Does the SEC’s roadmap mean that U.S. companies may soon report under International Financial Reporting Standards?

By Parveen P. Gupta; Cheryl Linthicum, CMA, CPA; and Thomas G. Noland, CMA, CPA

Ten years ago, harmonization of worldwide accounting standards was considered a worthwhile, yet likely unachievable, goal. Today, the term “convergence” is in vogue, and much more than terminology has changed. In 2002, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) co-signed the Norwalk Agreement, pledging to work toward a single set of high-quality global accounting standards. Since that time, the two organizations have joined forces in drafting several new and updated standards.
In 2005, Donald Nicolaisen, then the Securities & Exchange Commission’s (SEC) chief accountant, published a roadmap for the possible elimination of the reconciliation of International Financial Reporting Standards (IFRS) to U.S. Generally Accepted Accounting Principles (GAAP). Given that foreign (non-U.S.) registrants must either provide U.S. GAAP statements or reconcile to U.S. GAAP, eliminating the reconciliation would signify a significant regulatory change. Currently, the SEC recognizes FASB standards for reporting; the elimination of the reconciliation would, in effect, allow two sets of standards to coexist in U.S. markets.

But the roadmap didn’t call for eliminating the reconciliation without review. Rather, Nicolaisen’s 2006–2009 plan calls for evaluation of IFRS, given that they would stand alone absent reconciliation to U.S. GAAP. Nicolaisen’s plan didn’t hold the IASB and FASB to full convergence so that reconciliation would be dropped; rather, the threshold for elimination of the reconciliation from IFRS to U.S. GAAP is the consistent application of IFRS as a high-quality basis of accounting.

**CURRENT STATUS OF IFRS IN THE U.S.**

After the mandatory adoption of IFRS in the EU for fiscal years ended in 2005, the SEC saw a critical mass of IFRS filings in 2006. The EU now has more than 7,000 listed companies that are required to report under IFRS. As IFRS continue to replace dozens of national accounting standards, the question becomes: Should IFRS replace all GAAP, including U.S. GAAP, as the basis for U.S. filings, or should they at least serve as an alternative for U.S. filings?

At a March 2007 SEC-sponsored roundtable on International Financial Reporting Standards, Don Nicolaisen suggested that the SEC should require both U.S. and foreign registrants to file their periodic financial statements using one set of global accounting standards because it created confusion among investors by allowing both U.S. GAAP and IFRS to be followed. He added that if the SEC drops the requirement for foreign private issuers to reconcile their financial statements to U.S. GAAP, as he proposed in his 2005 roadmap, U.S. registrants will want the option to use international standards.

Catherine Kinney, president of the New York Stock Exchange Group, also commented that U.S. companies may want to report using IFRS rather than U.S. GAAP. Phillip Jones, manager of accounting policy at DuPont, said that DuPont has subsidiaries around the world and would be supportive of a single global accounting standard.

After the March roundtable, the SEC began work on two important regulatory releases. The first is a proposed rule to eliminate the reconciliation from IFRS to U.S. GAAP. The proposal is open for comment through September 24, 2007. The second is a concept release that has been published that requests feedback on the question of whether or not IFRS should be allowed as a reporting option for U.S. companies. The concept release is open for comment through November 13, 2007.

Although support for the proposed rule is likely to run in favor of eliminating the reconciliation, the longer-term prospect of allowing IFRS for U.S. issuers will probably elicit mixed comments and much debate. Nicolaisen’s proposal for one single set of global accounting standards may be a subject of even greater debate. His proposal may be sound for large U.S. registrants that have substantial international operations, but several implementation issues must be addressed before full-fledged implementation of IFRS for all U.S. registrants. Besides cost factors such as accounting systems and software implementation, the issues fall primarily into three categories: (1) training and education, (2) consistency in application, and (3) lack of uniform audit standards.

