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# Adoption of International Financial Reporting Standards: Analysis of Effects and Risks and What Has Been done to Mitigate the Risks

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# Adoption of International Financial Reporting Standards:

# Analysis of Effects and Risks and What Has Been Done to Mitigate the Risks

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ABSTRACT (100 – 200 WORDS):

This research project was conducted to gain more insights on the fact that even though the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have taken significant steps to push the U.S. toward adoptions of International Financial Reporting Standards (IFRS), there are still concerns regarding the costs versus benefits of the conversion. As a result, the paper concentrates on the effects and risks that the conversion from U.S. GAAP to IFRS will bring to four main affected parties: the regulators and standards-setting bodies, the financial statements users, the financial statements issuers, and the financial statement auditors. In addition, the paper will not address the effects and risks resulting from the convergence of U.S. GAAP and IFRS for a better set of standards or make any judgment whether the conversion is beneficial to the U.S. or not overall.

This research project was conducted using the primary and secondary sources. Primary sources are publications from the regulators and standards-setting bodies such as the Securities and Exchange Commission (SEC), FASB, and IASB. Secondary sources are usually scholarly journal articles. Since the nature of this paper is informative, there is no conclusion made from the costs-benefits analysis of the conversion.

# Adoption of International Financial Reporting Standards

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Analysis of Effects and Risks and What Has Been Done to Mitigate the Risks

## BACKGROUND

In the US, the Federal Accounting Standards Board (FASB) issues U.S. Generally Accepted Accounting Principles (GAAP). The FASB, a private standards-setting body representing the accounting profession and the investing community, was delegated the authority to set generally accepted accounting principles by the Securities and Exchange Commission (SEC). The SEC requires publicly traded companies to adhere to U.S. GAAP. Besides the overarching supervision of the SEC, FASB is also under the authority of the Financial Accounting Foundation (FAF). The FAF, an independent, private-sector organization, oversees standards-setting bodies, selects their members and protects their independence. The FASB's mission is to "[serve] the investing public through transparent information resulting from high quality financial reporting standards" (Financial Accounting Standards Board, n.d.).

Compared to a 60-year-history of U.S. GAAP, International Financial Reporting Standards (IFRS) is a young set of standards developed by the International Accounting Standards Board (IASB) following an international consultation process. The IASB is an independent standards-setting board, supported by an external advisory council, the Standards Advisory Committee (SAC), and an interpretations committee, the International Financial Reporting Interpretations Committee (IFRIC). The IASB is overseen by the Trustees of the International Accounting Standards Committee (IASC) Foundation who are accountable to the public interest. The IASB's mission is to "develop, in the public interest, a single set of high quality, understandable and international financial reporting standards (IFRSs) for general purpose financial statements" (About Us, n.d.).

Currently, the IASB is working, with national accounting standards-setting bodies around the world, towards a global set of high quality standards that would encompass the needs of many countries. IFRS are already accepted by more than 100 countries, including those in the European Union, Asia, and Latin America. Since 2005, the use of IFRS by publicly traded European companies has become mandatory by the European Commission. Other countries from different continents following the European Union's footstep have taken their countries' accounting standards through a major overhaul. Israel completed its transition to IFRS in 2008. Chile and Korea will finish their conversion in 2009. Canada will join in 2011 and allow early adoption in 2009. Brazil and India also have set a date to move toward IFRS.

The convergence of US Generally Accepted Accounting Principles (GAAP) with International Financial Reporting Standards (IFRS) first started in 2002 when the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) signed the Norwalk Agreement. The Norwalk Agreement demonstrates the FASB's strong commitment in working with the IASB for global convergence of financial reporting standards. Since the agreement, significant steps have been made to encourage the convergence. The FASB and the IASB held meetings in April and October 2005 which indicated their resolve to achieve a common set of high quality accounting standards. In 2005, the Securities and Exchange Commission (SEC) allowed foreign private issuers that are first-time adopters of IFRS to file two years rather than three years of IFRS financial statements. In February 2006, the FASB and IASB released a memorandum of understanding, reiterating their commitment to the convergence of U.S. GAAP and IFRS. The two standards-setting bodies planned several projects to aid the conversion.

During the time period from 2007 to present there have been several important highlights. In August 2007, the SEC issued a concept release titled "Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards." The concept release proposed to allow some foreign issuers who are registered in the US to prepare their financial statements according to IFRS without reconciling to U.S. GAAP. In September 2007, the IASB published an Exposure Draft on joint arrangement (joint ventures). During 2008, the FASB and the IASB contemplated and continued doing short-term projects on major convergence topics: business combinations, financial instruments, financial statement presentation, intangible assets, leases, liabilities and equity distinctions, revenue recognition, consolidations, de-recognition, fair value measurement, and post-employment benefits (Concept Release, 2008). Recently, on August 27$^{th}$, 2008, the SEC released a proposed road map for public comments on potentially requiring U.S. financial statement issuers to prepare financial statements in accordance with IFRS. The roadmap states that the SEC will meet in 2011 to assess the transition process from U.S. GAAP to IFRS and decide whether to adopt IFRS. In order to effectively and efficiently assess the transition, the roadmap also lists a set of seven milestones:

- Improvements in accounting standards
- The accountability and funding of the International Accounting Standards Committee Foundation, which oversees the IASB
- Improvements in the ability to use interactive data-tagging technology, also known as XBRL, for IFRS reporting
- Education and training related to IFRS
- Limited early use of IFRS where this would enhance comparability for U.S. investors
- The anticipated timing of future rulemaking by the SEC
- And the implementation of the mandatory use of IFRS by U.S. issuers. (Roadmap, 2008)

This paper discusses the major effects that the conversion from U.S. GAAP to IFRS places on different participating parties. Four main affected parties are identified as the regulators or standards-setting bodies, the financial statement users, the financial statement issuers, and the financial statement auditors. A description of these affected parties is provided below.

