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Global Accounting Convergence and the Potential Adoption of IFRS by the U.S. (Part II): Political Factors and Future Scenarios for U.S. Accounting Standards

Luzi Hail, Christian Leuz, and Peter Wysocki

SYNOPSIS: This is the second article of a two-part series analyzing the economic and policy factors related to the potential adoption of IFRS by the United States. In Part I (see Hail et al. 2010), we develop the conceptual framework for our analysis and discuss economic factors driving the costs and benefits associated with IFRS adoption. In this part, we provide an analysis of the political factors related to the possible U.S. adoption of IFRS, present several scenarios for the evolution of U.S. accounting standards, and outline opportunities for future research on global accounting standards and regulation. We start with a general discussion of the standard-setting process in accounting and how a U.S. switch to IFRS might affect worldwide competition among accounting standards and standard setters. We discuss potential political ramifications of such a decision on the standard-setting process in the United States, as well as on the governance structure of the International Accounting Standards Board. Drawing on our economic framework and the insights from our analysis, we conclude by outlining several possible ways of how U.S. accounting standards could evolve. These scenarios include maintaining U.S. GAAP, letting firms decide whether and when to adopt IFRS, mandating full compliance with IFRS within a prespecified schedule, or creating a competing U.S. GAAP-based set of accounting standards that could serve as a global alternative to IFRS.

Keywords: accounting regulation; standard setting; U.S. equity markets; mandatory disclosure; political economy; convergence; harmonization.

JEL Classifications: F50; G15; G38; K22; M41; M48; O51.

Luzi Hail is an Assistant Professor at the University of Pennsylvania, Christian Leuz is a Professor at The University of Chicago, and Peter Wysocki is an Associate Professor at the University of Miami.

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Corresponding author: Luzi Hail
Email: lhail@wharton.upenn.edu

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INTRODUCTION

This article is the second of a two-part series analyzing the economic and policy factors related to the potential decision by the U.S. Securities and Exchange Commission (SEC) to mandate that publicly listed U.S. companies prepare and file financial reports in accordance with International Financial Reporting Standards (IFRS). In Part I, we develop the conceptual framework for our analysis of costs and benefits from IFRS adoption in the United States, and we assess the potential impact of IFRS adoption on the quality and comparability of U.S. reporting practices; the ensuing capital market effects; and the potential firm-specific and economy-wide costs of switching from U.S. GAAP to IFRS.

In this second part, we identify and analyze political factors and policy issues surrounding the possible adoption of IFRS. Specifically, we consider issues related to the economics of the standard-setting process and discuss the political ramifications of IFRS adoption in the United States. This includes potential consequences for the international competition among accounting standards and standard setters, as well as governance issues related to having a supranational organization, namely the International Accounting Standards Board (IASB), establishing global accounting standards.

Next, building on our economic and policy analysis in Parts I and II, we develop several scenarios for the evolution of accounting standards in the United States. The scenarios are (1) maintaining U.S. GAAP; (2) maintaining U.S. GAAP, but with a special emphasis on a continued convergence between IFRS and U.S. GAAP; (3) allowing the choice between IFRS and U.S. GAAP, but requiring firms to reconcile their numbers to the other system; (4) allowing unrestricted choice between the two sets of standards; (5) adopting a U.S.-specific version of IFRS; and (6) setting a conditional timetable for full IFRS adoption. In the final scenario (7), we entertain the potential creation of a competing U.S. GAAP-based set of accounting standards that could serve as a global alternative to IFRS. In the conclusion of Part II, we summarize the key insights from our analysis of the political factors and outline opportunities for future research on U.S. and global accounting standards and regulation.

While we acknowledge and highlight that the motivating question for our analysis and the scenario development is *normative* in nature, our discussion should be viewed as laying out the economic and political issues related to the SEC's decision about IFRS adoption, rather than as advocating a particular decision or a particular scenario.[1] At the same time, the analysis contained in this two-part series demonstrates how academic research can inform policymakers about the potential impact of new financial reporting or disclosure regulation.[2] We also recognize that some of our analyses and conclusions extrapolate existing research and, hence, have speculative elements. In our view, this is the price for analyzing a policy issue before a decision is made and implemented.

STANDARD SETTING AND POLITICAL RAMIFICATIONS OF IFRS ADOPTION IN THE UNITED STATES

In Part I (see Hail et al. 2010), we did not directly consider the process by which IFRS and U.S. GAAP are established—and how they evolve. In this section, we consider issues related to the economics of the standard-setting process and ask whether a single set of global accounting standards is a desirable, as well as a feasible, economic outcome. As the adoption of IFRS is not

[1] See also Bradshaw et al. (2010) for a related discussion of the SEC's proposed roadmap for the potential adoption of IFRS by U.S. issuers.

[2] See, for example, the "FAF and FASB Response to the SEC Roadmap" in a comment letter to the SEC dated March 11, 2009 (available at http://www.fasb.org). For a discussion of the role of academic research in standard setting, see also Fülbier et al. (2009).

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just an economic but also a political issue, we further lay out the potential political, legal, and institutional ramifications of adopting (or not adopting) IFRS in the United States. This includes discussions of the future role of U.S. authorities (namely, U.S. Congress, the SEC, and the FASB) in setting generally accepted accounting principles and how the governance structure of the IASB may affect the future evolution of international accounting standards.

Competition among Standards and Standard Setters

A key role of accounting standards is to reduce the economy-wide transaction costs of communicating information among various stakeholders, allowing them to make more efficient real decisions and undertake transactions within, outside, and between firms. At the same time, accounting standards impose regulatory and compliance costs, and could increase the barriers to entry into public capital markets. The academic literature discusses some of the trade-offs of accounting and disclosure regulation (see survey by Leuz and Wysocki 2010).[3] Much of the literature focuses on whether to regulate and how to regulate, but there is less work on the development of standards and the regulatory process itself.

An important issue for this study is whether having a single set of accounting standards around the world is desirable and would benefit firms, investors, and other stakeholders. As we discussed in Part I, moving to a single set of accounting standards can create some cost savings and comparability benefits. However, there are also concerns related to the standard-setting process. One particular concern about the adoption of IFRS in the United States is that such a move would largely eliminate the existing competition between IFRS and U.S. GAAP, essentially granting monopoly status to IFRS.

