Services, *Examining the SEC’s Agenda, Operations, and FY2016 Budget Request*, Hearing, 114th Cong., 1st sess., March 24, 2015.

⁴⁰ Kara M. Stein, *International Cooperation in a New Data-Driven World*, SEC, March 26, 2015, <http://www.sec.gov/news/speech/2015-spch032615kms.html#.VShOeGAlsQ>.

3. Greater market liquidity—A uniform global accounting standard might increase cross-border investor interest, which could result in assets that can be easily purchased or sold without significant change in the asset's price.

Despite the potential benefits of adopting IFRS or a similar uniform global accounting standard, U.S. GAAP might already provide the aforementioned benefits, and it is not certain that IFRS would be able to achieve these benefits. FASB has been responsive to customize and evolve the U.S. GAAP to address the needs of the growing economy in the United States. Further, the benefits of adoption should not be overstated, because even under a single set of high-quality financial standards, financial reporting may vary among firms, industries, and jurisdictions. Institutional infrastructure plays a significant role in how accounting standards are interpreted and implemented in each jurisdiction.⁴¹

In addition, a single set of global accounting standards that must address the needs of both the less sophisticated smaller economies and the more sophisticated larger economies may not serve the best interests of U.S. investors and firms.⁴² U.S. GAAP has evolved over the past 80 years and is customized to meet the needs of U.S. investors and firms. Any changes to existing accounting standards must be considered in a broader context of how U.S. GAAP has evolved within the U.S. institutional infrastructure.

The rest of this section of the report provides contextual background on how the different accounting standards might affect U.S. investors and firms, including certain concerns that have been raised regarding IASB. It also discusses potential effects on U.S. equity. A more detailed analysis of challenges U.S. investors and firms might face under various policy options is discussed later in the report.

Investors

U.S. investors have become familiar with financial statements and disclosures issued under U.S. GAAP, which has evolved within the institutional infrastructure of the United States since the 1930s. Investors who have been using financial statements under U.S. GAAP for more than 80 years may find adapting to IFRS a significant challenge. A 2012 SEC study on the incorporation of IFRS found that U.S. investor knowledge of IFRS ranged considerably, with many unfamiliar with IFRS.⁴³ If insufficient time were allowed for further incorporation of IFRS into the U.S. capital markets, individual investors may lack the resources to become familiar with IFRS at the same speed as institutional investors. Individual and institutional investors would also need to have sufficient financial resources to weather any uncertainties that may arise as part of either adoption or convergence with IFRS.

In addition, recent events have led some to view IFRS critically. During the recent financial crisis, there were allegations that IASB sidestepped due process. Reportedly, IASB did not give

⁴¹ Luzi Hail, Christian Leuz, and Peter D. Wysocki, *Global Accounting Convergence and the Potential Adoption of IFRS by the United States: An Analysis of Economic and Policy Factors*, FASB, February 2009, p. 4.

⁴² The United States is the world's largest economy at nearly \$17 trillion in gross domestic product (GDP). The next two largest economies combined, China and Japan, total nearly \$14 trillion in GDP. The World Bank, "World Development Indicators," Washington, DC, 2015, <http://databank.worldbank.org/data/views/reports/tableview.aspx>.

⁴³ SEC, Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers, Final Staff Report, July 13, 2012, p. 73, <http://www.sec.gov/spotlight/globalaccountingstandards/ifrs-work-plan-final-report.pdf>.

sufficient notice and time for comment and review of the draft proposal on the interpretation of fair value standards. The interpretation was quickly issued, which allowed financial institutions to reclassify some loans as a way to avoid revaluing those loans at lower market prices.⁴⁴ These accounting changes allowed firms to value these assets at a price higher than otherwise might have been allowed, which did not require these firms to recognize the losses immediately.

If a firm does not recognize losses when assets are not performing, it has the potential to harm investors. In the short run, investors may perceive the firm as being healthy, although in the end, unless the asset value recovers, investors may suffer substantial losses. In 2013, a group of British investors reportedly had similar concerns that led them to write to former EU Internal Markets Commissioner Michel Barnier that IFRS accounting rules were harming shareholders and destabilizing the economy.⁴⁵ They reportedly raised concerns that IFRS rules adopted by the United Kingdom in 2005 had allowed companies and banks to hide the increased risks on their balance sheets. FASB's and IASB's response to fair-value accounting standards during the recent financial crisis might have slowed further erosion of asset values that could have led to a more significant systemic crisis.⁴⁶

Another perspective to consider is that investors may have greater confidence under rules-based U.S. GAAP if equity valuations are consistently more predictable than under principles-based IFRS. A firm's management, arguably, could have greater influence on the firm's earnings under IFRS. Two studies that examined net income under the two different standards found that higher net income was reported under IFRS than under U.S. GAAP. The principles-based approach, arguably, allows for more management discretion when determining net income under IFRS. An analysis of foreign private issuers (FPIs) that filed Form 20-F⁴⁷ with the SEC in 2006 found that 75% of the FPIs reported higher net income and 43% reported higher stockholders' equity under IFRS than under U.S. GAAP.⁴⁸ Another study analyzed 73 of the largest European companies that reported under both U.S. GAAP and IFRS and found that 60 (82%) of them reported higher net income under IFRS than under U.S. GAAP.⁴⁹