#### THE STANDARD-SETTING BODIES AND REGULATORS

In the United States, Congress placed the authority to set standards and regulate the capital market to the SEC after the stock market crash in the 30's. The SEC then delegated the authority to set accounting standards to private sectors. FASB sets accounting standards for for-profits companies and non-profit non-governmental entities while the Governmental Accounting Standards Board (GASB) sets accounting standards for governmental and non-profit governmental entities.

On the other hand, the IASB based in London, UK was found on April 1, 2001 to take over the responsibilities of the IASC Foundation which was founded in June 1973. The IASB develops IFRS that would be applied to for-profit entities which specializes in commercial, industrial, financial and similar activities (Session 4: International Accounting Standard Board, n.d.).

#### THE FINANCIAL STATEMENTS USERS

Financial statements users can be common investors who want to obtain ample knowledge regarding a company they are thinking of investing in. They can be investment advisors who need to gather adequate financial information in order to assist their client in making the right decision. They can also be prospective creditors who desire some level of confidence from understanding how financially stable the company is.

#### THE FINANCIAL STATEMENTS ISSUERS

The SEC mandates all of the publicly held corporations to issue audited financial statements conforming to a generally accepted set of accounting standards. The audited financial statements provide the public information about the company's business activities. The information from the audited financial statements is guaranteed by the issuers to be reasonably presented and provides investors with some degree of confidence to make their investment decisions.

#### THE FINANCIAL STATEMENT AUDITORS

Publicly held companies must have their financial statements audited before filing with the SEC. Auditors perform certain procedures to test the reasonableness of the information being presented to the public by the companies, as well as the internal controls of the companies. They express opinions on whether the financial statements are fairly presented and internal controls in place are effective. These opinions provide the financial statement users some degree of confidence in the information presented by the companies. Auditors also work with governmental or non-profit entities as well as privately held companies.

## HOW DOES THE ADOPTION OF IFRS AFFECT DIFFERENT PARTIES?

As the U.S. is preparing for the conversion, the debate as to whether or when the U.S. should adopt IFRS is intensifying. With the intention of analyzing the effects of the conversion on each of the four aforementioned parties, this section will identify the objective of each party then examine how adopting IFRS would affect each party revenue- and cost-wise.

### REGULATORS AND STANDARDS-SETTING BODIES

#### Objective

US regulators and standards-setting bodies show enormous support for the conversion but might not agree on the same approach. Their main objective in setting standards is to provide an encouraging and safe environment for the investors. Often they struggle setting strict standards to protect the investors while relaxing the standards enough to promote trade businesses. For example, even though the SEC acknowledges that U.S. GAAP is a "well-established basis of financial reporting" it has to recognize that IFRS has the potential to become the single set of high-quality standards in this globalized business world (Roadmap, 2008, Potential for IFRS as the Global Accounting Standard, para.4). Former SEC chairman, Christopher Cox, justified the SEC's rush to converge U.S. GAAP with IFRS as a way to benefit "investors who seek comparable financial information to make well-informed investment decisions'" (William, 2008, para.2). US regulators claim that adoption of IFRS will increase comparability and consistency of financial statements across the US and the world. As a result, US investors can be more comfortable comparing financial results of a U.S. company to a non U.S. company and make better decisions. Contrary to her predecessor, the new SEC chair, Mary Schapiro, does not "feel bound by the existing roadmap that is out for public comment" (WebCPA, 2009). Schapiro raises doubts about the independence of IASB as well as the lack of guidance in IFRS and would like to proceed with great caution.

#### Effects of Conversion

**Potential Benefit**

Regulators assert that IFRS would enhance U.S. investors' ability to expand their trading and investment on a global scale as well as widen the door for the US to an abundant supply of capital. As the SEC acknowledges in its proposed roadmap for the conversion, modern technology has enabled U.S. investors to reach across borders, and the demand for a single set of standards has been amplified (Roadmap, 2008). In addition, Peter Williams (2008) identifies the continuingly increasing percentage of the world capital market that is adopting IFRS, which stands at 35%, and comments that "as the US capital markets represent 28% of the value of the global capital markets, it is possible to appreciate that the US fears it is being left behind in the accounting revolution" (William, 2008, para.3). The U.S. has been losing its dominating power in the world market as many sources of economic power are rising from different parts of the world. The U.S. may no longer be the one who sets standards for everyone to follow. It might be the time when the world sets standards and the U.S. has to follow, or falls behind. IFRS can create an encouraging environment to attract non U.S. companies to list their stocks without incurring significant costs.

**Potential Cost**

Although the conversion can provide many great benefits, if done incorrectly, it can undermine the quality of financial reporting resulting in irreversible consequences to the economy on a grand scale. David Bogoslaw (2008) is concerned that regulators and standards-setting bodies restlessly pushing for IFRS might forget that ensuring the highest quality accounting standards is their ultimate job. For example, the commotion relating to fair value accounting as the aftermath of 2008 financial crisis was unfolding showed the IASB's inability to uphold its important value. Under the pressure from the European political leaders, the IASB has abandoned fair value accounting which it has been vigorously promoting. This abandonment questioned the quality financial statements prepared under IFRS in the public's eyes. A set of financial reporting standards that cannot defend for its stance will result in losing the public's trust. Once the public's trust is lost, the capital market will be frozen since the citizens will not want to invest their money. When the flow of capital from individuals or households to industries is stopped, the domestic economy will consequently suffer since there is no capital for companies to sustain operations or expand capacities. If the U.S. still plays such an important role in the world economy, a halt in the U.S. economy will spread across the globe. The conversion can cost the U.S. economy in particular, and the world economy as a whole, a great deal when the outcomes defeat its purpose.