The literature on the economics of accounting standards views monopolies as problematic for a number of reasons (e.g., Ball 1995; Dye and Sunder 2001; Sunder 2002, 2009; Benston et al. 2006; Meeks and Swann 2009; Stulz 2009). A monopoly standard setter has few incentives to react quickly to changes in the market place, to innovate, or to implement the best possible accounting standards for investors. The monopoly can impede experimentation with alternative accounting treatments; lead to an overinvestment in existing and new accounting standards without a proven track record; and prevent specialization of standards geared toward a particular subset of firms (e.g., Benston et al. 2006). Lacking an observable price mechanism to inform the markets as well as clearly defined criteria of social choice, monopolistic standard setters also become prone to pressure from political lobbying.

Moreover, empirical evidence from firms opting out of their local disclosure rules by cross-listing in the United States (e.g., Doidge et al. 2004; Hail and Leuz 2009), from firms voluntarily replacing domestic GAAP by IFRS or U.S. GAAP (e.g., Leuz and Verrecchia 2000; Daske et al. 2009), and from comparisons of mandatory disclosure regimes across countries (e.g., Hail and Leuz 2006) shows that regulatory differences affect managers' and investors' decisions; that firms attempt to take advantage of these differences; and that there appear to be benefits from competition among regimes. While opting out of a given regulatory regime is costly and difficult for many firms, the mere existence of an alternative reporting regime provides incentive for an incumbent standard-setting body to pay attention to stakeholders' needs. Thus, a functioning market mechanism mitigates incentive problems with respect to standard setting and increases the responsiveness of standard setters, thereby fostering the development of future standards and regulatory innovation. But, as we discuss below, a market mechanism could also induce a race to the bottom.

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[3] See also the debate about the Sarbanes-Oxley Act of 2002 and related work (e.g., Rezaee and Jain 2005; Leuz 2007; Li et al. 2008; Zhang 2007; Leuz et al. 2008).

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If the United States adopts IFRS, lack of competition among standard setters could lead to pressures on the IASB from its members and stakeholders to justify both its existence and the costs of maintaining its operations. These pressures could yield an overproduction of standards by either revising existing standards or developing new IFRS. Alternatively, the IASB could try to expand its influence by venturing into new markets. The current project of IFRS for small and medium-sized private entities could be seen as a step in this direction. Lacking an objective market mechanism, the evaluation of such ventures is often arbitrary. Moreover, experience from other supranational institutions like the World Bank, the International Monetary Fund, or the United Nations suggest that a single global standard setter will face mounting political pressure as consensus must be reached across a wide range of political regimes and interests, likely affecting the issuance and evolution of accounting standards (e.g., Werle 2001; Charnovitz 2005).

A related concern about a single set of global accounting standards is that the standard-setting process involves a compromise among a large and very diverse set of constituents from around the world. Different countries have different goals with respect to financial reporting regulation. While current IFRS are arguably focused on the needs of "outside investor" economies such as the U.K., Australia, or the United States, the majority of the economies around the world still rely heavily on close relationships among a large set of stakeholders and is less focused on outside capital markets. A potential risk for the United States and countries with similar "outside investor" models is that the IASB could be influenced to modify IFRS to meet the demands of "insider" or "stakeholder" economies.[4] As a result, future IFRS may be less suited for "outside investor" economies, such as the United States, and may fail to meet the needs of companies and investors that rely heavily on arm's-length transactions in capital and product markets.

It is also important to recognize that competition among standard setters or accounting standards can take on various forms and occur at various levels (e.g., Benston et al. 2006). Currently, we face a situation of competition between regional monopolies, namely U.S. GAAP in the United States versus IFRS for large parts of the world. One could make the argument that IFRS have evolved into a set of high-quality standards and closely resemble U.S. GAAP precisely because there already was a major competitor in the marketplace. On the other hand, it seems unlikely that competitive forces from foreign standards (e.g., German GAAP or U.K. GAAP) were the primary drivers behind the long history of innovative accounting solutions in U.S. GAAP.[5] For the most part, it is very difficult and costly for firms to opt out of their home-country reporting requirements. That is, while non-U.S. firms can adopt U.S. GAAP, they generally still have to comply with their home-country GAAP, and a U.S. firm cannot simply opt out of U.S. reporting requirements and adopt the reporting requirements of another country.[6] Thus, at the country or regional level, competition among standards does not take place unless the countries themselves are in the process of adopting a different set of standards, or at least willing to consider such a move (e.g., Hope et al. 2006). That said, the existence of multiple standard setters could, nevertheless, provide some discipline to the standard-setting process.

Alternatively, competition among standards can take place at the exchange level. Individual exchanges can compete with each other by setting their own listing requirements. For instance, non-U.S., non-U.K. firms can choose to cross-list on NASDAQ, NYSE, or the London Stock Exchange's Main Market (or its Alternative Investment Market), each with different admission

4 See Leuz (2010) for more details on this distinction and further references.

5 A more likely explanation is the U.S. institutional framework that created a demand for high-quality reporting. We come back to this point at the end of this section. See also, our discussion of institutional complementarities in Part I.

6 Cross-listing often involves opting into a set of foreign reporting requirements, but at the same time, firms remain subject to their home-country accounting standards. To completely opt out, firms essentially have to incorporate in other countries.

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criteria, reporting rules, and oversight consequences (e.g., Piotroski and Srinivasan 2008). The choice of listing venue likely conveys information to the markets and allows firms to cater to a specific investor clientele. However, as pointed out before, firms generally have to satisfy home-country reporting requirements, unless they incorporate abroad or choose the foreign exchange as their primary listing venue. Thus, firms can voluntarily opt into stricter regimes (and also satisfy home-country requirements), but cannot easily escape to weaker regimes, which in turn limits the competition among accounting standards at the exchange level.

As a third possibility, competition among standards and the choice of accounting standards can take place at the firm level. In this case, firms are able to select among a prespecified set of accounting standards the ones that best fit their needs, i.e., offer the highest net benefits (lowest net costs). It is at this level at which the arguments in favor of competition discussed earlier most likely apply.[7] They are much less convincing if competition takes place among regional monopolies that are supported by the regional governments. But with a few exceptions (e.g., Germany and Switzerland during the 1990s), we have not seen this type of competition among standards within a single economy and, therefore, do not have much empirical evidence on its consequences.[8]

Furthermore, we should note that allowing for competition between different providers of accounting standards, regardless of the level at which the competition takes place, is not without problems. Some of the arguments against competition among accounting standards as being desirable include the fear of a "race to the bottom," leading regulators to loosen existing rules; the view that comparability benefits and network externalities in accounting give rise to a natural monopoly as well as concerns about the absence of a real market for accounting standards; and the non-profit status of the standard-setting bodies (e.g., Dye and Sunder 2001; Sunder 2002; Benston et al. 2006).