The accounting standards developed by IASB might not only be influenced by the needs of the capital markets but also by how IASB is funded and governed. In 2014, the IFRS Foundation received more than 25% of its annual contributions from international accounting firms. One of the firms not only contributes to the IFRS Foundation, but also audits its financial statements,

⁴⁴ FASB also changed fair-value accounting standards that allowed financial institutions to value fewer loans using mark-to-market accounting during the recent financial crisis. Arguably, FASB allowed a shorter time for due process than normal. FASB, FAS 157—Determining Fair Value When the Volume and Level of Activity for the Asset or Liability have Significantly Decreased and Identifying Transactions that are Not Orderly, Project Update, http://www.fasb.org/project/fas157_active_inactive_distressed.shtml#objective.

⁴⁵ Louise Armitstead, "IFRS Could Be Stripped of Accountancy Watchdog Role," *The Telegraph*, March 15, 2014, <http://blog.windhambrannon.com/articles/share/63497/>.

⁴⁶ Floyd Norris, "Banks Get New Leeway in Valuing Their Assets," *The New York Times*, April 2, 2009.

⁴⁷ Form 20-F is a report that foreign private issuers (FPIs) file with the SEC in lieu of 10-K annual statements that domestic companies are required to file. The SEC changed the requirement for 20-F filings for FPIs in 2007, allowing FPIs to file reports based on IFRS.

⁴⁸ Marlene Plumlee and R. David Plumlee, "Information Lost: Descriptive Analysis of IFRS Firms' 20-F Reconciliations," *The Journal of Applied Research in Accounting and Finance*, vol. 3, no. 1 (July 2008), p. 17.

⁴⁹ John Briginshaw, "What Will the International Financial Reporting Standards (IFRS) Mean to Businesses and Investors," *Graziadio Business Review*, vol. 11, no. 4 (2008), <http://gbr.pepperdine.edu/2010/08/what-will-the-international-financial-reporting-standards-ifs-mean-to-businesses-and-investors/>.

raising concerns over conflict of interest.⁵⁰ In addition, Members of the European Parliament (MEPs) criticized the IFRS Foundation for poor governance structures, a lack of transparency, and close links to the accounting industry. The former MEP and Chairman of the European Economic and Monetary Affairs Committee, Sharon Bowles, reportedly stated, “Questions have been raised by the European Parliament about the governance structures and the lack of transparency of these bodies, as well as their close links to the accounting industry.”⁵¹

Firms

U.S. firms rely heavily on publicly traded equity and debt financing to raise funds. The financing provided through capital markets is usually from a large pool of investors at arm’s length (i.e., parties to a transaction that are independent and on equal footing without any special relationship or having another agreement on the side). Consequently, U.S. firms’ financial statements and disclosures face scrutiny by investors who rely on publicly available information to make informed decisions.⁵² U.S. GAAP has evolved over the past 80 years in conjunction with the U.S. institutional infrastructure and its capital market participants, including investors, creditors, accountants, auditors, and regulators.

In contrast to how U.S. GAAP has evolved to serve the specific interests of the U.S. capital markets, IFRS was created to serve the interest of more than 100 jurisdictions with gross domestic products (GDPs) of varying sizes and differing levels of economic development. On the one hand, not adopting or converging with IFRS could potentially put U.S. firms at a competitive disadvantage in raising funds in overseas markets and therefore increase their capital costs. On the other hand, delegating authority to an international body to set accounting standards in the United States might not serve the best interest of U.S. firms.

Based on the expectation that the United States will eventually either adopt or converge with IFRS, the SEC in 2007 changed the requirement for FPIs to file Form 20-F and allowed FPIs to file under IFRS.⁵³ This ruling eased concerns that some foreign corporations might delist from the U.S. exchanges due to additional costs they would incur either reconciling or converting from IFRS to U.S. GAAP. In 2014, more than 5,000 companies were listed on the major U.S. exchanges.⁵⁴ The SEC estimates that there were nearly 1,000 FPIs in 2014; of which,

⁵⁰ IFRS Foundation, *Annual Report 2014 - Financial Reporting Standards for the World Economy*, May 5, 2015, <http://www.ifrs.org/About-us/IFRS-Foundation/Oversight/Annual-reports/Documents/IFRS-Foundation-Annual-Report-2014.pdf>.

⁵¹ Louise Armitstead, “IFRS Could Be Stripped of Accountancy Watchdog Role,” *Telegraph*, March 15, 2014, <http://www.telegraph.co.uk/journalists/louise-armitstead/10700745/IFRS-could-be-stripped-of-accountancy-watchdog-role.html>.