**TRAINING AND EDUCATION**

During the roundtable, several auditors and preparers stated that a “paradigm shift” would have to occur if the SEC allowed U.S. registrants to report using IFRS. The first concern was that, even if a registrant has expertise in IFRS, the registrant’s auditors may not have enough IFRS technical experts to audit the company if a large number of the auditor’s clients began to report using the standards. For firms to gain the necessary expertise, they would have to invest a substantial amount of time and money in training their personnel. In addition to auditing firms gaining expertise in IFRS, the investing public and institutional investors have to be given time to study the standards. The SEC’s mission of investor protection and maintaining orderly and efficient markets requires investors to have a basic understanding of the accounting principles that are used in the financial statements of public companies.

If the SEC allows the use of IFRS, it would also have to consider the impact on smaller U.S. public companies. These registrants may take action to go private or be acquired because they don’t have both the time and money to invest in training their staff on the standards. Mandating IFRS for U.S. registrants may also lead to a further concentration of firms that audit publicly traded companies. Smaller audit firms that don’t have the budget or the
in-house training capacity that large U.S. audit firms possess may opt out of performing audits on publicly traded companies.

Another issue if IFRS are mandated is the content of the Certified Public Accountant (CPA) examination. The CPA exam would have to include testing of items based on IFRS. If U.S. GAAP isn’t eliminated, the exam would have to cover both IFRS and U.S. GAAP. If International Standards on Auditing are adopted, they would also have to be tested on the exam. These changes would require a longer and, most likely, more expensive exam in order to establish a candidate’s competency in the subject matter. The biggest impact would be on the educational system. Many universities offer only one course in international accounting, and in some cases this course is an elective. Universities would have to be given the time to train their professors and revise their curricula to begin to teach IFRS. Continuing professional education courses would also have to be retooled to focus on IFRS requirements. At a minimum, it would appear that a three- to four-year period would be needed for universities and others to get up to speed on IFRS and to change their curricula.

**CONSISTENCY IN APPLICATION**

Also during the March roundtable, there was near unanimity among the participants that the requirement for foreign private issuers to reconcile IFRS to U.S. GAAP be eliminated. Several said that this should be done as quickly as possible and not wait until 2009 as Nicolaisen originally proposed. But others were concerned about problems with consistent application of IFRS. Several studies have shown that IFRS aren’t applied consistently yet. The question of whether the inconsistent application is due to implementation issues surrounding the adoption of new reporting standards, results from cross-border cultural differences, or stems from some other reason remains unanswered. SEC Chairman Christopher Cox said that companies don’t yet have the experience with IFRS that is needed and may be putting their own national interpretations on the standards.

A July 2006 PricewaterhouseCoopers (PwC) study of large insurance companies on the application of IFRS found a number of problems with regard to consistency. Titled “Reporting under the New Regime: A Survey of 2005 IFRS Insurance Annual Reports,” the study found that the statements were difficult to compare because of the wide degree of discretion in the presentation format. PwC stated that the financial statements were less clear and were harder to follow than in prior years and concluded that insurers still have a way to go to satisfy users’ demands for greater quality, clarity, and comparability in their disclosure.

Similarly, a December 2006 KPMG study titled “The Application of IFRS: Choices in Practice” found that in many cases a registrant’s previous home-country GAAP had the greatest influence on the choices the registrant made in applying IFRS. It also found significant variability in how companies presented interest paid, interest received, and dividends received on the statement of cash flows. And the study found differences in how companies accounted for government grants related to assets. Some companies deducted the grant from the carrying amount of the related asset, and others recognized the grant separately in deferred income. Other differences were found in how companies accounted for inventories (FIFO vs. weighted average) and how they accounted for borrowing costs on qualifying assets (expense vs. capitalization). The KPMG study concluded that, with the exception of financial institutions, industry consistency was found to be a lesser influence on financial reporting choices than a company’s country of domicile.

In a December 2006 speech before the American Institute of CPAs (AICPA) National Conference on Current SEC and PCAOB Developments, Julie Erhardt, SEC deputy chief accountant, Office of Chief Accountant—International, said that the information foreign private issuers provided when filing their IFRS financial statements tended to be a “little all over the place.” She also noted that there was a lack of consistency in the starting point for what is labeled “operating income” on the statement of cash flows. In addition, Erhardt was concerned with “shallow” disclosure in such areas as revenue recognition. She felt that the minimal boilerplate disclosure may not give investors enough information to make investment decisions.