One of the reasons contributing to the potentially decreased quality of financial reporting is the loss of total control over setting accounting standards in the United States. Miller (2008) emphasizes that "the big issue is that sending it offshore diminishes our control and in a time of crisis where accounting has played a part, [he does not] think it's especially wise to create a new system that diminishes U.S. control over accounting standards" (Miller, 2008, Who Feeds the Watchdogs?, para.3). The IASB's reaction to the financial crisis has casted doubts about the IASB's future sustainability and independence during crisis. At critical times, the US might find it more convenient and advantageous to manage its own accounting standards so that it can accommodate the nation's own set of problems. The flexibility of the U.S. to solve issues during critical times will be reduced because IFRS do not only take into consideration the U.S.'s interest, but also any other country. Even the SEC has acknowledged that once the U.S. adopts IFRS "U.S. capital market participants will have a lesser degree of input into the standard setting process including fewer members of the IASB [...] than they currently have in the US standard setting process" (Roadmap, 2008, pg. 46 -47). The specific needs of U.S. companies can no longer be accommodated quickly by the local standards-setting bodies but rather have to wait for other countries to agree on. Also, the SEC can only regulate the U.S. companies, but does not have any authority outside of the United States. Lacking control over its own standards can limit the U.S. government's ability to remedy any extraordinary events that occasionally happen.

During the process of creating a global set of high quality standards, the two standards-setting bodies recognized that the current version of U.S. GAAP or IFRS alone cannot meet the demand of the world as a whole and consented that a careful combination of U.S. GAAP and IFRS can be the ultimate answer for the world. In the article "Obama needs to tackle IFRS and regulatory cooperation," Kyle Siskey (2008) states that the core differences between U.S. accounting systems and European accounting systems. The U.S. system which measures executives' performance based on net income is more vulnerable towards income statement fraud, while the European system tends to suffer balance sheet fraud. The two standards-setting bodies need to work together in order to address these different types of risks. John Gallagher, a managing director of accounting policies and support at UBS AG believes that there are certain areas the two regulators might not be able to come to a consensus on (Confusion or clarity?, 2008). These areas consist of but are not limited to fair value measurement, insurance contracts, post-employment benefits (including pensions), and revenue recognition. A hard question to answer is how the IASB and the FASB are going to react when they are unable to come to a consensus with each other, let alone with other countries that also adopt IFRS. In order to achieve a single set of high quality standards, standards-setting bodies will have to overcome a lot of differences and maybe even let go some of their own interest for a greater benefit of all members.

Moreover, many warn the possibility of falling back to be rules-based. U.S. GAAP once was principles-based, but over the span of more than 60 years it has become heavily rules-based due to the litigation environment in the States. Some warn that history will repeat itself for IFRS, since IFRS is a very young set of standards. An article of the CPA Journal states the concern of Robert H. Colson, a partner at Grant Thornton, that the U.S.

might not be able to refuse the path to more specific regulations because standards-setters are used to being expected to solve problems by issuing new accounting standards (How does the U.S. measure up?, 2008). One way to remedy this risk as Gannon said is to establish "standards that would cut across industries" and determine "how [a country] can apply standards to these different industries" (How does the U.S. measure up?, 2008, para.3). This is not an easy task since every industry has different traits that other industries might not have. Even though industries with similar traits can be grouped together, not all industries can be grouped together. Regulators and standards-setting bodies will have to be cautious not to fall back to rules-based mentality

## FINANCIAL STATEMENT USERS

### Objective

The financial statement users can be anyone who has money to invest or trade. Financial statement users want to be well-informed with sufficient and relevant information to make the right investing decision. They demand the ability to trust the information presented in the financial statements so that they can achieve a certain level of confidence in their decision making. The main purpose of any audited financial statements and any set accounting standards is to protect the financial statement users' interest, and in turn encourage inflows of capital back to the market at a low cost of capital. Therefore, the financial statement users, especially the U.S. investors, should be the ultimate benefiters of this conversion.

### Effects of Conversion

There is no concrete answer for questions about the financial statement users would appreciate the change from U.S. GAAP to IFRS. However, the financial statements users have some opinion about changing to IFRS without having to reconcile to U.S. GAAP and some of them might show criticism rather than appreciation. In the article "Global Accounting Standards? Not So Fast," David Bogoslaw (2008) states that even financial advisers, who are more technically fluent in analyzing the financial statements, "believe investors have already lost valuable information with the SEC's elimination last year of the reconciliation between GAAP and the non-U.S. GAAP standards used in foreign companies' financial reports" (Bogoslaw, 2008, Loss of Information, para.1). In fact, he quotes Sondhi, an investment adviser—president of A.C. Sondhi Associates in Maplewood, N.J., stating that U.S. GAAP reconciliation gives him a great deal of valuable information regarding the companies' cash flow generating ability which he could not get from the IFRS version of financial statements. Donald Robertson, Vice President and senior accounting analyst at Moody's Investors Service, raises doubt about IFRS's ability to survive any economic storms and recommends to strive for something beyond U.S. GAAP and IFRS (Confusion or clarity?, 2008). While some financial statements users find the value in having the reconciliation, some say that they can live with "a single set of standards, as long as they are of the highest quality" (Bogoslaw, 2008, Loss of Information, para.3). However, for now it is uncertain that IFRS possesses the highest quality. The reaction of the financial statements users is regardless of the standards the statements are prepared in accordance with, the statements are only good when it can provide sufficient amount of useful information for decision making.