Another limitation of the competition argument and the long-run coexistence of U.S. GAAP and IFRS is that U.S. GAAP could become an ineffective competitor relative to the increasingly dominant IFRS. At present, foreign countries seem to be "voting for IFRS with their feet." This suggests that either current U.S. GAAP standards, while well suited for U.S. firms and the U.S. environment, do not meet the needs of companies in other jurisdictions, or countries do not feel their current and future needs being adequately represented in the U.S. standard-setting process. The declining relative market share could turn U.S. GAAP into a non-credible alternative for multinational firms operating around the world. It is also possible that the convergence process between the FASB and the IASB has brought the two standards already fairly close together and, as a result, the choice to adopt either U.S. GAAP or IFRS by other countries is primarily a political decision driven by considerations such as the amount of influence on the standard-setting process.

Finally, from a more pragmatic standpoint and setting the issue of desirability aside, we can ask whether a single set of globally accepted accounting standards is, indeed, the likely outcome. Based on our discussion of the economic framework in Part I, we expect incentives and institutional factors to remain a driving force of reporting practices in the years to come. Hence, adopting IFRS on a worldwide scale will hardly eliminate all national, industry, and firm-level forces and incentives that influence firms' financial reporting practices. Local capital markets, enforcement institutions, and economic forces are simply too strong and diverse, making a uniform implementation of IFRS around the globe highly unlikely (e.g., Ball 2006; Nobes 2006; Daske et al. 2008, 2009). Moreover, globally adopting IFRS likely shifts regulatory competition from the creation of accounting standards to the interpretation, implementation, and enforcement of existing IFRS in

[7] One way to achieve such competition in the United States would be to allow a choice between IFRS and U.S. GAAP for U.S. firms. See also the following section on future scenarios for U.S. accounting standards.

[8] See, e.g., Leuz (2003) for a study of Germany's New Market in which U.S. GAAP and IAS were competing.

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local markets. These forces could lead to regional versions of IFRS or different *de facto* standards. For instance, financial crises, new business practices, or innovations in the capital markets can require changes or new interpretations of extant IFRS, which in turn might lead certain countries to opt out or adopt their own version of IFRS. The carve out of specific sections in IAS 39, *Financial Instruments*, announced by the European Commission during the endorsement process of IFRS in November 2004, is just one example of such a nationalized version of IFRS, which sets an important precedent (e.g., Armstrong et al. 2010). The recent financial crisis presented the IASB with the threat of another EU carve out (Tweedie 2008).

Pressures from the capital markets and new business practices can also help explain why U.S. GAAP, notably a *local monopoly* for listed U.S. firms, have evolved into a high-quality set of accounting standards. As discussed in Part I, the needs of investors and other participants in U.S. capital markets are an important driving force of U.S. accounting standards and practices. That is, the same market and institutional forces that shape managers' reporting incentives are likely to be the primary drivers for reporting innovations and the development of standards. It is quite possible that these forces are more important than regulatory competition among standards from different countries or regions. Moreover, these forces remain in place and continue to exert pressures on standard setting, even if the United States decides to adopt IFRS.

Political Ramifications of IFRS Adoption in the United States

A potential political benefit for the United States from IFRS adoption is that it signals an additional willingness on the part of U.S. policymakers to cooperate with other major countries on important global issues. However, there are also political risks for the United States, which we discuss below.

Under the current system, U.S. Congress has delegated oversight over public security offerings and the security markets to the SEC, which in turn looks to the private sector, namely the FASB, for leadership in establishing and improving accounting standards.[9] The SEC supervises this process; essentially retains veto power with respect to the use of standards by U.S. firms; provides implementation guidance; and monitors the conformity of the financial reporting practices by publicly listed firms with the standards. In addition, the SEC issues additional disclosure requirements for publicly traded firms that are registered with the SEC.

A switch to IFRS reporting in the United States would certainly affect the complex interplay of these institutions, as well as create an additional player with a formal standard-setting role. IFRS are set by the IASB, which acts as an independent supranational standard-setting body appointed and overseen by the Trustees of the IASC Foundation and the Monitoring Board.[10] Although the IASB has pledged to cooperate with national standard setters to achieve convergence in accounting around the world, there is little left for individual rule-making bodies in a given country, at least as far as the standards themselves are concerned, except perhaps to act as local agents or constituents of the IASB.[11] In theory and without further stipulations, this would also apply to the U.S. Congress and the SEC and, hence, transfer the authority to set standards in the

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[9] Note that this does not involve a delegation of the SEC's substantive rulemaking authority to the FASB.

[10] Many viewed the lack of oversight by a securities regulator like the SEC as a flaw in the (old) IASB governance structure (e.g., Tweedie 2008). In response to this perception, the Trustees of the IASB approved in January 2009 the creation of a Monitoring Board, which comprises leaders from the SEC, the Japanese Financial Services Agency, the European Commission, and the International Organization of Securities Commissions (IOSCO).

[11] Note that in many countries the mandate of IFRS reporting applies only to consolidated financial statements of publicly listed firms. Statutory (or parent-only) accounts as well as financial reporting by private firms are explicitly excluded and, therefore, countries might still retain a national accounting standards regulator.

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areas of accounting measurement, recognition, and disclosure to the IASB. Such a delegation of standard-setting power to the IASB, by its very nature, poses numerous political challenges beyond the economic aspects that we have discussed, so far.

Legislative bodies like the U.S. Congress have an innate resistance to give up power to a foreign authority or standard-setting body. One of the major concerns from a U.S. perspective is that foreign governments and interest groups exercise an undue influence on the IASB and, consequently, the formulation of IFRS. For instance, it is not clear that other countries have the same goals as the United States when it comes to defining the role of accounting, or when they opted for IFRS to replace their domestic accounting standards in the first place (e.g., Hope et al. 2006). As discussed in Part I, the U.S. economy has several unique features and the U.S. reporting system has evolved in concert with these features. For instance, current U.S. GAAP tend to be very investor-oriented and capital market-oriented. In contrast, many foreign countries are less reliant on public equity and debt markets and, hence, foreign governments may push for accounting standards that focus more on protecting employees' or creditors' interests. They could also put less weight on public or private enforcement mechanisms that impose IFRS on firms in their countries.

