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A Perspective on the SEC's Proposal to Accept Financial Statements Prepared in Accordance with International Financial Reporting Standards (IFRS) without Reconciliation to U.S. GAAP

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Financial Accounting Standards Committee,
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SYNOPSIS: The Securities and Exchange Commission (SEC) recently issued a call for comment on a proposal to accept financial statements prepared in accordance with International Financial Reporting Standards (IFRS) without reconciliation to U.S. GAAP. Accounting researchers have attempted to assess the quality of IFRS using different methods and criteria. While we are skeptical of drawing direct conclusions about the SEC's proposal based on this research, there is adequate evidence that both IFRS and U.S. GAAP provide useful information to investors and other users of financial statements. Moreover, we see no conclusive research evidence that financial reports prepared using U.S. GAAP are better than reports prepared using IFRS. The prudent approach when faced with alternatives with no clear difference in quality is to promote competition among them, which supports adopting the SEC's proposal to permit foreign private issuers a choice between IFRS and U.S. GAAP. Furthermore, to help improve U.S. and international GAAP through standards-setting competition, we recommend that the Commission extend the choice of IFRS to U.S. companies, and require all companies to indicate clearly whether they are filing under U.S. GAAP or IFRS. Finally, we recommend that the Commission and its staff investigate and seek feedback on the educational consequences of its proposed actions. This attention will help educators to better prepare future professionals to implement these proposed regulatory changes.

INTRODUCTION

The Securities and Exchange Commission (SEC) recently issued a call for comment on a proposal (hereafter, Proposal) to accept financial statements prepared in accordance with International Financial Reporting Standards (IFRS) without reconciliation to U.S. GAAP.

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While this paper summarizes the comments of the Financial Accounting Standards Committee of the American Accounting Association to the SEC, it does not represent an official position of the American Accounting Association.

The SEC's call for comment is a 121-page document that seeks advice on 49 separate issues with respect to private foreign issuers that do not use U.S. GAAP. Rather than commenting on each specific issue, we will discuss five key issues where extant accounting scholarly research has most relevance.

Accounting researchers have attempted to assess the quality of IFRS using various approaches. While we are skeptical of drawing direct conclusions about the SEC's proposal based on this research, there is adequate evidence that IFRS and U.S. GAAP both meet a minimum quality threshold. Moreover, we see no conclusive research evidence that either is of higher quality than the other at this time. The prudent approach when faced with alternatives with no clear means of ranking on quality is to promote competition among them, which supports adopting the SEC's basic proposal to permit foreign private issuers a choice between IFRS and U.S. GAAP.[1]

Another stream of academic research emphasizes that the quality of financial accounting and reporting standards is not sufficient to ensure their comparable application because of differences across national, sovereign environments in which such standards are applied. Issues associated with reconciliation of IFRS with U.S. GAAP will depend as much on the legal, auditing, regulatory, governance, enforcement, financing, and cultural environments of a country as on the financial accounting and reporting standards adopted. Delaying the adoption of IFRS, or insisting on convergence of IFRS with U.S. GAAP before permitting IFRS use, does not strike us as necessary while these other issues are dealt with. Since all foreign companies issuing shares in the United States will be subject to the SEC's jurisdiction and enforcement, these national institutional differences are not relevant to companies listed on U.S. stock exchanges.

To help improve U.S. and international GAAP through standards-setting competition, we recommend that the Commission should also consider extending the choice of IFRS to domestic (U.S.) companies, and require all companies to indicate clearly whether they are filing under U.S. GAAP or IFRS.

We also recommend that the Commission and its staff should address and seek feedback on the educational consequences of its proposed actions as a part of its routine process going forward in the future. Such attention will help better implement the regulatory intent of the Commission.