The financial statement users also would like to receive the highest quality information they can get from companies, and one single set of accounting standards might not be able to afford the highest quality. Bogoslaw (2008) cites Paul Miller, a professor of accounting at the University of Colorado, about his preference for competing standards around the world. Miller believes that "the only standards all countries would be able to agree on would be very weak ones [...] and a unified set of standards, rather than being helpful, would stifle much-needed innovation given that most of the existing accounting standards are more than 60 years" (Bogoslaw, 2008, Loss of Information, para.3). He makes a plausible argument because every country has different economic problems and political situations and in order to address all those issues in one set of standards is almost impossible. Therefore, IFRS might have to forgo some of the issues to encompass every country's needs on a grand scale. Bogoslaw (2008) comments that "the fact that many analysts in the U.S. and overseas used to rely on the reconciliation suggests they found the differences between GAAP and foreign standards very useful" (Bogoslaw, 2008, Loss of Information, para.3). The risk of not having the highest quality information might be passed from financial statement users to companies by an increase in cost of capital such as higher interest rates or stricter debt covenant.

### FINANCIAL STATEMENT ISSUERS

#### Objective

The financial statement issuers are usually publicly held corporations whose objective is to inform the current and prospective investors about the financial situation of the company, in order to attract investments in their companies. In the U.S., large and globalized companies welcome the rise of IFRS due to its level of simplicity in preparing the financial statements and less potential liabilities since there is no right or wrong answer. However, smaller companies which do not have international operations might hesitate to convert since the conversion can cost them greatly. For example, even before the SEC released its proposed roadmap, Peter A. Bridgman, Senior Vice President and Controller of PepsiCo, believes that IFRS is making progress on refining the quality of financial reporting and urges regulators to set some conversion dates so that U.S. companies can start preparing for IFRS (Confusion or clarity?, 2008). Setting the conversion dates can signal the government's expectation for U.S. companies to start preparing for IFRS.

#### Effects of Conversion

**Potential Benefit**

Companies favor IFRS because IFRS leaves room for judgment with less liability on the companies' side. IFRS often does not result in a definite right or wrong answer, it might require the companies and its auditors to truly understand the underlying business transactions and document their viewpoints appropriately. Bogoslaw (2008) also makes a good point about how the litigation system in the U.S. has shaped the accounting standards of the nation into the voluminous body. Companies and accounting firms constantly face the threat of being sued for even the smallest mistakes, so they seek detailed regulations as a blanket of security. However, focusing on too much detail can lead to missing the big picture. In the article "Confusion or Clarity?" Peter A. Bridgman is cited praising IFRS as the cause of improvements in the quality of financial reporting the around the world (Bogoslaw, 2008). The intention to move toward IFRS is to encourage companies as well as accounting firms to account for transactions so that financial statement users can understand the underlying nature of the transactions, instead of only meeting the requirements of the regulations. Companies are better off because they can reduce the possibility of getting sued by the investors or creditors as long as they can defend their judgments. On the other hand, the investors and creditors are better off comprehending what type of accounting judgments the companies made, the reason behind the companies' choice of accounting treatments and whether the companies intend to present true information to the public. John Gallagher, Managing Director of accounting policies and support at UBS AG, agrees: "In the principles-based [model], I think it [is] harder to evade what the economic substance of the transaction is" (Bogoslaw, 2008, para.5). IFRS can provide investors a clear understanding of the companies' financial situations as well as take some weight off the companies.

In addition to the ability to reduce huge litigation costs, only preparing financial statements under IFRS offers the opportunity to reduce such huge costs of preparing the financial statements for companies whose operations requires them to prepare financial statements under both IFRS and U.S. GAAP. A single set of standards for the world would bring about efficiency in financial reporting by eliminating duplicative and the need for reconciliation between financial statements prepared under two different sets of standards (IFRS FAQs, 2008). If the SEC by 2011 mandates all U.S. companies to comply with IFRS, U.S. companies will enjoy the benefit of only having to prepare one set of financial statements. This set of financial statements can be used not only in the U.S. but also in other parts of the world where companies might have interest in expanding capital. Not only does this reduction of redundancy save companies an enormous amount of professional fees, it also enables companies to reach far outside of the U.S. and tap into the greater global capital market.

Also, companies' revenue might look better under IFRS than under U.S. GAAP resulting from more room for judgments. A study of 129 IFRS-GAAP reconciliation reports of foreign companies reported in the article "What the Switch from GAAP to IFRS means for credit pros," reveals that just a simple change from U.S. GAAP to IFRS can raise some companies' profit by 8% (What the Switch from GAAP to IFRS Means for Credit Pros, 2008). This means good news for U.S. based companies, because their financial statements' number sure would appear better than other U.S. companies which do not use IFRS. A change in accounting standards used can reflect in the financial statements immediately and affect the decisions of investors who focus more on the bottom line result of a company instead of taking into account other operating elements.

**Potential Cost**

Despite all the perceived benefits, IFRS can cause problems for companies sometimes. Bogoslaw (2008) is concerned that since IFRS allow a greater degree of freedom, companies might start "[interpreting] standards to suit their convenience, which undercuts auditors' ability to prohibit certain accounting choices" (Bogoslaw, 2008, Don't Sue Me, para.2). Rules are helpful sometimes when there is a need to point out right and wrong. Judgment can be hard in those situations since judgment can be right as long as there is reason to justify it. Companies can maneuver judgments to come up with the best accounting treatments and manipulate the financial statements since there is no hard line to follow. Flexibility is good as some "have argued that reasonable actions taken in good faith would be more easily defended under a more principles-based approach to standards" (Kroll, 2008, View from Corporate America, para.11). However, good faith is hard to difficult to justify sometimes. The cost to the investors from getting misleading information can cause major losses to the investors and eventually catch up to the companies. Marie Leone, Sarah Johnson, and Tim Reason (2008) argue in the article "Convergence Divergence" that "moving away from U.S. GAAP will 'put in jeopardy the thing that gives the U.S. a competitive advantage,' [...] '[we] have the lowest cost of capital in the world. Do we really want to give that up?'" (Leone et al, 2008, para.3). Since the investors or creditors lose trust in the companies, they will impose higher interest rates, or stricter debt covenant to compensate for the risk they are taking. The beneficial nature of IFRS such as requiring more judgment and allowing leeway for companies should not be abused; otherwise IFRS will turn around to cost companies a great deal.