Presumably due to similar concerns with respect to their economies, several countries and regional entities, most prominently the EU, have put in place an endorsement mechanism for future amendments of existing IFRS or the creation of new IFRS.[12] This mechanism not only grants them a veto right, but also levers their influence in negotiating changes to IFRS (e.g., Benston et al. 2006; Chand and Cummings 2008), as has been highlighted by the events related to the recent financial market crisis. It is unlikely that U.S. Congress will forgo the option to implement similar endorsement and veto mechanisms, especially in light of the fact that other countries already retain such rights.[13] While such endorsement mechanisms are a safeguard against undue foreign influence, they tend to complicate and slow down the development and implementation of new IFRS. Moreover, if the United States adds or opts out of certain IFRS provisions as part of an endorsement process, this could bring us back to regional or national sets of standards (e.g., NAFTA version versus EU version of IFRS). Such a regionalization of IFRS goes against the stated goals of creating a global set of accounting standards that facilitate cross-border comparability around the world.

In the past, IFRS were largely geared toward the market needs of "outside investor" economies such as the U.K., Australia, and the United States. In addition, the inherent competition between the IASB and the FASB, as well as the dialog between these two bodies as part of the convergence project, acted to discipline the process for setting current IFRS. However, a significant risk for the United States is that the dynamics of the IASB may change in the future, as its constituencies change and the future IASB membership includes greater representation of "insider" or "stakeholder" economies.[14] This could result in a future incarnation of IFRS that is less compatible with U.S. institutions and may not meet the needs of U.S. investors and companies.

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[12] For instance, in Australia, accounting standards are part of the law and the parliament has delegated the task of rule making to the Australian Accounting Standards Board (AASB). Retaining reference to Australian Accounting Standards in the law together with retaining the function of the AASB acts as a safeguard to preserve the legislator's veto rights, while at the same time the Australian Accounting Standards are essentially equivalent to IFRS.

[13] In the past, the United States and other large countries have exercised the right to opt out of certain rulings of international governing bodies like the United Nations, the World Trade Organization, or the International Atomic Energy Agency.

[14] One could argue that a refusal by the United States to adopt IFRS will accentuate this problem or trend. However, the sheer size of the U.S. economy, potential network benefits for non-U.S. firms, and the importance of the United States in the IASB's quest for truly global accounting standards could serve as mitigating factors, ensuring that the interests of U.S. investors are still considered, even if the United States decides against IFRS adoption at this point (but keeps open the possibility to do so in the future).

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Therefore, the United States must consider not only the current version of IFRS and the current structure of the IASB, but also how IFRS and the IASB will evolve in the future.

This evolution is likely to be influenced, among other things, by the growing importance of emerging markets like China, India, and other developing nations. With the growing relative capitalization of these emerging markets, it is expected that investors and companies in these markets will command a greater say in future debates about firms' disclosure choices and accounting standards. That being said, we also expect that, as these emerging markets grow and develop, the needs of their investors will begin to resemble the needs of U.S. investors, essentially leading to some convergence of national interests. Regardless, capital markets in the United States will continue to claim a sizable share of and influence on world capital markets for years to come.

An additional concern is that foreign regulators provide interpretations of IFRS and implementation guidance. Therefore, U.S. firms and authorities would have to monitor the actions of multiple regulators and governing bodies around the world. Moreover, based on the experiences of other jurisdictions with the implementation of IFRS (e.g., KPMG 2006; ICAEW 2007; PwC 2007), U.S. firms are expected to rely on extant SEC and FASB guidance in cases for which IFRS have gaps or are too vague, which could lead to regional interpretations and fragmented international accounting practices. Thus, even if all countries adopt a single set of accounting standards, there will be strong forces toward local adaptation of IFRS and differences in the *de facto* standards. It is important to note that these forces not only exist with respect to IFRS implementation at the firm level (as discussed in Part I), but also at the country level, with respect to local regulators and governing bodies.

From the preceding discussion, it is clear that the future roles of the SEC and the FASB need to be redefined if the U.S. adopts IFRS.[15] Aside from their involvement in the development of future standards, it is expected that both bodies would continue to weigh in on the implementation of IFRS (e.g., in the form of SEC Staff Accounting Bulletins or via the FASB's Emerging Issues Task Force), although the extent of such activity likely depends on the FASB's future funding and research capability. In addition, the SEC will play a role in the governance structure of the IASB as part of the newly approved Monitoring Board.

Moreover, SEC and FASB guidance could serve as instruments to require tighter disclosure standards for U.S. firms (e.g., in the areas of management compensation, board independence, etc.). Unlike specific recognition or valuation requirements, adding disclosure requirements on top of IFRS does not hurt comparability (at least not directly). They are, rather, a way to customize IFRS reporting to the U.S. environment, and enable the United States to lead the way in terms of corporate transparency and to build on its competitive advantages. However, such supplementary disclosure requirements likely change firms' reporting incentives and, hence, indirectly affect firms' reporting practices, which in turn can hamper the comparability of U.S. financial reports. Thus, in thinking about additional disclosure requirements, the key trade-off is assuring an appropriate reporting quality in the United States versus achieving comparability of U.S. reports with the rest of the world.

If the goal is to follow this competitive strategy without sacrificing some of the comparability benefits, both the SEC and the FASB need to evaluate their interactions with the IASB and aim for

[15] In addition, there exist areas for which current legislation in the United States may be inconsistent with IFRS or with delegating standard-setting power to the IASB. For instance, under Section 108 of the Sarbanes-Oxley Act, the SEC retains the authority to establish accounting principles or standards for purposes of enforcement of U.S. securities laws and, unless the law is changed, the IASB would have to accept SEC oversight. Because many SEC rulings are specific to U.S. GAAP and have no IFRS counterparts, the SEC, in its roadmap, has started to identify areas that require changes in an IFRS regime and has proposed initial amendments to existing rules and forms (SEC 2008). However, additional amendments and new guidelines will likely be necessary.