RESPONSE TO SEC QUESTIONS

The SEC proposes to accept financial standards based on IFRS with no reconciliation to U.S. GAAP. Current scholarly research provides relevant insights on the following five issues raised in the SEC's proposal:

- Are IFRS "quality" accounting standards? (Q1, p. 27)
- Should acceptance of IFRS-based accounting standards be contingent on convergence of U.S. and IFRS standards? (Q2, p. 27)
- Should the timing of acceptance of IFRS-based financial statements depend on foreign issuers, audit firms, and other constituencies having more experience with preparing IFRS financial statements? (Q6, p. 34)
- How useful is the reconciliation to U.S. GAAP from IFRS for comparing companies? (Q11, p. 41)

[1] On November 15, 2007, the SEC voted to allow foreign issuers to use IFRS without requiring a reconciliation to U.S. GAAP. See the announcement at http://www.iasplus.com/index.htm#drop.

- Do you agree with our assessments of costs and benefits? (Q47, p. 101)

Are International Financial Reporting Standards "Quality" Standards?

The quality of IFRS is a critical question underlying the SEC proposal. Will financial reports prepared based on IFRS be as informative and useful as financial reports prepared under current U.S. GAAP? This is a difficult question to answer because the quality of accounting reports depends on a variety of environmental factors, such as accounting standards, auditing, governance practices, the accounting education system, the legal regime, information intermediaries, and various regulatory bodies, all of which influence the incentives and competence of preparers, auditors, and users of financial reports. Accounting scholars have used a variety of research approaches to develop insights that may be useful to the SEC in addressing this issue. Four of these approaches have the most implications regarding the quality of IFRS.

One approach focuses on behavioral changes by users and preparers after a firm adopts IFRS. This research presents evidence that after IFRS were adopted, analysts' forecast accuracy improved (Ashbaugh and Pincus 2001), analyst following increased (Cuijpers and Buijink 2005), and foreign mutual fund ownership was higher for adopters compared with firms that used their own national GAAP (Covrig et al. 2007). Evidence also suggests that adoption of IFRS leads to better reporting (less earnings management) relative to the use of national GAAP in many countries (Barth, Landsman, and Lang 2007; Barth, Landsman, Lang, and Williams 2007). These studies indicate that adoption of IFRS provides benefits to users of financial statements. It should be noted that this evidence is not conclusive because of the self-selection bias inherent in studies where firms are not assigned randomly to each condition. Consequently, IFRS adopters may vary from nonadopters on important variables other than IFRS. Therefore, differences between the two groups cannot be attributed solely to IFRS. This caveat notwithstanding, the results of these studies indicate that users and preparers of financial statements benefit from adoption of IFRS.

A second approach has sought to use the correlation between reported accounting earnings and stock returns as a measure of accounting quality (called the "value-relevance" literature). This literature assumes that the higher the correlation between accounting numbers (e.g., earnings) and stock returns, the higher the reporting quality. The use of this correlation criterion to measure quality has been controversial. Detractors (e.g., Holthausen and Watts 2001) have argued that these results are irrelevant for standard setting because of the use of an invalid quality criterion, self-selection problems, concerns about the valuation models used, and a host of other methodological concerns. Proponents of this approach (e.g., Barth et al. 2001) have defended its use and argued that the methodological issues can be dealt with effectively. Although the committee is skeptical about this approach, it is widely used. Hence, its key results will be discussed without the committee's endorsement of their relevance for SEC policy.

Value-relevance studies (e.g., Alford et al. 1993; Pope and Walker 1999) have found that countries with similar accounting standards (the Anglo-Saxon countries: the United States, the United Kingdom, Canada, and Australia) have similar market correlations with reported accounting numbers. This is not surprising as the GAAP of these reporting regimes are similar, although U.S. GAAP is found to be slightly more conservative than the others. Reported accounting numbers from some continental European companies that use their country's national GAAP also have similar correlations with stock returns (e.g., German companies studied by Harris et al. [1994] and French companies studied by Alford et al. [1993]). National GAAP from other (especially non-Anglo-Saxon) countries can vary substantially from that of U.S. GAAP and are usually less highly correlated with stock returns. The general conclusion offered by value-relevance researchers is that U.S. GAAP is very similar to the national GAAP of developed countries such as the United

Kingdom, Canada, Australia, France, and Germany. Given that IFRS draws on the expertise and GAAP reporting traditions of these countries, these findings suggest that it is likely that IFRS is on a quality par with U.S. GAAP.