Along with the conversion, professionals have been anticipating that the conversion will cost companies a great deal of resources such as implementation costs. Not surprisingly, as much as companies would like to move to IFRS, they are delaying the process of conversion by being unprepared for the big change. According to Ajilon Finance Solutions and the Institute of Management Accountants, a survey of approximately 500 finance and accounting professionals reveals that fifty-eight percent of U.S. companies did not train their staff for the transition from U.S. GAAP to IFRS (Proposed IFRS Roadmap Unveiled, 2009). Some companies hesitate to make the transition too early because the cost to move from U.S. GAAP to IFRS can be substantial. For instance, the adoption of IFRS in 2005 has cost European companies significant amounts of resources.

- For companies with greater than €7.33 billion (USD $8 billion as of October 13, 2008) in annual sales, implementation costs are estimated to be 0.005% of sales or about USD $400,000.
- For companies with sales greater than €5 billion (USD $6.77 billion as of October 13, 2008), implementation costs take 0.05% of sales (Kroll, 2008). For companies with sales between €500 million and €5 billion, the implementation costs would be 0.05% of sales (What the Switch from GAAP to IFRS Means for Credit Pros, 2008).
- Lastly, for companies with sales of less than €500 million (USD $676 million as of October 13, 2008), the implementation costs would take up 0.31% of sales or USD $2,095,600 (Kroll, 2008).

For companies with greater than $8 billion in annual sales, the implementation cost is lower than that for companies with less than $676 million in annual sales because larger companies have more in-house resources to draw from than smaller companies. The significant amount of expense companies will incur changing from US GAAP to IFRS reveals another obstacle US companies have to stumble through before reaping any benefits from the conversion.

## FINANCIAL STATEMENT AUDITORS

### Objective

The financial statement auditors ensure that financial information is reasonably presented, in order to keep the investor well-informed about the financial situation of a company. The financial statement issuers or companies compensate the financial statement auditors to audit their financial statements, so that they can list their stock on the national stock exchange. Trying to satisfy the needs of both sides can sometimes result in a conflict of interest for auditors. The auditors walk a fine line between fulfilling its core objective of protecting the public by supplying fairly presented information and maintain its sustainability through revenue from services provided to companies. Under US GAAP, the auditors have some sort of standards to rely on when they stand up to management. However, since IFRS relies so much on the auditors' judgment, it creates a greater dilemma for auditors to make judgment mainly based on their experience and observation without taking into consideration the pressure from companies.

### Effects of Conversion

#### Potential Benefit

The demand for accountants might increase as a result of the conversion. Some might argue that a reduction in compliance work could hinder demand for accountants. However, a survey from WebCPA.com claims that 86% of professionals are optimistic about the effect of IFRS conversion on the accounting profession (Proposed IFRS Roadmap Unveiled, 2009). Bill Carlino (2008) in "A Lesson in Reaction" also anticipates an increase in demands for CPAs and financial professionals in general. There might be less work for auditors and companies since they only have to prepare one set of financial statements instead of two sets of financial statement and then the reconciliation between the two financial statements. Nevertheless, the auditors under IFRS are required to provide professional judgments which can require substantial research work and thorough understanding of the underlying transaction before any judgment can be formed. A partner from Ernst & Young, Danita Osling, concurs that the auditors have to "look at a transaction, figure out the substance of that transaction, and then apply the principles to that substance" when they are applying IFRS (How does the US measure up?, 2008, para.1). U.S. GAAP lays out specific steps and requirements for companies to follow. The underlying nature of the transaction is often ignored as long as the transaction is tailored to meet all the requirements. At the same time, anyone who has the ability to comprehend rules can follow the rules explicitly stated to determine the accounting treatments for a transaction. The professionals would not be able to add any more value except their title of being a CPA. With IFRS, on the other hand, the decision involves more judgments from experienced professionals who have been working in a specific industry. Without a profound understanding of a specific industry, a professional cannot justify his or her opinion on the appropriate accounting treatment for the situation. In short, the more professional judgment involved, the more valuable an accountant becomes, and the higher demand for well-prepared accountants there is.

Also, the conversion can reduce the enormous amount of liabilities U.S. accounting firms face since there is no straight line for the courts to follow. The courts have to base their judgments accordingly to each situation. Bogoslaw (2008) confirms this belief stating that "the big accounting firms that are drawn to IFRS believe they [will] get sued less since it will be harder to point to their mistakes" (Bogoslaw, 2008, Don't Sue Me, para.2). In the U.S., litigation risks and litigation costs play a major role in any companies' decision, and accounting firms are not an exception. Accounting firms would benefit greatly from a reduction in their litigation risk and exposure. One can argue that the more interpretative nature of IFRS may result in an increase in litigation since the auditors do not have any firm guidance to follow and therefore unable to protect themselves from being sued. However, since there is so much interpretation in these court decisions, accounting firms may be able to argue their position more effectively because of the lack of firm guidance court and this advantage may discourage potential suitors from filing a lawsuit. In short, the U.S. accounting firms might be able to avoid some of litigation costs due to the flexibility provided by using judgments.

**Potential Cost**

Just like any other party, the benefits IFRS brings to the financial statement auditors needs to be weighed against the cost of converging IFRS and U.S. GAAP. And just like companies having to prepare for the conversion, accounting firms need to prepare their employees for the upcoming standards. In fact, accounting firms need to be prepared earlier than companies since they will provide consulting services for companies in order to aid the companies' transition. The cost of training employees will be more for smaller or domestic accounting firms since they have not had as much exposure to IFRS prior to the implementation. In contrast, the international accounting firms have the advantage of exposure to IFRS when working with European companies. They can pull their resources and experienced employees from Europe to help the U.S. based employees get acquainted with the new regulations and avoid missteps in implementing the new standards. Accounting firms will incur significant costs to prepare itself for the new conversion.