⁵² Luzi Hall, Christian Leuz, and Peter Wysocki, “Global Accounting Convergence and the Potential Adoption of IFRS by the United States: An Analysis of Economic and Policy Factors,” *Financial Accounting Standards Board*, March 11, 2009, pp. 29-30.

⁵³ SEC, *Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards without Reconciliation to U.S. GAAP*, December 21, 2007, <http://www.sec.gov/rules/final/2007/33-8879.pdf>.

⁵⁴ Dan Strumpf, “U.S. Public Companies Rise Again - Stock Market Listing Grow for First Time Since the Internet Boom,” *The Wall Street Journal*, February 5, 2014, <http://www.wsj.com/articles/SB10001424052702304851104579363272107177430>.

approximately 50% of foreign private issuers filed under IFRS without reconciling to U.S. GAAP.⁵⁵

Policy Considerations

Perspectives on a unified global accounting standard have evolved in the United States since the signing of the Norwalk Agreement in 2002. Many in the global community prefer that the United States adopt or closely converge with IFRS, but perspectives vary among domestic stakeholders on what best serves the interest of U.S. capital markets.

Congress, in its oversight capacity of the SEC and FASB, has several policy options. In choosing between U.S. GAAP and IFRS accounting standards, arguably, the policy goals of protecting investors and facilitating capital formation would need to be weighed. This section of the report examines the benefits and challenges of three of those policy options:

1. Maintain U.S. GAAP, while continuing to work with IASB on convergence (issuing joint standards) when it serves in the best interest of U.S. capital markets. Another aspect to consider within the scope of maintaining U.S. GAAP is to create and promote International U.S. GAAP (I-GAAP).⁵⁶ The new I-GAAP would incorporate the best aspects of U.S. GAAP, yet it could be responsive to the needs of the world's capital markets that are similar to the United States.
2. Adopt IFRS as the U.S. accounting standard, which would require some timeline for implementation that considers the interests of various stakeholders.
3. A hybrid policy option would give U.S. firms the choice of issuing financial statements under either U.S. GAAP or IFRS, or include IFRS financial statements as supplemental information to U.S. GAAP.

Maintain U.S. GAAP

One policy option is to maintain U.S. GAAP. Because accounting standards are continuously evolving, maintaining the status quo raises the question of whether FASB and IASB should coordinate when responding to emerging issues. FASB, in its capacity as the accounting standard setter in the United States for private firms, has jointly worked with IASB to develop certain accounting standards, but coordination has fallen short of working toward convergence.

The rest of this section of the report discusses various aspects of why maintaining U.S. GAAP might be in the best interest of the U.S. capital markets. The discussion begins by providing two different examples of how U.S. GAAP financial statements are integrated into the institutional infrastructure of the United States and why changing to a different accounting standard would need careful consideration. It then discusses, based on current events, reasons why maintaining a responsive and independent U.S. accounting standards setter is important to U.S. investors and firms. The next section discusses why the SEC might want to change a 2007 ruling that allowed foreign firms listed in the United States to file under IFRS. In 2007, the SEC changed its ruling

⁵⁵ Information on number of FPIs was obtained through an email from the SEC on April 3, 2015.

⁵⁶ Luzi Hail, Christian Leuz, and Peter D. Wysocki, *Global Accounting Convergence and the Potential Adoption of IFRS by the United States: An Analysis of Economic and Policy Factors*, FASB, February 2009, pp. 92-94.

that required foreign-listed firms to reconcile their financial statements to U.S. GAAP and allowed them to file under IFRS. Lastly, it presents a discussion on creating a new alternative international accounting standard based on U.S. GAAP.

U.S. GAAP and Institutional Infrastructure

Switching to IFRS would have consequences beyond financial reporting. Two different examples of how U.S. GAAP is closely linked with other aspects of the U.S. institutional infrastructure—tax laws and statutory reporting—might illustrate this interplay.

Tax laws require that taxable income be computed under the method of accounting that a taxpayer maintains for computing their income (i.e., normal business income).⁵⁷ The change from U.S. GAAP to IFRS might not only affect financial reporting but how the tax liability is determined for U.S. firms that carry inventory. The U.S. tax code allows Last In First Out (LIFO) valuation of inventory as a consequence of GAAP accounting when determining tax liability, whereas IFRS does not allow LIFO (see text box).⁵⁸ The issue surrounding LIFO has been one of the most frequently discussed issues over IFRS adoption. The issue was discussed at a March 24 SEC budget hearing held by the House Financial Services Committee.⁵⁹

Last In First Out Inventory Method

Last In First Out (LIFO) inventory method, arguably, measures the more recent cost of inventory that is purchased and sold to generate the revenue in the most recent period.⁶⁰ During periods of inflation, LIFO results in lower gross income (e.g., sales revenue – cost of goods sold = gross income) than under other commonly used inventory methods. The lower gross income will generally result in lower tax liability. The other commonly used inventory valuation methods are First In First Out (FIFO) and weighted average.