A third approach has tried to bypass concerns about value-relevance by looking at aggregate properties of the stock market. A study by Leuz (2003) provides the most direct and relevant evidence about the efficacy of U.S. versus IFRS GAAP. This study investigates information asymmetry between investors (proxied by bid-ask spreads) and liquidity (proxied by trading volume) for companies listed in Germany's Neuer Markt that could choose to use IFRS or U.S. GAAP for their financial reporting. The underlying notion is that the better the financial reporting, the better the total flow of information to the market and the lower the information asymmetry among investors, which results in greater liquidity. The results indicate no statistical or economically significant differences in the bid-ask spreads or liquidity of companies that used IFRS compared with those that used U.S. GAAP. Again, the conclusion from this research is that IFRS is equivalent to U.S. GAAP.

A fourth approach focuses on institutional factors in the reporting environment, such as the legal regime, auditing, securities regulation, the industry in which a company operates, and other factors that may affect the implementation of reporting standards (e.g., Ball et al. 2003). According to this view, accounting standards evolve in accordance with a country's legal, auditing, regulatory, governance, and financing systems. Therefore, there is no "one" optimal set of accounting standards. Rather, accounting is an evolving process. Experimentation with a variety of approaches has the potential to help identify better accounting standards, improve the education of future accountants, and provide managers with a better opportunity to communicate their results to investors. This research implies that regulatory competition would be beneficial to the development of good accounting standards (Sunder 2002; Benston et al. 2003). Based on this evidence, we offer that not only should the SEC allow foreign companies to use IFRS (as proposed), but it should also allow U.S. companies to choose IFRS if they wish. The reporting environment in the European Union is as conducive to good reporting as is the U.S. environment, and enforcement appears to be no less rigorous. Hence, there is no reason to believe that IFRS is not equal in quality to U.S. GAAP.

In conclusion, four different approaches for assessing reporting quality support a similar conclusion: the quality of IFRS and U.S.GAAP is comparable and the proposal to allow foreign companies to use IFRS deserves support.

Should Acceptance of IFRS-Based Accounting Standards be Contingent on Convergence of U.S. and IFRS Standards?

The research results discussed in the previous section suggest that IFRS are of high quality and equivalent to U.S. GAAP in terms of providing useful financial information, irrespective of any global standards convergence process. The research community has speculated that the lack of substantial differences between the national GAAP of various developed countries and U.S. GAAP could be caused by companies that cross-list in the United States adopting discretionary accounting choices close to U.S. GAAP. Leuz (2003) attempted to control for this U.S. market-listing effect.[2] The companies examined in that study are German firms listed in Germany and not cross-listed in the United States. The IFRS adopters produce accounting reports whose information value to investors is equivalent to that of U.S. GAAP adopters.

[2] The Leuz study is an archival study and thus has a potential self-selection problem. The control over listing is a nice feature, but not a perfect control.

Facilitating the development of a harmonized set of global accounting standards is one of the motivations behind the SEC's willingness to accept IFRS. On the contrary, harmonization per se is not necessary and need not be desirable. The research results discussed above are independent of any harmonization effort, yet they find that IFRS is equivalent to U.S. GAAP. Furthermore, there is some skepticism in the academic literature about the benefits of accounting-standard harmonization (Ball et al. 2003; Dye and Sunder 2001, Benston et al. 2006), and some researchers have concluded that regulatory competition is beneficial to the development of good accounting standards (Sunder 2002; Benston et al. 2003).

Skepticism about the potential benefits from harmonization arises from a concern that the quality of reported accounting numbers is determined by the incentives of preparers and auditors of financial statements. These incentives are primarily influenced by legal, auditing, governance, and regulatory regimes—not primarily by accounting standards (Ball et al. 2003). An attempt to force an inexact practice like accounting into having one global "correct" accounting solution for all issues has the potential to promote form over substance, retard the development of thought among students aspiring to be accountants, and make it difficult for regulators and society to experiment with different approaches, and get feedback about effectiveness of alternative accounting treatments (Sunder 2002). While AAA members have very diverse opinions about the benefits of harmonization or convergence, the preponderance of the academic research evidence does not support the view that harmonization is a necessary condition for high-quality GAAP. Consequently, IFRS-based accounting standards can and should be accepted by the SEC without requiring a convergence process between U.S. GAAP and IFRS.