Another potential cost of converting to IFRS is that the credential CPA might be replaced by an international credential. Auditors in the U.S. receive college education to prepare for the U.S. CPA exam. Now if an international credential replaces U.S. CPA credential, auditors in the U.S. need to forget the old materials under U.S. GAAP and take some time to learn the new materials under IFRS. Carlino (2008) also questions the future of the U.S. CPA designation. In a global market, it is not certain whether the CPA certification will able to sustain its credibility and power, or yield to a new international credential that would adhere with IFRS. IFRS is such a principles-based standard that it might be harder to assess the accountants' ability to make reasonable judgments. Hence, an international credential might be difficult to attain and can cost accounting firms huge amounts of resources to get their employees qualified for the new credential.

## EXAMPLE: REVENUE RECOGNITION FOR MULTIPLE DELIVERABLES

A prominent example demonstrating how the difference between U.S. GAAP and IFRS will affect the four main affected parties is revenue recognition. According to the discussion paper "Preliminary Views on Revenue Recognition in Contracts with Customers," U.S. GAAP provides more than a hundred standards on revenue recognition while there are only two main standards on revenue recognition under IFRS, IAS 18 *Revenue* and IAS 11 *Construction Contracts*, and fewer than 10 related categories. Specifically, guidance on revenue recognition for multiple deliverables includes but not limited to Emerging Issues Task Force (ETIF) 00-21; Interpretation 45; Technical Bulletin 90-1; and Statement of Position (SOP) 81-1, 97-2, and 00-2. For the limitation of this paper, only ETIF 00-21, SOP 97-2, and IAS 18 will be examined.

### U.S. Generally Accepted Accounting Principles

U.S. GAAP provides specific guidance on how to account for multiple deliverables arrangements. EITF 00-21 sets general revenue recognition standards for any industries whose activities will generate multiple sources of revenue from one sale and for all kinds of deliverables such as products, services or rights to use assets. Basically, EITF 00-21 addresses, but is not limited to, two main issues:

- whether to account for revenue arrangement as separate units of accounting
- and if revenue arrangements should be divided into separate units of accounting, how the revenue arrangements will be allocated among those units of accounting

The first issue can be solved by applying a step-by-step process. First the test examines the items that are delivered to see whether they have standalone value to the customers. If the delivered items do not have standalone value to the customers, the delivered items cannot be accounted for as a separate unit of accounting. Otherwise, the test moves on to determine whether undelivered items of the contract have fair value that can be supported by objective and reliable evidence. If the answer is no, the delivered items cannot be accounted as a separate unit of accounting. If the answer is yes, the test questions whether the arrangement includes a general right of return relative to the delivered items, and whether the delivery of the undelivered item(s) is probable and substantially controlled by the vendor? If the answer is no, the delivered items cannot be accounted for as a separate unit of accounting. If the answer is yes, the delivered items can be accounted for as a separate unit of accounting.

EITF 00-21 addresses the second issue, measurement and allocation. For those delivered items that are not allowed to be accounted for as a separate unit of accounting, generally the total arrangement consideration will be recognized for one single unit of accounting, meaning revenue will be deferred until all elements have been delivered since all the deliverables are grouped into one single unit of accounting. For those delivered items that are allowed to be accounted or as a separate unit of accounting, there are two possible situations. If there is an objective and reliable evidence of fair value for both undelivered and delivered items, the arrangement consideration can be simply allocated to the separate units of accounting based on their relative fair values. If there is objective and reliable evidence of fair value for only undelivered but not delivered items, the arrangement consideration can be allocated by using the residual method. The residual method allocates arrangement consideration to delivered items the amount left over after subtracting the aggregate fair value of the undelivered item(s) from the total arrangement consideration (EITF 00-21).

SOP 97-2 takes a deeper and more specific look into a type of multiple revenue-generating activities: Software Revenue Recognition. The scope of SOP 97-2 indicates appropriate compliers as "all entities that license, sell, lease, or market computer software" and only applies to "hosting arrangement in which customer has the option to take possession of the software" (Petra et al, 2005, Background, para.1). The underlying concept of SOP 97-2 is somewhat similar to that of EITF 00-21 but only SOP 97-2 focuses on software specifically. According to the article on the CPA Journal "Revenue Recognition for Software Products with Multiple Deliverables", if EITF 00-21 uses standalone value of delivered items to customers, SOP 97-2 requires a stricter rule which only allows "stand-alone value to that established by the vendor only and does not allow the value to be determined by other vendors or by the customer's ability to resell the element on a stand-alone basis" (Petra et al, 2005, Background, para.6). Also, SOP 97-2 requires the essential to the functionality test in order to prevent the deferral of revenue recognition on the delivered elements. In short, SOP 97-2 goes beyond EITF 00-21 to specify the treatment of multiple deliverables for software industry.

**International Financial Reporting Standards**

IAS 18 under IFRS provides minor guidance on revenue recognition. IAS 18 only addresses revenue recognition in extremely general guidelines with exceptions of the followings: the insurance contracts, construction contracts, leases, investments in associates, financial instruments, agriculture, customer loyalty programs, and revenue in barter transactions involving advertising services. IAS 18 identifies three main sources of revenue: products sold, services rendered, or miscellaneous income (income from interest, royalties, and dividends). Under each source, IAS 18 provides a list of criteria for recognition of revenue. Then it identifies the risks that would otherwise prevent revenue recognition from sale of products. Lastly, it determines what method should be used to account for revenue from services rendered and what disclosure requirements should be fulfilled for interest, royalties, and dividends. Since IAS 18 covers revenue recognition in a broad spectrum, it lacks of clear guidance on how to deal with multiple revenue-generating activities.

