If IFRS Offer the Answer, They Sure Raise a Lot of Questions

By Glenn A. Cheney

For America's financial executives who haven't kept up with the latest accounting news, a call this summer for comments from the U.S. Securities & Exchange Commission (SEC) should garner your attention.

The issue is a big one: Should the SEC (and thus U.S. capital markets) change its rule of having foreign issuers reconcile their financial reporting to U.S. generally accepted accounting principles (GAAP), or should we accept financial reports that comply with International Financial Reporting Standards (IFRS)?

The deceptively simple question has spawned a host of related questions and scenarios. Is this a way for foreign companies to evade U.S. law? Would American companies be allowed to use IFRS? Would the move toward a global system of standards result in two systems of standards in the U.S., and would that be any less complex than the current system? Do we want a standard-setter — the International Accounting Standards Board (IASB) — that's beyond the reach of the SEC? Do we need a global SEC?

The more you think about it, even more questions are raised. Will it be fair if the SEC interprets and enforces IFRS one way while equivalent commissions in other countries interpret and enforce in other ways? Will principles-based IFRS lead to more litigation? Are IFRS easier or more difficult to understand than U.S. GAAP? What would be the role of the Financial Accounting Standards Board (FASB) in a world ruled by IFRS? And, ultimately, how will all of this impact the competitiveness of U.S. financial markets and U.S. companies?

Good questions all, and that's hardly the end of them.

The SEC has been accepting financial reports prepared under IFRS for years — when reconciled with U.S. GAAP. But reconciliation takes a lot of the fun out of transnational reporting, and filing with the SEC sans reconciliation would likely open U.S. markets to many foreign companies that had been deterred by the extra efforts and costs needed to reconcile to U.S. GAAP.

The U.S. has committed to a roadmap toward accepting IFRS (for foreign filers) without reconciliation by 2009, and the European Union (EU) is on the same road headed the other way, toward accepting U.S. GAAP by that same year. At that point, people are sure to ask why we have two systems. Ideally, the two will have converged by then, or come close to it, and that is what FASB and IASB are working towards.

But still: that's two systems in places where each once had one — hardly the intent of the effort to establish a single set of standards for the whole world. (In reality, however, if you count IASB's proposed special standards for small and medium-

As SEC talk turns to actions — towards accepting one set of accounting standards worldwide — serious concerns for American regulators and U.S. GAAP-filing companies surface and need to be addressed.

INTERNATIONAL ACCOUNTING

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sized entities (IFRS for SMEs), there'd be three systems. But that's a kettle of questions for a different day.)

FASB Chairman Robert Herz says the consequences of allowing foreign companies to file financial statements under IFRS in the U.S. could be good and bad. On the good side, he says, more foreign companies will register on U.S. exchanges, giving investors more options. It will also increase interest in IFRS among Americans. On the bad side, despite considerable convergence between the two accounting systems, they do not yet add up to the same bottom lines.

"As much as we like to take credit for marching convergence along, we have a long way to go," Herz says. "There are still very significant differences. Without the reconciliation, it's hard to measure apples to apples. That puts a burden on investors."

Comparing IFRS to U.S. GAAP

Research by accounting analyst Jack T. Ciesielski reinforces Herz's concern. Ciesielski took a small sampling of financial statements prepared under IFRS and GAAP and found disturbing differences. Out of 20 statements, 10 showed lower earnings under IFRS while the other 10 showed the opposite. One IFRS statement showed earnings 41.3 percent over GAAP, while another showed GAAP reporting 336.6 percent more than IFRS. One showed equity 83.4 percent higher under IFRS, while another had GAAP reporting 98.7 percent more.

Comparing these statements, Ciesielski said, will demand considerable knowledge from American investors who are woefully unprepared for the task. At the same time, if U.S. companies have the option of using IFRS, their decision might well be based on the results they want.

Herz believes that reconciliation has been a quality-control mechanism that forces a certain discipline on companies and auditors in countries where regulation and enforcement are relatively weak. He can imagine a worst-case scenario in which a foreign company in bad financial shape enters the U.S. market with unreconciled financials. It soon goes belly-up, and investors quite rightfully holler at the SEC for letting it happen. Not only would investors lose their money, but the incident would leave an ugly black stain on the concept of international standards.

On the other hand, Herz fears that failure to lift the reconciliation requirement could get the U.S. into a regressive tit-for-tat trade war. "There are people who believe that lifting the reconciliation is a necessary step toward getting to the ultimate goal of a single set of standards, [and] that if the SEC doesn't do that, other parts of the world will retaliate and impose reconciliation requirements on U.S. companies that raise money in their markets," Herz says. "The European Union has basically said that."

Currently, most parts of the world accept U.S. GAAP. The EU accepts it with certain footnote disclosure.

Dennis Beresford, former chairman of FASB, now a professor of accountancy at the University of Georgia at Athens, is less than optimistic about Americans learning a new set of standards. In the 1990s, he set FASB on the road toward convergence with what is now IFRS, and progress in that direction has been accelerating ever since. Though convergence would ease a transition, he doubts the world will see either FASB or IASB as the sole source of standards in the foreseeable future.

"I was with a company just a couple of days ago, and they said it would be a nightmare for them to do this now because their accounting is so complex and so ingrained that the idea of starting all over again with IFRS is just not something that would be taken very seriously," Beresford said. "If, at some time in the very distant future, there was such a thing as no U.S. GAAP and no choice but IFRS, they'd obviously have to do that, but right now, if the SEC gives them that option — which is a very big 'if' — I honestly don't think many companies will avail themselves of this."