Other key differences exist on inventory valuation between U.S. GAAP and IFRS regardless of which tracking method is used. Remaining inventory (i.e., inventory on hand) is valued on the basis of lower of historical cost versus market price under U.S. GAAP. The principle of conservatism, a dominant feature of U.S. GAAP, requires the inventory to be written down to the lower price. IFRS requires a similar valuation on the basis of lower of historical cost or net realizable value, but IFRS allows the write-downs to be reversed as selling prices rise. Reversals are not allowed under U.S. GAAP.⁶¹

Similar to how financial reporting is closely linked with requirements in tax laws, statutory reporting (i.e., regulatory filings) is closely linked to financial reporting. Although statutory reports often leverage some of the GAAP financial information, they communicate a different set of information that is not readily communicated by GAAP financial statements. For example, in the insurance industry, statutory reports focus on the insurance firm's ability to pay the claims of the insured, whereas GAAP statements focus on the revenue and profit generated by the insurance firm. Likewise, the banking industry requires banks to file call reports with the bank regulators. Call reports communicate additional information about the bank's capital and liquidity among other information about the health of the bank. Both GAAP and statutory filings are useful for

⁵⁷ 26 U.S.C. §446(a).

⁵⁸ 26 U.S.C. §471 and 26 U.S.C. §472.

⁵⁹ U.S. Congress, House Committee on Financial Services, *Examining the SEC's Agenda, Operations, and FY2016 Budget Request*, Hearing, 114th Cong., 1st sess., March 24, 2015.

⁶⁰ CCH "Applying LIFO for Book and Tax Purposes," in *LIFO Method of Accounting for Inventories Applying LIFO for Book and Tax Purposes* (CCH, 2015).

⁶¹ Dahli Gray and Clemense Ehoff Jr, "Lower of Cost or Market Inventory Valuation: IFRS Versus US GAAP," *Journal of Business and Economics Research*, vol. 12, no. 1 (First Quarter 2014), pp. 19-20.

investors and regulators. Regulators frequently use statutory reports to gather information about the health of a specific industry, which is often useful for policymakers.

Need for Independent U.S. Standards Setter

An example of FASB's ability to maintain its independence and be responsive to the needs of U.S. capital markets is how it has addressed the concerns of U.S. firms over the implementation of the new revenue recognition standard. On May 28, 2014, the FASB and IASB issued a joint revenue recognition standard for revenue from contracts with customers.⁶² The new standard was to go into effect for reporting periods beginning after December 15, 2016. However, in response to firms' concerns,⁶³ on April 1, 2015, FASB sought comments on delaying the implementation of the new revenue recognition standard by one year to December 15, 2017, without IASB consent.⁶⁴ Reportedly, when FASB was initially considering postponing the implementation date, IASB was not.⁶⁵ Nearly a month later, when FASB voted to delay implementation, IASB voted to publish an exposure draft proposing a one-year delay in implementation "to keep the effective date of the IASB's and the FASB's revenue standards aligned."⁶⁶ FASB's ability to respond to the concerns of U.S. capital market participants at a faster rate than IASB might provide policymakers with a significant reason to maintain the institutional structure of U.S. accounting regulators and U.S. GAAP.

As FASB and IASB try to create converged standards, some of the underlying differences in accounting standards are becoming more apparent, leading to divergence between U.S. GAAP and IFRS. The degree of convergence or divergence might become more evident as the accounting standards are updated over time. For example, FASB and IASB have had differing approaches in response to constituents' concerns about accounting for "Financial Instruments" that began as a joint project in 2005. In 2014, based on the feedback it received on the exposure draft, "Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities," FASB revised its original proposal and chose a deliberative approach in three phases, while IFRS issued the new standard, IFRS 9, to be effective January 1, 2015.⁶⁷ Much of the recent U.S. debate among stakeholders and Congress has focused on how much convergence is desirable.

⁶² FASB, *In Focus - Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606)*, May 28, 2014, pp. 1-5, http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176164075187.

⁶³ Reportedly, the software, entertainment, and telecom industries were concerned with the ability of software vendors to adapt their software to the new standard and the need to review large volume of contracts. Joanne M. Flood, "FASB Proposes Delay to Effective Date of the New Converged Revenue Standard," *Wiley Insight*, April 1, 2015, <http://ifrs.wiley.com/news/fasb-proposes-delay-to-effective-date-of-the-new-converged-revenue-st>.

⁶⁴ FASB, *Revenue Recognition*, April 1, 2015, http://www.fasb.org/cs/ContentServer?c=Page&pagename=FASB%2FPage%2FBridgePage&cid=1351027207987#section_7.

⁶⁵ Ken Tysiac, "FASB, IASB to Propose Clarifying Revenue Recognition Guidance," *Journal of Accountancy*, February 18, 2015.