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more influence and cooperation. Close cooperation between the IASB and the FASB has intensified since 2002 with the signing of the Memorandum of Understanding. A switch to IFRS can potentially strengthen the U.S. influence. However, other countries could resist a high level of SEC or FASB involvement, and some argue already that the level of cooperation has become too intense (e.g., Chand and Cummings 2008).[16] Aside from bolstering the capital market and investor orientation of IFRS, a strong U.S. influence could, in the long run, move IFRS closer to a system of standards that is similar in nature to current U.S. GAAP, i.e., a system in which specific rules gradually supplant the more generic principles of existing IFRS.

Another widely recognized concern about the IASB is whether its present funding structure is appropriate (e.g., SEC 2008). At the moment, private corporations, instead of government entities, provide the majority of funding on a voluntary basis. While switching to a more permanent source of funding can address certain resource constraints, there are also other issues to consider such as political influence, lobbying, and holdup problems. On one hand, to maintain its independence, the IASB might consider expanding its own capacity and capabilities, as currently it outsources much of its research to national standard-setting boards. On the other hand, the IASB could retain its relatively lean organization and put the expertise of national standard-setting bodies to use by delegating specific tasks to local authorities like the FASB and only assuming a coordination role. However, such a strategy would likely slow down the standard-setting process and make it harder for the IASB to resist the influence of local interest groups. As the governance structure of the IASB is still somewhat in flux, it is difficult to render opinions on the likely outcomes. However, lessons can be learned from the organizational and governance choices and resulting successes and failures of other international governing bodies such as the UN, World Bank, or OECD, as well as the current governance structure of the FASB. It seems that economic and political independence is an important guiding principle in institutionalizing a standard-setting body that is responsive to the needs of investors and capital markets. Equally important is the role of an effective securities regulator that monitors the development, implementation, and enforcement of the standards, thereby providing strong incentives for transparent and truthful reporting (e.g., Leuz and Wysocki 2010). The implementation and enforcement aspects of global accounting convergence are largely missing from the IFRS debate, which we view as a serious shortcoming.[17]

Finally, a switch to IFRS by the United States also faces substantial political challenges within the United States. The lobbying view of regulation suggests that various stakeholders will weigh in on the process, depending on their benefits and costs from either maintaining the *status quo* or adopting IFRS. Therefore, various stakeholders have incentives to lobby for a particular agenda, because the decision to adopt or forgo IFRS will have redistributional effects across these stakeholders. For example, large multinational firms are likely to lobby in favor of IFRS adoption, given the potential cost savings and comparability benefits from using a uniform set of standards throughout their global operations. International auditing and advisory firms are also likely to support IFRS adoption, given their prior experience with IFRS in other countries and the significant revenues that a switch to IFRS will generate during the transition period. On the other hand, smaller local auditors or domestically oriented U.S. firms may lobby against IFRS adoption. As such, the lobbying activities will provide useful information about the costs and benefits of various constituents, and undoubtedly influence the U.S. Congress in its decision on the future direction of U.S. financial reporting.

[16] Currently, three out of the 13 members of the IASB and five out of the 22 trustees of the IASC Foundation have a U.S. background.
[17] See Leuz (2010) for a proposal on how to overcome this shortcoming with the creation of a global segment of firms subject to stricter enforcement.

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SCENARIOS FOR FUTURE U.S. ACCOUNTING STANDARDS

In this section, we outline several possible scenarios for the evolution of financial reporting standards in the United States. We discuss how the various economic and policy factors identified in Parts I and II of this series will likely play out in each of the scenarios in order to highlight the interactions and trade-offs between them. Toward this goal, the scenarios are intentionally stylized. It should also be noted that they are neither exhaustive nor mutually exclusive. Furthermore, our discussion should not be seen as advocating specific scenarios or actions. We also acknowledge the (necessarily) speculative nature of some of our discussions.

As we outline the scenarios, we highlight: (1) possible outcomes for financial reporting quality and comparability; (2) the role of incentives in determining financial reporting outcomes; (3) how complementary institutions influence reporting outcomes and whether a scenario is compatible with existing U.S. institutions; (4) potential transitional and long-term costs of a scenario; and (5) policy and macroeconomic implications associated with a scenario.

The scenarios we discuss are: (1) maintain U.S. GAAP with acceptance of IFRS for foreign firms; (2) maintain U.S. GAAP with a new IASB-FASB agreement to accelerate convergence between IFRS and U.S. GAAP; (3) choice between IFRS and U.S. GAAP, but require reconciliation; (4) unrestricted choice between IFRS and U.S. GAAP; (5) "U.S. IFRS"—require IFRS for all firms plus an SEC/FASB overlay that provides guidance, additional disclosure requirements, and, in some cases, supplemental standards; (6) flexible timetable to fully adopt IFRS; and (7) International U.S. GAAP (I-GAAP)—a competing set of international standards (drawing on the foundation of U.S. GAAP) designed to meet the needs of the United States and other countries. Scenarios 1 through 6 can be viewed as an ordering from minimal to more extensive IFRS adoption. Scenario 7 is "outside the box," and suggests a more proactive U.S. strategy to influence the direction of regional and international financial reporting, disclosure, and enforcement standards.

Scenario 1: Maintain U.S. GAAP

This scenario maintains the requirement that U.S. firms file financial reports compliant with U.S. GAAP (which, at the present time, is different from IFRS). It is, nevertheless, dynamic because, consistent with past trends, both U.S. GAAP and IFRS will evolve and change in the future.[18]

We perceive the following issues and outcomes under the scenario in which U.S. public companies continue to file reports under U.S. GAAP. First, the comparability of U.S. financial reports will likely *increase* internationally because more countries plan to adopt IFRS, and differences between IFRS and U.S. GAAP are smaller than differences between U.S. GAAP and other countries' domestic GAAP. However, there will be residual differences among IFRS and U.S. GAAP and, hence, some comparability issues at the standard level remain. These differences in the standards likely impose some costs on both U.S. and foreign investors wishing to compare U.S. and foreign firms. Given the sheer size of the U.S. capital markets and the large number of U.S. firms, it is likely that foreign investors will, at least in the short and medium term, continue to maintain bilingual capabilities between IFRS and U.S. GAAP in this scenario. Conversely, growing IFRS adoption around the world suggests that U.S. investors must also develop and improve such bilingual capabilities. In addition, we expect institutional differences to persist across countries. These differences will continue to affect both firms' reporting incentives and reporting outcomes. Thus, even among IFRS countries, financial reports will not become fully

[18] The recent financial crisis provides a good example of how accounting standards are affected by changes in capital market conditions and the political landscape.