The potential effects the conversion can have on the four affected parties in the industry providing multiple-element arrangements are summarized as follows:

**Regulators or standards-setting bodies**

Within the U.S. there already exists conflict between the two standards EITF 00-21 and SOP 97-2 which was addressed in another standard, EITF 03-5. The level of complexity just keeps building up when the regulators try to address every aspect of the issue. The article "Revenue Recognition for Software Products with Multiple Deliverables" claims that since many software companies deliver non-software products along with software products in the same arrangement it is undeterminable whether EITF 00-21 or SOP 97-2 should be applied (Petra et al, 2005). The article identifies that EITF 00-21 would provide a better answer for the companies' net income since it allows companies to recognize revenue for those delivered items that have little or no utility to the customer, until the undelivered elements arrive" (Petra et al, 2005, The Issue, para.2) And those two standards are very specific in terms of criteria about how to accounts for delivered items in a multiple-revenue generating activities, as well as how to measure and allocate the arrangement amount to those items. On the opposite side, IAS 18 reduces regulators' responsibilities in regulating the revenue recognition process for multiple revenue-generating activities and opens for professional judgments since it does not address this topic in a general manner. The guidance provided in IAS 18 reads as follow: "... in certain circumstances, it is necessary to apply the [revenue] recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction (IAS 18, 2003, Identification of the Transaction, para.13). The standards-setting bodies acknowledge the gap between the two standards and the lack of guidance on the topic. However, they still struggle to come up with a set of general principles instead of falling for specific rules. The process of converting from the two extremes to something in the middle would be challenging to standards-setting bodies.

**Financial statement users**

Since there is no identified approach on how to converge this area of standards, the effect on financial statement users is unknown. However, if the consensus is to move away from substantial amount of guidance and towards greater degree of flexibility, the financial statement users can face the risk of not being able to compare companies in the same industry because each company might have different judgments coming from different standpoints and motives.

**Financial statement issuers**

Changing from U.S. GAAP to IFRS might be uncomfortable to some companies since they have no concrete answers for recognizing revenue. Companies prefer having more revenue presented on their financial statements for a more appealing net income. Therefore, regulators set detailed guidance to counter companies' tendency to recognize more revenue than they are entitled to, especially when there is no exact time as when the revenue from multiple deliverables will be earned. For instance, under SOP 97-2, software companies might have to defer revenue "until [vendor-specific objective evidence (VSOE)] can be established for all elements in the arrangement or until all elements have been delivered" (Petra et al, 2005, Background, para.3). EITF 00-21 is more lenient and general in terms of recognizing revenue. However, it still requires companies receiving revenue from multiple revenue-generating activities to determine whether they can account for the revenue arrangement as separate units of accounting. Usually companies would like to account the revenue arrangement as separate units of accounting because they can recognize revenue as soon as some of the elements are delivered instead of deferring revenue until all elements are delivered.

**Financial statement auditors**

The more flexibility companies enjoy in recognizing their revenue, the more caution auditors will have in designing their audit engagements due to a greater risk of companies manipulating their revenues. Companies and auditors, with the same set of fact patterns, still can come up with different interpretation of the standards. Taking IAS 18 as an example, paragraph 17 and 19 can be interpreted differently. Paragraph 17 of IAS 18 reads "[if an enterprise retains only an insignificant risk of ownership] revenue [...] is recognized at the time of sale provided the seller can reliably estimate future returns." Paragraph 19 of IAS 18 reads "revenue and expenses that relate to the same transaction or other event are recognised simultaneously [...] revenue cannot be recognised when the expenses cannot be measured reliably." According to the discussion paper "Preliminary Views on Revenue Recognition in Contracts with Customers," these paragraphs can be understood as "permitting the recognition of all the revenue for a multiple-element arrangement upon delivery of the first element if all the elements are sold together" (Preliminary Views, 2008, pg.21). On the other hand, these paragraphs can also be interpreted as "[requiring] deferral of revenue for all the elements until delivery of the final element" (Preliminary Views, 2008, pg.21). The convergence between U.S. GAAP and IFRS will result in some sort of guidance for revenue recognition of multiple deliverables. This guidance should fall between the rigid rules of U.S. GAAP and the extreme flexibility of IFRS. However, when the auditors can choose different ways to interpret standards, not only will they face the challenge of acquiring expertise to form an opinion on the subject but also they will struggle between protecting the public's interest and their own interest. Since there is no hard rule for the auditors to stand against management, they might lose clients because companies can always go out to find other auditors who will be willing to interpret the standards more favorable for the companies.

## WHAT HAS BEEN DONE TO MITIGATE THE RISKS?

Before the conversion starts taking place, risks should be addressed and ways to mitigate the risks should be discussed. Consideration of risks can provide decision makers a clear understanding of what matters the most. The U.S. still has until 2011 to know for sure whether it will adopt IFRS or not. From now until then, it is essential that the four main affected parties assess their risks and figure out approaches to remedy the effects. If a reasonable solution for risks is not attainable, the U.S. might not choose to adopt IFRS.

### REGULATORS AND STANDARD-SETTING BODIES

There is always a risk that IFRS would not work out for the U.S., and maybe the U.S. would like to come back to following U.S. GAAP. That risk is amplified when one of the purposes for conversion becomes unclear. Bogoslaw (2008) also raises doubt that "while attracting more capital to the US is a valid business objective, it is not clear we can do that by going to international financial reporting standards" (Bogoslaw, 2008, Don't Sue Me, para.3). The U.S. government needs to weigh the opportunity cost of going through an accounting revolution in order to fit with the whole world, versus that of losing opportunity to approach the global capital market. The cost to convert from U.S. GAAP to IFRS and then convert back to U.S. GAAP can create a setback to the U.S. economy due to the large effect and lengthy implementation process. As a way to mitigate the risks, the SEC allows about 110 companies which are in the top of their industry to convert to IFRS starting December 15, 2009. Those companies are capable of sustaining the loss and will be able to give the U.S. regulators an idea of how U.S. companies will be able to react to the change. The U.S. needs to carefully consider the cost and benefit of going IFRS in order to alleviate the risk of wasting resources.