Should the Timing of Acceptance of IFRS-Based Financial Statements Depend on Foreign Issuers, Audit Firms, and Other Constituencies Having More Experience with Preparing IFRS Financial Statements?

IFRS standards are not as comprehensive and detailed as U.S. GAAP. IFRS standards are in the process of being adopted by countries that previously had a highly regarded national GAAP (e.g., the United Kingdom, Canada, and Australia) as well as by many countries that lack the tradition of sound national GAAP. The evidence cited earlier about the quality of IFRS and the equivalence of the quality of accounting numbers in developed countries cannot be generalized on a global basis. Ball et al. (2000) and Ball et al. (2003) have reported evidence suggesting that quality of accounting numbers varies significantly among countries that have adopted IFRS.

For countries that have had a tradition of sound national GAAP there is no need to wait for experience in adopting IFRS. The governance, education, audit, legal, and regulatory systems required to promote good financial reporting are already in place. For countries that lack this broader reporting infrastructure, there is no evidentiary basis to conclude that the required reporting infrastructure will evolve over time.[3] Moreover, it is unlikely that time is the key element in determining the proper adoption and implementation of IFRS.

As noted earlier, the evidence from academic research indicates that IFRS adoption in countries with developed governance, legal, auditing, and enforcement infrastructures offer accounting numbers that are the equivalent of numbers prepared and presented under U.S. GAAP, implying that there is no reason to impose costs on U.S. investors and foreign-listed firms from those countries that want to offer their shares in U.S. stock markets (Bushman and Piotroski 2006). Furthermore, investors who conclude otherwise can avoid purchasing the securities of companies

[3] The economic institutions of a country are influenced by complex political forces. It is thus hard to provide any general prediction about how the economic institutions of any country will evolve over time.

whose financial statements use IFRS. Indeed, investors exhibit some home-country bias, and some of them will avoid buying securities of companies that report using IFRS (Bradshaw et al. 2004).

In addition, the European Union (EU) has endorsed the current set of IFRS and requires it for firms preparing consolidated financial statements and trading their shares on an EU exchange. Although there is no research to cite, experience suggests that if the United States continues its bias against IFRS, the EU is likely to retaliate by requiring U.S. companies to reconcile their statements to IFRS, which would be a costly and unnecessary process. There is nothing to be gained from delaying the recognition of IFRS and much that could be lost to both U.S. investors and companies.

How Useful Is the Reconciliation to U.S. GAAP from IFRS-Based Financial Statements?

Reconciliation between IFRS and U.S. GAAP has the potential to be useful to investors if four conditions were met: (1) the differences in reported numbers are large in magnitude; (2) the items causing the difference are hard to understand from reading the financial statements; (3) extensive judgment is required to determine the accounting numbers causing the differences, and (4) the costs to companies of producing an audited reconciliation are not greater than the benefits that investors obtain from them.

If we accept the Leuz (2003) result that IFRS standards produce accounting numbers that are of similar quality to those prepared under U.S. GAAP, then it is unlikely that the reconciliation schedule would provide useful information to investors, unless the IFRS were not implemented properly. For developed countries with a tradition of a good national GAAP, a reconciliation schedule is a costly exercise with few apparent benefits. For countries where implementation of IFRS is questionable, reconciliation to U.S. GAAP might be useful to investors.

Do You Agree with Our Assessments of Costs and Benefits?