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comparable, requiring U.S. (and foreign) investors to understand the heterogeneity among institutions and reporting practices around the world.

Second, we expect the direct capital market effects of maintaining U.S. GAAP (relative to the effects if the United States switches to IFRS) to be minimal. The reasons, established in Part I of this series, are that a switch to high-quality reporting standards has measurable effects *only* in countries where IFRS are a major improvement over the local standards and *only* if complementary institutions, like enforcement, change at the same time or at least support the introduction of IFRS. However, both of these conditions seem not to apply to the United States. Current U.S. financial reporting is already of high quality, and we do not foresee a major change to U.S. enforcement institutions, which are among the strongest in the world, even following a potential switch to IFRS.

Third and closely related to the above point, we also do not foresee major changes to the reporting incentives of domestic firms and foreign private issuers in the United States. As highlighted in Part I of this series, incentives play an important role for financial reporting practices, arguably even more so than stated accounting standards. Hence, unless incentives fundamentally change, high-quality financial reporting in the United States likely persists regardless of IFRS adoption by the United States and accounting trends abroad. Similarly, the mere adoption of IFRS by other countries does not imply immediate improvements in the quality and comparability of foreign firms' financial reports.

Fourth, in the short to medium term, this scenario does not introduce major (incremental) adjustment costs. The interplay between U.S. GAAP and other legal, regulatory, enforcement, and private-sector institutions in the United States have jointly evolved over time, creating a relatively efficient system of complementary checks and balances for financial reporting and other elements of the U.S. institutional framework. This system is expected to continue to operate relatively efficiently, at least over the short to medium term.

Fifth, in the long run, the "maintain U.S. GAAP" scenario forgoes potential cost savings for some firms and (modest) comparability benefits for all U.S. firms (and investors) from moving to IFRS. That is, for a select group of U.S. firms, costs are likely to be higher compared with an IFRS-adoption scenario. This group comprises multinational firms that want or have to use IFRS for their foreign operations. A potential remedy is to allow an exemption for U.S. multinationals that (1) wish to report under IFRS, and (2) have significant foreign operations (see, e.g., Scenario 4).

Sixth, the macroeconomic effects of the "maintain U.S. GAAP" scenario are likely to be mixed and mainly redistributional in nature. In the services area, financial and information intermediaries (auditors, analysts, etc.) have to maintain U.S. GAAP capabilities, presumably in close proximity to their U.S. client base, thereby reducing the risk of extensive offshoring (see Effects on Service Providers in Part I). Foreign financial intermediaries, on the other hand, would be at a competitive disadvantage. At the same time, U.S.-based service providers could suffer internationally because they lack specific or sufficient IFRS expertise. Thus, maintaining U.S. GAAP can be viewed as a non-tariff trade barrier between U.S. and foreign markets. In the education realm, U.S. GAAP capabilities keep their priority, but there would also be a demand for expanded IFRS offerings in the curriculum to meet the needs of U.S. investors in international markets.

Seventh, maintaining U.S. GAAP allows U.S. legislators (i.e., Congress and the SEC) to retain unrestricted control over domestic financial reporting. In addition, maintaining U.S. GAAP

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could be seen as a way to promote competition between standard-setting bodies.[19] However, as discussed in the previous section, competition among regional monopolies of accounting standards is likely limited. In addition, (1) foreign countries seem to be "voting for IFRS with their feet," suggesting that the current form of U.S. GAAP and the U.S. standard-setting process do not meet the needs of other countries; and (2) the declining market share of U.S. GAAP could turn them into a marginal competitor in the international domain.

Finally, foreign countries are likely to perceive the United States as non-cooperative in a multilateral effort to harmonize accounting standards if it retains U.S. GAAP, which has political ramifications, potentially beyond accounting. However, it should be noted that maintaining U.S. GAAP in the near term does not rule out the pursuit of other scenarios in the future, and this scenario can, therefore, be viewed as a "deferral" option.

Scenario 2: Maintain U.S. GAAP with Continued Convergence between IFRS and U.S. GAAP

This scenario also maintains the requirement that U.S. firms file financial reports compliant with U.S. GAAP, but adds the element of accelerated convergence between IFRS and U.S. GAAP. In the short run, the first six issues from the pure "maintain U.S. GAAP" scenario will likely also apply to this scenario. However, many of the issues dissipate as U.S. GAAP and IFRS eventually converge. The key difference between this scenario and the earlier scenario is that U.S. authorities renew their commitment to the "convergence project" with the IASB in 2011. Additionally, the following issues become relevant.

First, in the near term, the SEC and FASB maintain their influence on U.S. financial reporting, possibly increasing their bargaining power in negotiations with the IASB relative to being simply one of many constituents of the IASB. In this scenario, some competition between the two sets of standards remains. However, it is likely to be considerably weaker due to the existence of a formal convergence process. Moreover, the beneficial effects of competing standards diminish as the remaining material differences between IFRS and U.S. GAAP disappear as part of the convergence project. Aside from competition, the convergence process itself can be a source for improvements in financial reporting standards, as it has been in the past. But again, this force and the influence of the United States on future standards is likely to weaken over time, as the remaining differences between U.S. GAAP and IFRS become smaller.[20]

Second, this scenario can be viewed as a phased adoption of IFRS with substantial U.S. input on the eventual form of IFRS. As U.S. GAAP is slowly modified to converge with IFRS, U.S. stakeholders have sufficient time to adapt to the changes. This approach is likely less costly (in present value terms) and creates less extreme disruptions for firms, investors, and the reporting infrastructure, reducing the aggregate transition costs. For instance, contractual agreements tied to accounting numbers do not have to be rewritten immediately because U.S. GAAP gradually change over time. On the other hand, the benefits of reporting comparability will also be realized more slowly and there will be continuous changes to the accounting standards due to the convergence process (beyond the normal rate of change in the standards).

Third, this scenario gives rise to a number of implementation issues including (1) the extension of and changes to the Memorandum of Understanding between the FASB and the IASB; (2)

[19] Alternatively, maintaining U.S. GAAP could be viewed as a way to maintain the convergence process between IFRS and U.S. GAAP, which arguably has been a force in the development of accounting standards as well. We discuss this aspect under Scenario 2.

[20] Of course, standard setters could still aim to improve the accounting standards over time, but these improvements would be no longer driven by convergence *per se*.