⁶⁶ International Accounting Standards Board (IASB), *IASB Votes to Defer the Effective Date of the New Revenue Standard*, April 28, 2015, <http://www.ifrs.org/Alerts/ProjectUpdate/Pages/IASB-votes-to-defer-the-effective-date-of-the-new-revenue-Standard.aspx>.

⁶⁷ Ken Tysiac, "Convergence Unachieved After IASB Publishes Financial Instruments Standard," *Journal of Accountancy*, July 24, 2014, <http://journalofaccountancy.com/news/2014/jul/201410624.html>.

The differences in accounting standards could benefit capital markets if the competition and evolution of different approaches between accounting standards lead to better standards over time. Differing approaches could lead to FASB and IASB learning best practices from each other, which could result in improved financial reporting and disclosures, but it could also lead to continued divergence from creating one common global accounting standard.

Require U.S. GAAP for Foreign Issuers

In 2007, the SEC changed the requirement for foreign private issuers to file Form 20-F and allowed FPIs to file under IFRS.⁶⁸ Congress and the SEC may want to consider requiring all listed firms in the United States, including foreign private issuers, to report under U.S. GAAP or reconcile IFRS financial statements with U.S. GAAP standards. The SEC could change its 2007 ruling that allowed FPIs to file under IFRS and require them to reconcile (Form 20-F) to U.S. GAAP or file under U.S. GAAP. As previously discussed, requiring all U.S.-listed companies to file under one accounting standard might eliminate any investor confusion, but foreign firms might respond to this change by delisting.

U.S. International GAAP

If the United States continues to maintain U.S. GAAP, an option to consider is to create and promote an international version of U.S. GAAP (I-GAAP), as proposed in a FASB-commissioned report in 2009.⁶⁹ For countries that have similar characteristics to the U.S. economy and institutional infrastructure, adoption of I-GAAP might promote greater confidence in their capital markets. Continued divergence between GAAP and IFRS might provide more of a reason to create I-GAAP, which would adhere to the fundamentals of the rules-based approach of U.S. GAAP but would have greater input from other jurisdictions.⁷⁰ As previously discussed, competing standards (I-GAAP and IFRS) might lead to better standards that benefit capital markets. An ongoing criticism of IFRS is the ability of each jurisdiction to effectively implement and enforce the newly adopted IFRS standards within its jurisdiction. To counter some of the criticisms faced by IFRS adoptees and maintain I-GAAP's credibility, I-GAAP adoptees could be required to adhere to specific expectations on implementation, enforcement, and auditing requirements. Each jurisdiction must initially qualify to adopt and implement I-GAAP.

An international FASB (I-FASB) could be established as the governing body to develop I-GAAP and to determine which countries qualify to adopt I-GAAP. Acceptance into I-GAAP after meeting certain standards might function in a similar fashion to how member countries are admitted to the EU. Thereafter, each jurisdiction could be periodically certified by I-FASB on

⁶⁸ SEC, Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards without Reconciliation to U.S. GAAP, December 21, 2007, <http://www.sec.gov/rules/final/2007/33-8879.pdf>.

⁶⁹ Luzi Hail, Christian Leuz, and Peter D. Wysocki, *Global Accounting Convergence and the Potential Adoption of IFRS by the United States: An Analysis of Economic and Policy Factors*, FASB, February 2009, pp. 92-94.

⁷⁰ The SEC estimates that in 2014 almost half of nearly one thousand foreign private issuers (FPIs) used U.S. GAAP to file reports with the SEC. These FPIs had the option to file under either IFRS or U.S. GAAP. The European Union also accepts U.S. GAAP as equivalent to IFRS. European Commission, *State of play on convergence between International Financial Reporting Standards (IFRS) and third country national Generally Accepted Accounting Principles (GAAP)*, Working Paper, Brussels, BEL, July 28, 2011, p. 2, http://ec.europa.eu/finance/accounting/docs/20110728_report_en.pdf. Information on number of FPIs was obtained from the SEC through email on April 3, 2015.

their compliance with I-GAAP. Certifying only select countries to implement I-GAAP and monitoring their ongoing adherence could help maintain the credibility of I-GAAP. Although there might be many benefits to dual international accounting standards, dual standards may prevent eventual global convergence to a single set of standards.⁷¹

Adopt IFRS

A second policy option for Congress and the SEC to consider is the complete adoption of IFRS as the U.S. accounting standard. This section of the report discusses different ways (options) of adopting IFRS and specific issues related to those options; transitional issues common to the ways of adopting IFRS; and the role of U.S. institutions.

Options

The first way is for the SEC to choose a specific date that all public companies must begin reporting under IFRS. This approach might be the least confusing and most straightforward for firms and investors, but it presents a particular set of challenges. Not all firms may be able to adhere to a specific date, because a significant amount of basic resources (e.g., human, technology, and financial) necessary for IFRS implementation might not be available at the same time.⁷² If the conversion date was set far into the future with sufficient planning, then the resource constraint might not be as significant.