She pondered that some of the variability could be due to the first-time adoption of IFRS, stating that several registrants had acknowledged that they just didn’t accumulate enough information called for by the standards. Erhardt said that she hopes this is only a short-term data-gathering problem and not a long-term issue.

**Smaller U.S. public companies may take action to go private or be acquired because they don’t have both the time and money to invest in training their staff on the standards.**

September 2007 | Strategic Finance 31
One more problem she brought up is that the SEC has seen a number of filings based on national jurisdictional adaptations of IFRS. While these filings are accepted by the SEC, they don’t appear to meet the goal of one set of global accounting standards.

**THE CONVERGENCE PROJECT**

Another issue that remains to be resolved is the results of the FASB/IASB convergence project. The Norwalk Agreement, a memorandum of agreement between the two groups, acknowledged each Board’s commitment to high-quality, compatible accounting standards. The FASB and IASB are working diligently on converged standards on important topics such as business combinations, consolidations, revenue recognition, and post-retirement benefits. It remains to be seen how converged these standards become. While complete convergence doesn’t appear to be necessary to drop the GAAP reconciliation, substantially full convergence may be needed before one single set of standards could be adopted.

It’s important to point out that there will be some variability in the application of IFRS, which shouldn’t be a detriment to their adoption. U.S. GAAP contains variability because of the number of estimates and differences in accounting principles (e.g., depreciation methods). Investors and analysts are able to understand differences in U.S. GAAP and will be able to understand differences in IFRS as well. In fact, there is initial empirical evidence that European investors reacted positively when firms adopted IFRS. (See “Market Reaction to the Adoption of IFRS in Europe,” which is available at the Social Science Research Network (SSRN) website at [http://ssrn.com/abstract=903429](http://ssrn.com/abstract=903429)) In addition, a study conducted by professors at Stanford and Harvard found that the market perceives net benefits associated with improved information quality under IFRS.

**AUDIT STANDARDS**

Right now there are three sets of audit standards that a U.S. auditor may have to learn. The first set is established by the Public Company Accounting Oversight Board (PCAOB) for audits of public companies. The second set is established by the AICPA’s Auditing Standards Board. The AICPA’s standards are considered authoritative for private companies in the U.S. The third set of auditing standards is promulgated by the International Auditing and Assurance Standards Board (IAASB). The objective of the IAASB is to serve the public interest by:

- Setting, independently and under its own authority, high-quality standards on auditing, quality control, review, other assurance, and related services, and
- Facilitating the convergence of national and international standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession.

The Commission on the Regulation of U.S. Capital Markets in the 21st Century recommended that the SEC and PCAOB work with their international counterparts and the IAASB toward global convergence of U.S. and international auditing standards. At the moment, the Sarbanes-Oxley Act (SOX) requires auditors of SEC registrants to conduct an integrated audit. No other jurisdiction has bought into this notion of control governance. The convergence of audit standards should improve audit quality because audit firms would be able to focus their efforts on a single set of standards. The Commission’s report called for both accounting and auditing convergence to be completed within five years.

Previous SEC rules also played a role with varying audit standards because the SEC didn’t require all public companies to follow the same audit rules. The Commission never required public companies with less than $75 million in public float to provide audited internal control reports required by SOX Section 404. This discrepancy has been eliminated with the recent adoption of the PCAOB’s Auditing Standard No. 5, “An Audit of Internal Control over Financial Reporting that Is Integrated with an Audit of Financial Statements.” The auditing requirements as established in AS5 now apply equally to companies of all sizes and complexity.

The PCAOB also faces the reality of inspecting non-U.S. firms that audit non-U.S. issuers that elect to have their securities trade in the U.S. markets. The Board is trying to closely coordinate its work with similar regulatory bodies in other countries and may at its own discretion rely on inspections and work of these audit oversight bodies. This reliance on other oversight bodies could lead to a difference in the audit quality of public companies. These differences may well lead to what PCAOB Chairman Mark Olson calls regulatory arbitrage, which could occur if the audit oversight approach of one regulatory body is substantially different from that of other audit oversight bodies.