### FINANCIAL STATEMENT USERS

IFRS is praised as a way to promote comparability; however, the financial statement users might not be able to enjoy the ability to compare financial statements from across the globe to identify the best investment opportunity. Heffes (2008) expresses his view on how the goal of having one single set of standards can be unattainable. He argues that even though more than 100 countries are adopting the use of IFRS, they might or might not choose to adopt the entire set of standards. In fact, some countries have chosen to adopt only parts of IFRS while keeping the rest consistent with their current standards. Opting to adopt only parts of IFRS defeats the purpose of having a single global set of standards. Heffes (2008) acknowledges that "the SEC has attempted to mitigate any carve-outs by asserting that it would only accept filings that comply with IFRS 'as issued by the IASB'" (Heffes, 2008, More Than Just Accounting, para.6 and 8). Also, the SEC has announced that it only accepts financial statements prepared in accordance with IFRS issued by the IASB in London. However, the effort to include every country's own problems into a set of standards might produce a cumbersome set of standards whose volume would exceed that of current U.S. GAAP.

Comparability between U.S. and non U.S. companies might be enhanced due to the conversion, but comparability among U.S. companies will surely be reduced due to the layered adoption process. The roadmap suggests starting conversion for the large accelerated filers by 2014, for the accelerated filers by 2015, and the non-accelerated filers by 2016. The time difference when U.S. companies converge will generate another source of incomparability. The SEC recognized this risk, and proposed two ways to mitigate this incomparability. Proposal A suggests that U.S. companies should prepare a one-time reconciliation from IFRS to U.S. GAAP in the first year of conversion. Proposal B suggests the reconciliation from IFRS to U.S. GAAP be prepared on a continuing basis (Roadmap, 2008). Proposal A will cause investors some difficulties in comparing financial statements prepared under IFRS and U.S. GAAP during the years after the first year of conversion. Proposal B will cost U.S.-based companies extra compared to its competitors, either U.S. or non U.S., during the period the conversion is carrying out since U.S.-based companies have to keep track of information under IFRS and U.S. GAAP instead of under only one set of standards and then prepare reconciliation from IFRS to U.S. GAAP. The investors would suffer from the incomparability among U.S. companies if there is no action taken, and U.S. companies which are eligible to convert will suffer if actions are put in place.

#### FINANCIAL STATEMENT ISSUERS

Besides from the regulators and the financial statement users, the financial statement issuers usually bear a substantial amount of risk from the conversion. In the article "Lessons Learned From Europe's IFRS Conversion," Cheryl de Mesa Graziano and Ellen Heffes (2009) cite the warnings of Danita Ostling, a partner in Ernst & Young's Assurance and Advisory Business Services group and Americas IFRS leader, about IFRS's effect on not only accounting and financial reporting but also other business processes and departments (Graziano et al, 2009). If the conversion cannot provide value as expected, companies would suffer losses due to the fact they have to invest so many resources into the conversion. The cost of conversion includes the cost of training employees, changing business processes, and altering ways of collecting and reporting information. Employees within the companies can receive training on the upcoming standards through experts in academia. Changing business processes contains the most risk. Danita Ostling states in her article "IFRS: The Financial Road Ahead" the fact that "many companies did not take a holistic approach to the change ans psent several years after the conversion date dealing with business and operational issues" (Ostling, 2008). Sometimes companies might incorrectly identify its core competitive advantages. Therefore, they choose the unnecessary business processes to keep while eliminating the essential processes that would otherwise enhance the performance of business. Richard Stolz (2008) cites Gannon on his concern: "'Are there going to be different kinds of data you're going to have to capture –will there be systems changes?" (Stolz, 2008). Altering ways of collecting and reporting information can cost a lot due to the fact that accounting information systems are expensive to set up and implement while taking a long time to become effective. After fighting through all those hurdles, companies would not want to return to U.S. GAAP for the fact that so many resources have been invested. The risk of not being able to convert back can be daunting to companies.

#### FINANCIAL STATEMENT AUDITORS

The financial statement auditors, the last affected party of the conversion, have been warned to prepare for the risk attached with making judgments. In order to make sound judgment and plausible arguments, auditors have to possess a certain level of experience in the specific industry and an understanding of the underlying essence of transactions. They run into the risk of not having enough knowledge and proficiency to articulate a reasonable judgment and then protect their judgment. In the article "Confusion or Clarity?, Samir M. El-Gazzar, the KPMG Professor of Accounting at Pace University is cited "[wondering] if accounting that relied more on judgment might lead to disagreements. 'What would happen if management believes one way and the accountant believes the other way? Which way is going to prevail?'" (Confusion or clarity?, 2008, para.) It is possible that auditors and management will not agree on some issues. In order for auditors to stand up to management and defend for their argument, it might require some substantial amount of expertise from the auditors' side. If auditors cannot defend their arguments showing their incompetence in doing the job, they might lose a stream of revenue. Judgments can help the auditors to relieve some liabilities, but they can also put auditors into a huge risk if they are prepared for the conversion.

The CPA credential has always been a way to prove whether an auditor is capable of doing his or her job; however, with the new standards coming up the horizon, the auditing profession in the U.S. faces a challenge on the existence of the CPA credential. In fact, in the article "As the Move to IFRS Accelerates, Liability Looms

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