The second way to implement IFRS is in multiple phases. In the United States, the last significant changes to accounting standards as required by the Sarbanes-Oxley Act were phased in over a number of years.⁷³ Implementing IFRS over several years based on firm-revenue size or by industrial segment might allow stakeholders sufficient time to adapt to the new standards without significant disruption to individual firms or the economy.

Phasing in IFRS based on firm-revenue size with larger firms adopting first could be justified on the grounds that firms with higher revenues are able to absorb the costs more readily than smaller firms. Further, because there are significantly more smaller firms than larger firms, it will allow more time for the supporting companies to scale up their resources to support the transition.⁷⁴ This approach might enable smaller firms to learn from the successes and failures of larger firms and identify ways to reduce costs of conversion. The potential for investor confusion exists, however, during the period of transition as firms within the same industry could be reporting under two different standards.

⁷¹ Luzi Hail, Christian Leuz, and Peter D. Wysocki, *Global Accounting Convergence and the Potential Adoption of IFRS by the United States: An Analysis of Economic and Policy Factors*, FASB, February 2009, pp. 92-94.

⁷² There are multiple companies that offer IFRS certification, including the American Institute of Certified Public Accountants. As of April 3, 2015, the full cost IFRS certification through AICPA is \$1,695. AICPA, *IFRS Certificate Program*, New York, NY, 2015, http://www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/InternationalAccounting/PRDOVR~PC-159770/PC-159770.jsp.

⁷³ Securities and Exchange Commission, *SEC Announces Next Steps for Sarbanes-Oxley Implementation*, press release, May 17, 2006, <https://www.sec.gov/news/press/2006/2006-75.htm>.

⁷⁴ U.S. Congress, Joint Committee on Taxation, *Choice of Business Entity: Present Law and Data Relating to C Corporations, Partnerships, and S Corporations*, committee print, prepared by Joint Committee On Taxation, 114th Cong., 1st sess., April 10, 2015, JCX-71-15 (Washington: GPO, 2015), pp. 24-29.

Another option would be to implement IFRS by specific industries over time. Industry-specific implementation would be easier for investors and other stakeholders trying to evaluate the performance of a company among its peers. However, specialization that auditors, financial analysts, and consultants develop in one industry might not readily translate to another specific industry. For example, consider an individual who is specialized in auditing banks. Arguably, the knowledge of the banking industry is not so readily transferable to the natural resources industry. This approach might present challenges to smaller firms, because they may not have the knowhow or financial resources to convert simultaneously with their peers that have higher revenues within the same industry.⁷⁵

Transitional Issues

Compared with the normal business operating cycle for individual firms and the economy, converting to a new standard arguably will require greater resources. U.S. GAAP and IFRS differ on what should be included on financial statements and how the information is presented. To accommodate the transition to a new accounting standard, existing computer systems that maintain the accounting records must be upgraded or new systems purchased. Companies would likely need to maintain the new systems and legacy systems until the usefulness of the information from legacy systems expires. In addition to the one-time cost of converting to IFRS, there would be ongoing costs similar to remaining on U.S. GAAP.

If firms choose to issue financial statements under both standards during the period of transition, there would be costs to reconcile both sets of financial statements and provide sufficient disclosures for investors to understand the potential differences in net income (loss) and asset valuation under each standard. Firms must also decide if the benefits outweigh the costs of having both sets of financial statements audited or just having one set of financial statements audited.

Another transitional issue of adopting IFRS is that the financial statements at first might be misrepresented either intentionally or unintentionally.⁷⁶ For example, a firm's management might have incentives (e.g., stock options or stock grants) to take advantage of the principle-based approach to engage in earnings management.⁷⁷ In addition, the learning curve for the firm's staff and auditors could lead to unintentional mistakes. If the financial statements' errors are significant, then the business must reissue the financial statements. A significant financial misstatement could lead to a decline in a firm's stock price and make it difficult to raise capital. If several companies have to restate their financial statements, investors may lose confidence in the overall U.S. capital markets, at least temporarily.⁷⁸ In turn, loss of confidence by the investment

⁷⁵ For definition of small firms, please see CRS Report R40985, *Small Business: Access to Capital and Job Creation*, by Robert Jay Dilger.

⁷⁶ Under convergence, issues similar to adopting IFRS may arise, arguably, to a lesser degree as elements of existing U.S. GAAP are likely to be maintained and each standard issued by IASB would likely receive greater scrutiny than under full adoption of IFRS.

⁷⁷ Earnings management is using accounting techniques to meet a targeted number instead of reporting the economic events as they are in a given period. For example, a firm may choose to delay maintenance expenses or delay writing off obsolete inventory to meet quarterly or yearly earnings expectations.

⁷⁸ During the early 2000s, a period of accounting scandals and financial restatements by major corporations led to the enactment of Sarbanes-Oxley Act of 2002. SOX was enacted, arguably, to help reform corporate governance, accounting, and auditing practices. The financial restatements by major corporations like Enron and WorldCom led to decline in their stock prices and their inability to raise capital. Many of these corporations eventually went out of business or their assets were purchased by other corporations at a significant discount (as compared with the previously (continued...))

community could increase the cost of capital or limit the availability of credit for U.S. firms. The investment community might discount the value of firms' equity or demand higher premiums for the debt issued by firms.