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the resolution of disagreements between the two standard-setting bodies on the convergence of more contentious standards; and (3) the time frame for the complete convergence of IFRS and U.S. GAAP.

Scenario 3: Allow Choice between IFRS and U.S. GAAP, but Require Reconciliation

Historically, the SEC has required foreign private issuers to either file financial statements in accordance with U.S. GAAP or file their domestic GAAP reports together with 20-F reconciliations. In this scenario, we outline potential issues arising from allowing U.S. firms the *choice* between U.S. GAAP and IFRS with the *supplemental requirement* that firms opting for IFRS must provide reconciliations to U.S. GAAP.

The academic literature on the relevance of 20-F reconciliations for investors has produced mixed results (see our literature review in Part I). Thus, it is *a priori* not obvious whether reconciling from IFRS to U.S. GAAP improves investors' insights into U.S. firms' operations. However, the "optional IFRS plus reconciliation" scenario enhances the comparability of financial statements along two dimensions: (1) all U.S. firms have "comparable" U.S. GAAP statements; and (2) the subset of U.S. firms that file primary reports under IFRS also has "comparable" statements with international firms reporting under IFRS. Yet, as pointed out in the Incentives as a Key Determinant of Reporting Quality and Comparability section of Part I of this series, this comparability applies only to the accounting standards that are being applied, not necessarily to firms' accounting practices. Reporting incentives are likely to differ substantially not only across IFRS and U.S. GAAP firms, but also within each group. As a result, we do not expect reporting outcomes to be fully comparable, even for firms providing U.S. GAAP reconciliations. Thus, it is difficult to predict the extent of comparability benefits under this scenerio for firms and investors.

One argument in favor of reconciliation is that it disciplines the implementation of IFRS by mitigating incentives to use the discretion inherent in IFRS in an opportunistic fashion. The counterargument is that firms could have incentives to minimize the reconciliation amounts they have to disclose, which in turn can reduce the quality of both IFRS and the reconciled U.S. GAAP numbers (Leuz 2006). In a similar vein, it is precisely those firms that have to be "forced" to disclose more information via a reconciliation for which the reporting incentives are weak and, hence, the quality and informational value of the reconciliations are presumably low.

Another argument in favor of reconciliation is that it educates investors about the differences between IFRS and U.S. GAAP and, hence, facilitates the long-run transition to an IFRS regime. Moreover, under this scenario all firms maintain some U.S. GAAP capabilities. If, at a future date, the SEC decides to reverse course and no longer permits IFRS for U.S. firms, there should be relatively few obstacles to reverting back to a U.S. GAAP regime.

It is important to also consider the costs of a reconciliation requirement. In this scenario, firms can choose the set of standards that delivers the highest net benefits, but if they choose IFRS they have to bear the costs of reconciliations. These costs are nontrivial, especially if reconciliation requires changes deep down in a firm's accounting system. In light of the SEC's recent ruling to waive the 20-F reconciliation requirements for foreign registrants reporting under IFRS, it is not obvious that the benefits of a reconciliation requirement outweigh the costs for domestic registrants.[21] There likely are firms for which reconciliations have net benefits, but those firms can voluntarily provide them to help investors understand the transition to IFRS. Given the additional

[21] It should be noted that the situations are not exactly the same because U.S. firms already produce U.S. GAAP reports. Unlike foreign firms that intend to cross-list in the United States, they do not have to build U.S. GAAP reporting capabilities from scratch and they always retain the option to revert to U.S. GAAP reporting.

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cost burden, we expect only a select group of firms to exercise the option to use IFRS for their primary financial statements if reconciliation to U.S. GAAP is a prerequisite for IFRS adoption.

Finally, this scenario can be viewed as a transitional option leading to either unrestricted choice between U.S. GAAP and IFRS (Scenario 4) or mandated full adoption of IFRS (Scenario 5). It should be noted that there is also the converse path: allow both IFRS and U.S. GAAP, but require reconciliation to IFRS for U.S. GAAP filers. This option may be a reasonable alternative to full adoption of IFRS if: (1) the United States intends to adopt IFRS in the long run; and (2) many firms find that reconciliations to IFRS are not as costly as a full mandated adoption of IFRS.

Scenario 4: Allow Unrestricted Choice between IFRS and U.S. GAAP

In general, the "unrestricted choice" scenario provides greater flexibility to U.S. firms and allows for firm-level competition between IFRS and U.S. GAAP within the U.S economy, which is likely to be far more effective than competition among regional monopolies. In addition to the issues that we have already discussed in Scenario 3, the following arguments apply.

The academic literature on voluntary disclosure argues that firms trade off the benefits and costs in making their financial reporting choices (see Conceptual Underpinnings section in Part I of this series). On one hand, firms can make "low-quality" reporting choices, but they ultimately bear the costs of these decisions, e.g., in the form of higher costs of capital or lower valuations. On the other hand, firms can strive for high-quality reporting, but this choice comes with additional direct costs (e.g., preparation and auditing costs) and potentially additional indirect costs (e.g., revelation of sensitive information to outside parties and competitors). The evidence from academic studies suggests that firms carefully weigh these costs and benefits and, hence, allowing firms a choice of standards can be individually beneficial. Doing so introduces non-comparability at the standard level in the sense that U.S. GAAP and IFRS reports coexist among U.S. firms. However, it is not clear that the negative effects from this non-comparability in the standards are large relative to the heterogeneity (or non-comparability) that currently exists among U.S. GAAP reports of U.S. firms, as suggested by the reporting incentives argument.

Moreover, it is important to consider firms' relevant peer groups. If investors really want to compare a domestically oriented U.S. firm to a multinational U.S. firm, then a switch of the international firm to IFRS reduces comparability. On the other hand, if the international firm is compared with its global peers, then the loss in comparability to purely domestic U.S. firms should not be an issue. While the reality probably lies somewhere in the middle, this example serves to highlight the trade-off. Furthermore, it should be noted that potential inconsistencies among U.S. firms are mitigated by the fact that *all* U.S. firms continue to face U.S. legal and other institutions; that these factors have a major influence on firms' reporting practices and, as such, serve as a force toward comparability among U.S. firms, regardless of the standards they follow.