Globally there are still differences in the areas of auditor independence and nonaudit services. There are issues of audit oversight boards not being independent of the industries they oversee, and, in some countries, audit
committee members aren’t independent of management. While these concerns are being addressed by the EU and other countries, it would seem that global convergence must be reached before similar levels of assurance could be given for both U.S. and foreign listed registrants.

OTHER ISSUES

One issue that hasn’t been discussed in public forums is the role of Congress in allowing an international board to establish reporting and auditing standards for U.S. companies. In 1996, as part of the National Capital Market Efficiency Act, Congress directed the SEC to give vigorous support to the development of high-quality international accounting standards. But some members of Congress have an interest in accounting policy issues and have been known to express their views to both the SEC and the FASB over controversial accounting issues, which could lead someone to conclude that some members of Congress may not be interested in a diminished role in connection with accounting standards setting.

Another issue that must be addressed is the funding of international boards. SOX Section 109 provides that funds to cover the PCAOB’s annual budget (less registration and annual fees paid by public accounting firms) are to be collected from issuers. Accounting support fees are based on the average monthly U.S. equity market capitalization of publicly traded companies, investment companies, and other equity issuers. The fees are paid by publicly traded companies with average monthly U.S. equity market capitalization of more than $25 million each and by investment companies with average monthly net asset value or U.S. equity market capitalization of more than $250 million each. International standards-setting boards would have to develop a funding stream that not only preserves their independence but meets the requirements of Congress and other international legislative bodies.

An additional factor in IFRS adoption is already being considered by the SEC. The Commission realizes that avoiding regulatory conflicts concerning the application of IFRS is crucial. In August 2006, it published a joint work plan with the Committee of European Securities Regulators (CESR) that requires the SEC staff and the CESR-Fin, the expert group within CESR focused on financial reporting, to share information about consistent application of IFRS. Protocols for sharing confidential information about companies that are listed with the EU and the SEC are to be established. The SEC will have to develop similar agreements with securities regulators in other jurisdictions to resolve IFRS issues for companies that have multiple exchange listings.

A LOOK AHEAD

Multiple jurisdictions have now adopted International Financial Reporting Standards. Because of this widespread acceptance, the SEC may eventually allow U.S. companies to voluntarily report using IFRS, which could ultimately lower multinational companies’ financial reporting costs while placing U.S. companies on a level playing field with IFRS-reporting companies from around the world. But before the SEC allows U.S. companies to do this, a number of impediments must be overcome. These impediments include the long-term funding and structure of the IASB, IFRS education for auditors and educators, and the need for additional collaborative agreements among the securities regulators of the world. These impediments may serve to formulate the “post-roadmap” travel plan for IFRS. Because of these obstacles, a bumpy, three- to four-year trip may be in order before we see the eventual adoption of International Financial Reporting Standards for U.S. companies.

Parveen P. Gupta, LLB, Ph.D., is a professor and chair of accounting at Lehigh University. He served as an Academic Fellow with the SEC’s Division of Corporation Finance during the 2006-07 year. You can reach him at (610) 758-3443 or ppg0@lehigh.edu.

Cheryl Linthicum, CMA, CPA, Ph.D., is an Academic Fellow at the SEC’s Division of Corporation Finance. She is on leave from the University of Texas at San Antonio, where she is the Clear Channel Junior Faculty Fellow and associate professor of accounting. You can reach her at Cheryl.Linthicum@utsa.edu.

Thomas G. Noland, CMA, CPA, CDFM, Ph.D., is an associate professor of accountancy at Georgia Southern University. He served as an Academic Fellow with the SEC’s Office of Chief Accountant-International during the 2006-07 year. You can reach him at (912) 486-7562 or tgnoland@georgiasouthern.edu.

The Securities & Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the authors and do not necessarily reflect the views of the Commission or of the authors’ colleagues on the staff of the Commission.