Michael Ryan, senior vice president and executive director of the U.S. Chamber of Commerce's Center for Capital Markets Competitiveness, doesn't think a temporary two-system approach will be excruciatingly traumatic because analysts already look beyond accounting rules to crunch their own numbers and figure out what they need to know.

"In many ways, we already have two systems in effect," he says. "Individual investors, institutional investors, accounting firms, law firms, audit firms, stock exchanges — every one of those parts of our system are already participating in global capital markets to varying degrees," Ryan says. "We, as a country, in many ways, are already relying on IFRS and using them. That is going to continue regardless of what we do, as a nation, regarding our internal policies."

U.S. companies will have plenty of incentive to file under IFRS if they can. Now that more than 100 countries accept IFRS, an increasing number of non-U.S. companies will be producing financial statements under those standards. There may come a point when so many foreign issuers file under IFRS that investors will ask for U.S. companies to follow suit to facilitate comparison shopping.

Multinational companies, too, will be tempted to use IFRS if a number of their offshore subsidiaries are already doing so. The lower cost of filing will translate into a lower cost of capital.

Consider that IFRS are coming close to being the world's preferred set of standards. An FT Research/PricewaterhouseCoopers survey of 187 European fund managers in early 2006 showed that, in terms of market cap, 35 percent of global financial statements were prepared under U.S. GAAP. But statements prepared under IFRS were very close behind at 33 percent. With another 22 percent intending to adopt IFRS, they will soon account for most of the world's equity.

Shifting to IFRS involves more than shifting to new rules. Many consider the international standards to be less dependent on the rigorous specificity that GAAP offers. GAAP, of course, ends with a "P" — as in principles. As SEC Chief Accountant Conrad Hewitt quipped in a speech in Zurich, "There is no 'R' in GAAP,' and there never has been."

But that doesn't mean IFRS aren't replete with rules. They may depend on general principles a little more than U.S. GAAP does, but they also depend on a lot of rules. And more rules — says Arthur Wyatt, a former FASB member and former chairman of IASB's predecessor, the International Accounting Standards Committee — are almost inevitable as the world's lobbyists and corporate interests take aim at inconvenient aspects of IFRS. The pressure to promulgate exceptions and special treatment may well come from national governments as well, a vicious up-tick in the politicization of accounting standards.

Standard-Setting Role Shift

Whatever the blend of international rules and principles, they will need interpretation in the U.S. As the role of setting standards migrates from FASB to IASB, the former board may evolve into an interpretive body, molding IFRS into GAAP. FASB may evolve into a generator of standards that are merely proposed to IASB.

Since the U.S. is likely to remain an innovator in business and financial dealings, its national accounting board is a logical place for new standards to be devised. As long as FASB and IASB are working under the same conceptual framework (which they will be working on over the next several years) the former should be able to provide the latter with proposals that stand a good chance of international acceptance.

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One industry that will certainly thrive on the use of IFRS in the U.S. is training, education and certification. Preparers, auditors and investors will need to learn to produce or interpret a new kind of financial statement. Professors will need to learn to teach IFRS; students will need new books. All sorts of certification programs will need to be revamped, including state CPA requirements.

A key to acceptance worldwide is: Will the world's nations manage to apply IFRS consistently and appropriately? Given that those qualities are in short supply, the world of accounting will need an organization dedicated to monitoring and perhaps regulating application. The International Organization of Securities Commissions (IOSCO) is likely to be the starting point here: It recently launched a database for cataloging and sharing securities regulators' experiences with IFRS.

That, however, is a veritable baby-step down a long and rocky road. Before the world somehow settles on a means of consistent interpretation, we may suffer what George Washington University Law School professor Lawrence A. Cunningham called (in his comment letter to the SEC) "a false sense of global comparability under a veneer of nominal uniformity." To that, he added: "Uniformity in written standards could disguise considerable diversity in actual practice."

Cunningham noted cases of EU members ignoring EU directives, Italy and France exercising national sovereignty to resist corporate takeovers and various countries establishing their own national version of IFRS.

"It is naïve to believe that any uniform global accounting standards will be applied uniformly in all these places," Cunningham wrote, "whatever securities regulators may agree to."

He also wondered what would become of FASB if it cedes much of its standard-setting power to IASB. FASB might be seen as not needing so much of the funding it receives from companies on stock exchanges, which could affect the indirect funding of the Governmental Accounting Standards Board (GASB).

Cunningham did not so go so far as to wonder how the U.S. would contribute to IASB activities, but should such a scenario play out someday, it is, indeed, a question that will have to be answered.

Thus, a lot of questions have to be answered *someday*. And some of them have to be answered now — such as commenting to the SEC on foreign filers using IFRS alone and U.S. companies using IFRS. Not many of the answers are easy, and each, it seems, generates a slew of yet additional questions.

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TAKEAWAYS

>> The SEC has committed to a roadmap toward accepting International Financial Reporting Standards (IFRS) for foreign filers without reconciliation by 2009.

>> Many issues surface when considering differences between U.S. generally accepted accounting principles (GAAP) and IFRS, one of which is differences in financial statement results.

>> Currently, over 100 countries accept IFRS, while 35 percent of the world's financial statements are prepared under U.S. GAAP. However, IFRS is gaining — with 33 percent using them and another 22 percent intending to adopt IFRS.