To mitigate some of the transitional challenges, U.S. firms might be able to leverage the knowledge gained from overseas firms that have adopted IFRS. Leveraging the knowledge from overseas firms could potentially result in lower costs of conversion for U.S. firms than the costs incurred by overseas firms. Similarly, U.S. regulators may also be able to learn best practices from their overseas counterparts and help implement a smoother transition.

Role of U.S. Institutions

The role of the SEC and FASB as accounting standard setters must be reconsidered if IFRS is adopted in the United States. FASB's role is limited to setting standards, whereas the SEC has a broad regulatory role in the capital markets, therefore the SEC's role in U.S. capital markets might not be significantly diminished. If the United States chooses to adopt IFRS without customization, then FASB's role could be diminished or possibly redefined. FASB could evolve to become an advisory body to the SEC.

Another issue to consider is that IFRS has not weathered the U.S. judicial process and remains a principles-based standard. If IFRS is adopted in the United States, over the ensuing years firms may interpret and apply standards differently. Similar to FASB's current role, a national standard setter could mitigate differences and issue uniform guidance. Further, without a standards body to provide guidance in the context of the U.S. institutional infrastructure, multinational firms may be influenced by how standards are interpreted in other jurisdictions.

Hybrid Methods

There are a few ways to incorporate IFRS into the U.S. financial reporting requirements. One option is to allow a choice between IFRS and U.S. GAAP or require firms to file under both standards. A second option, proposed by SEC's chief accountant, is to allow supplemental IFRS reporting.⁷⁹ These different options are discussed in detail below.

Allow Firms to Choose Between U.S. GAAP or IFRS

Congress and the SEC could allow firms to choose either U.S. GAAP or IFRS. Allowing firms the choice of accounting standards would give firms the flexibility to be more responsive to the desires of the investing community; in other words, let market demand determine which standard becomes pervasive in the United States. However, this option would make it challenging for investors to compare firms within the same industry, and there are other possible implications.

The choice of standards might become segmented by industry. Given their relative importance to investors, larger firms might have disproportionate influence over which standard their specific

(...continued)

stated values). See CRS Report RS21135, *The Enron Collapse: An Overview of Financial Issues*, by Mark Jickling.

⁷⁹ Ken Tysiac, "SEC Will Seek Comments on New Possibility for Voluntary IFRS adoption," *Journal of Accountancy*, December 8, 2014, <http://journalofaccountancy.com/news/2014/dec/ifrs-voluntary-adoption-201411476.html>.

industry follows. If a specific standard becomes firmly entrenched by a specific industry, it would be easier for investors to compare firms within the same industry, but it would be more difficult to compare firms across industries. Further, firms might periodically “venue shop” between both standards for best results. Similar to provisions in tax laws, Congress and the regulators could consider limiting how often firms change accounting standards. Tax law allows a business to change the method of accounting it uses for determining taxable income only with the consent of the Secretary of the Treasury.⁸⁰ Similar provisions could be made for switching financial reporting by firms with the consent of the SEC or FASB.

Another approach is to require all U.S. firms to file under both standards, which could be more expensive for firms but might help ease the transition to IFRS for investors. Policymakers could choose to require firms to report under both standards indefinitely or for a specific period of time. For example, policymakers could choose a five-year transition period in which firms are required to file under both standards and then require firms to report only under IFRS.

The choice of different accounting standards or requiring both accounting standards would make it more difficult for accountants, auditors, and regulators, because they must understand the nuances of each accounting and auditing standard. In the United States, private-firm auditors follow Generally Accepted Auditing Standards (GAAS)⁸¹ in conjunction with U.S. GAAP. Jurisdictions that have adopted IFRS generally use the International Standards in Auditing developed by International Auditing and Assurance Standards Board (IAASB).⁸² The adoption of IFRS does not necessarily mean the IAASB standard would be the default standard. The SEC and Public Company Accounting Oversight Board could determine which auditing standards would be used in the United States. Similar to accounting standards, auditing standards have also evolved with the institutional infrastructure of the United States. Implementation of IAASB must be considered in the context of specific legislation passed by Congress to protect investors (i.e., SOX). This hybrid option would require a decision to be made about which of these auditing standards firms would be required to follow. Similar to GAAS, a U.S. version of International GAAS (I-GAAS) could be created if IFRS were adopted in the United States.

Allow Supplemental IFRS

Another option to consider, as proposed by the SEC’s Chief Accountant, James Schnurr, in December 2014, would allow voluntary disclosure of IFRS financial information as a supplement to U.S. GAAP financial statements.⁸³ Schnurr’s proposal did not specify if full IFRS financial statements or selected financial data would be reported as supplemental information under IFRS. Further, Schnurr’s proposal did not specify if the supplemental IFRS information should be audited or unaudited.