There are direct costs involved with preparing and auditing the numbers in reconciliation schedules, and the SEC has made a reasonable attempt to quantify these costs. Given the controversy about excessive compliance costs of accounting-related mandates, such as Section 404 of the Sarbanes-Oxley Act (Brien 2006), we can appreciate the SEC's sensitivity to the magnitude of such costs. There is no clear evidence of any corresponding benefit to justify forcing all foreign-listed companies to incur these costs. Since the SEC can use its enforcement power to compel registrants to comply with its rules, there should be a clearly demonstrable benefit before companies are compelled to incur substantial regulatory compliance costs. In addition, these direct costs are not the only costs that should be considered. There is a broader cost to society, to current and future accounting students, and to the feedback and learning opportunities available to regulators from acting as if U.S. GAAP is the only acceptable GAAP in the world, and from attempts to harmonize the whole world on one set of "correct" GAAP.

CONSEQUENCES OF THE SEC PROPOSAL ON HIGHER EDUCATION

While the primary criteria for the SEC's decision relate to direct and immediate impact on capital markets, the SEC's regulatory actions and policies have major educational consequences. The Commission has not solicited comments on the educational aspects of its proposed action, but AAA members are deeply interested in accounting education, research, and practice. As the Financial Accounting Standards Committee of the AAA, we would like to submit the following unsolicited comments on the educational consequences of the proposed action. We urge the Commission and its staff to consider the educational consequences of its proposed actions as a part of its routine process going forward. Such attention will help better implement the regulatory intent of the Commission.

Over the seven decades since the passage of the federal securities laws, the scope of authoritative standards has expanded so dramatically that the SEC has formed a special advisory committee to study the problems of excessive accounting complexity. This expansion has led to fundamental changes in textbooks, course content, classroom discourse, and examinations, including the AICPA's exams for professional certification.

In the absence of an authoritative standard for a class of transactions, textbooks, classroom discussion, and examinations were designed to explore various possible ways in which a transaction could be accounted for and the consequences of alternative accounting treatments for various parties and for the economy as a whole. Such discourse develops the minds of students to think fundamentally, does not allow for black-and-white answers, and helps attract to the accounting profession young people who like to think independently and abstractly. Judgment, after all, is a hallmark of a profession.

With expansion in the scope of authoritative standards, however, educational discourse has progressively shifted toward rote memorization of written rules for regurgitation on exams. With the FASB's monopoly status for accounting standards for public companies, and especially adoption of a GAAP hierarchy (SAS No. 69), which officially assigns a legally enforceable hierarchy of authority, intermediate accounting classes have moved toward focusing on literal application of those standards, rather than on critical examination of the merits of alternative accounting treatments for various classes of transactions. Such "memory-based" curricula tends not to be attractive to talented students (Albrecht and Sack 2000).

In a prescient paper published in 1953, Professor Baxter anticipated that one consequence of the increased standardization of accounting and deference to authority would be diminishment not only of professional judgment, but also of accounting education (Baxter 1953). Unfortunately, his prediction appears to be coming true, and the outcome threatens the future health of the accounting profession. Accounting has largely become a service activity in M.B.A. programs and it is now rare for an M.B.A. student to major in accounting. An increased focus on asserting authority (e.g., a GAAP hierarchy) as the basis for understanding and applying accounting standards reduces the intellectual stimulation of accounting education and drives talented students to other fields.

On the other hand, if in the long-run interest of accounting education the Commission were to settle for a system of competitive standards of financial reporting, then there would be some hope that the accounting educational system will be induced to move in the direction of teaching general principles. Students educated in such a higher-level system of education are more likely to develop the powers of abstraction that would allow them to pick up any book of standards and apply them to specific transactions using sound judgment derived from education in general principles.

SUMMARY AND CONCLUSION

Financial statements based on IFRS can provide financial reports that are equivalent to those based on U.S. GAAP. While there are differences in the financial reporting environment (governance, legal regime, audit, and securities regulation) among countries, the SEC should not wait until all elements of the financial reporting environment are harmonized on a global basis, even assuming that harmonization is possible and desirable. Allowing foreign companies to use IFRS without costly reconciliations to U.S. GAAP is likely to make U.S. stock exchanges more competitive and provide useful feedback to U.S. accounting standard-setters about the efficacy of their standards. Furthermore, allowing U.S. companies to use IFRS might also benefit investors. This change could also help shift U.S. accounting education toward a richer principles-based education steeped in critical analysis and evaluation of competing approaches.

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