Currently, investors expect financial statements filed with the SEC to have been audited. Inclusion of IFRS financial statements with SEC filings has the potential to attract additional overseas investors, but unaudited statements might mislead investors, as they may assume that

⁸⁰ 26 U.S.C. §446(e).

⁸¹ Generally Accepted Auditing Standards established by the AICPA and overseen by Public Company Accounting Oversight Board and the SEC are the minimum standards auditors must follow when auditing public companies.

⁸² International Federation of Accountants (IFAC), “About IAASB,” <http://www.iaasb.org/>.

⁸³ Ken Tysiac, “SEC Will Seek Comments on New Possibility for Voluntary IFRS adoption,” *Journal of Accountancy*, December 8, 2014, <http://journalofaccountancy.com/news/2014/dec/ifrs-voluntary-adoption-201411476.html>.

IFRS financial statements are audited in similar fashion to U.S. GAAP statements. Alternatively, the SEC and PCAOB could consider requiring filers to disclose in their financial statements which statements are audited and unaudited.⁸⁴ To alleviate investors' concerns, the SEC and PCAOB could mandate that all financial information filed with the SEC must be audited. It would increase costs for companies to have both sets of financial statements audited, but inclusion of IFRS statements under this option would be voluntary, and not a requirement. Alternatively, as currently permitted, the SEC could allow only U.S. GAAP financial statements to be filed with the SEC. Any firms desiring to attract additional investors could issue audited IFRS financial statements independent of SEC filings.

For example, the advantage of this proposal is that firms would only undergo the additional expense of supplemental filing if it were beneficial to them. The introduction of IFRS financial information could benefit U.S. firms interested in attracting more overseas investors. However, inclusion of two sets of financial statements might also confuse both domestic and international investors, especially if revenue, expense, net profit, asset, and liability values differ in each set of financial statements.

⁸⁴ As previously discussed, the SEC in many respects delegates its authority for establishing accounting and auditing standards to nongovernmental organizations, such as the FASB and PCAOB. The PCAOB oversees the audit of public companies and broker-dealers. The PCAOB was established by Congress in 2002 through SOX (P.L. 107-204).

Appendix A. Key Definitions

The following definitions are described in the context of how they are discussed in this report; they are not meant to be precise legal or finance definitions.

Adoption—The acceptance of IFRS as the accounting standard for publicly listed firms.

Arm’s Length—Parties to a transaction that are independent and on equal footing without any special relationship or having another agreement on the side.

Capital Allocation—The process of allocating investments across borders, business units, or departments to maximize returns on the investments.

Convergence—Convergence might be described as a process by which a jurisdiction incorporates specific standards from International Financial Reporting Standard (IFRS) or modifies some or all of its Generally Accepted Accounting Principles (GAAP) to more closely resemble IFRS.

Conservatism Principle—In accounting, under the conservatism principle, if the probability of loss in value of an asset is high, then the loss should be recognized. Conversely, if the likelihood of a gain is low, then the gain should not be recognized. Similar application is required for recognizing estimates and profit (loss).

Due Process—Due process could be described as a principle of fairness in all legal matters that aspires to safeguard both private and public rights against unfairness. From this basic principle of fairness, many decisions including procedural and substantive rights and process are determined.⁸⁵

Cost of Capital—One of many possibilities is that increased interest from investors can lower a firm’s cost of raising capital either in debt or equity. In simple terms, a firm could pay a lower interest rate when issuing debt or issue fewer shares of stock at a higher price due to increased demand.

Listed Firms—Firms that are listed on a stock exchange (e.g., New York Stock Exchange [NYSE], National Association of Securities Dealers Automated Quotations [NASDAQ]).

Market Liquidity—Market liquidity is defined as assets that can be easily purchased or sold without significant change in the assets’ price.

Principles-Based Accounting Standards—They provide a framework for decisionmaking but do not provide specific guidance or a list of detailed rules to follow, and they are widely used to describe IFRS.

Rules-Based Accounting Standards—They rely on specific guidance and a list of detailed rules on how accounting principles should be applied to economic events. They are widely used to describe U.S. GAAP.

⁸⁵ West’s Encyclopedia of American Law, edition 2. *S.v.* “Due Process of Law,” retrieved June 17, 2015, from <http://legal-dictionary.thefreedictionary.com/Due+Process+of+Law>.

Venue Shopping—Choosing an accounting standard that reflects the firm’s performance in the best light possible to investors and regulators.

Appendix B. Acronyms

FASB	Financial Accounting Standards Board
FIFO	First In First Out
FPIs	Foreign Private Issuers
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IAASB	International Auditing and Assurance Standards Board
IFRS	International Financial Reporting Standards
ISA	International Standards in Auditing
LIFO	Last In First Out
MoU	Memorandum of Understanding
PCAOB	Public Company Accounting Oversight Board
SEC	Securities and Exchange Commission
SOX	Sarbanes-Oxley Act

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