The next issue is whether an economy with two sets of standards bears higher aggregate transaction and social costs than an economy with just one standard. For instance, under this scenario, the auditing industry must invest in dual auditing capabilities, potentially leading to overlap and inefficiencies. To mitigate these issues, the auditing industry is likely to segment itself into large, multinational auditors specializing in IFRS and small, domestic auditors focusing on U.S. GAAP.[22] Investors would also need to be able to understand the two sets of standards. In the United States, however, investors already face different accounting standards and practices, e.g., by foreign firms cross-listed on a U.S. exchange, or by private U.S. firms. Finally, the educational

[22] Note that this could create additional non-comparability with regard to firms' *audited* financial statements.

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system would need to develop a comprehensive curriculum covering both IFRS and U.S. GAAP. But U.S. investors already require such bilingual capabilities when investing in foreign stocks, considering that the rest of the world is moving toward IFRS.

As many of the benefits from moving to a single set of accounting standards come in the form of externalities and network effects, they require a sufficient number of participants and a large enough network size (e.g., Waehrisch 2001; Meeks and Swann 2009). With two standards coexisting in the United States, some of these network benefits could disappear or become substantially smaller. However, this reduction in network benefits likely affects firms reporting under U.S. GAAP more than IFRS filers, as the latter benefit from joining the growing network of international firms using IFRS.

The "unrestricted choice" scenario enables competition among IFRS and U.S. GAAP in its purest form (e.g., Sunder 2002, 2010). Thus, it provides standard setters with a market-based mechanism to assess their accounting provisions (e.g., by examining adoption patterns). But it can also be viewed as an intermediate stage leading to full IFRS adoption for all U.S. firms. If enough U.S. firms switch to IFRS, then maintaining two sets of accounting standards eventually becomes socially too expensive.

Scenario 5: Adopt "U.S.-Specific IFRS"

U.S. GAAP include, but are not limited to, the FASB's statements of financial accounting standards (SFAS), SEC guidance on the interpretation of these standards, and U.S. legal precedents that influence current and future accounting practices. Arguably, these extra FASB elements of U.S. GAAP are the result of forces in the U.S. institutional environment, e.g., the demand created by the capital markets. These institutional forces are expected to persist beyond the adoption of IFRS. Scenario 5 would address these forces. In this scenario, IFRS provide the foundations for U.S. accounting standards, but they are complemented by a SEC/FASB overlay of IFRS interpretations and implementation guidance, which sometimes may be based on current U.S. GAAP concepts. In addition, there can be supplemental disclosure requirements and standards that augment IFRS.

An advantage of this scenario (relative to maintaining U.S. GAAP) is that it moves U.S. firms closer to IFRS-compliant foreign filers in the United States and other international firms reporting under IFRS. However, the comparability is hurt by the additional SEC/FASB overlay because local adaptations and interpretations of IFRS are generally viewed as a step back in the global convergence process. But again, based on the incentives argument (see Part I, "Incentives as a Key Determinant of Reporting Quality and Comparability") it is important to recognize that other factors aside from the accounting standards are major determinants of financial reporting practices. As result, there will likely be heterogeneity in reporting practices, regardless of local adaptations of IFRS, and even under "pure IFRS" adoption. Moreover, "U.S.-specific IFRS" is likely to result in a better fit with the U.S. institutional environment. This benefit mitigates, and could even outweigh, the potential drawbacks from a loss in comparability.

Recognizing that U.S. legal, regulatory, enforcement, and private-sector institutions have evolved over time to create a well-functioning system, the "U.S.-specific IFRS" scenario could be viewed as a compromise that draws on some of the features of IFRS, but also maintains additional elements of U.S. GAAP that have a proven track record. That is, this scenario attempts to reduce institutional incompatibilities and, from a fit perspective, could be more workable in the United States than a set of "pure" IFRS (see also Compatibility of IFRS with U.S. Regulatory System, Legal Environment, and Economy in Part I of this series).

A U.S.-specific version of IFRS also induces some degree of competition and discipline into the standard-setting process, because the SEC and the FASB maintain the option to augment IFRS with "better" standards and disclosure requirements. Such competition (or discipline) not only

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benefits U.S. firms and investors, but can also work the other way round, as the IASB and foreign stock market regulators may wish to adopt the SEC/FASB supplemental accounting standards and disclosure rules. It may also strengthen the U.S. position in future considerations by the IASB regarding additions to or amendments of extant IFRS. Furthermore, we expect "U.S.-specific IFRS" to be more politically palatable given domestic concerns about ceding complete control over U.S. financial reporting to a foreign authority.

With respect to macroeconomic outcomes, the "U.S.-specific IFRS" scenario likely increases the competitive pressures on U.S. financial intermediaries (auditors, analysts, etc.), given that the United States will, in large parts, adhere to IFRS standards, and foreign service providers could be equally well equipped to render IFRS-related advisory services. On the other hand, U.S.-based service providers are in the medium term no longer at a disadvantage in international markets because of the IFRS capabilities they develop for their U.S. clients. In the area of education, IFRS training has to be complemented by knowledge of the additional standards and requirements applicable to U.S firms.

In terms of cost consequences, the "U.S.-specific IFRS" scenario should be less costly during the transition phase and in the long run than unconditional IFRS adoption, to the extent that many of the elements of current U.S. GAAP and SEC disclosure requirements are carried over. A related issue is whether the SEC would require foreign private issuers in the United States to meet the same supplemental standards and disclosure rules as U.S. firms.

Scenario 6: Set Conditional Timetable to Fully Adopt IFRS

If one views full adoption of IFRS by the United States as inevitable, then the only remaining issues are the exact implementation strategy and the adoption timetable. The SEC's "roadmap" toward IFRS reporting by U.S. issuers (SEC 2008) proposes a relatively rigid schedule, i.e., only a limited number of firms are allowed to adopt IFRS early and, once the SEC's decision in favor of IFRS is made, the transition dates for particular groups of firms are fixed. As an alternative, we consider a more flexible and conditional transition to IFRS. In this scenario, the decision and the timing of full IFRS adoption are endogenous.

As outlined in Part I of this series, different firms face different costs and benefits of switching to IFRS. Clearly, certain U.S. firms would prefer to switch quickly to IFRS, while others would rather delay IFRS adoption hoping that the transition costs decline. Hence, U.S. policymakers could consider a two-stage process of IFRS adoption. In the first stage (e.g., lasting five or even ten years), firms could voluntarily choose to switch to IFRS or keep reporting in accordance with U.S. GAAP. In the second stage, firms not yet reporting under IFRS would be required to switch, but only if certain preset conditions are met. Thus, the trigger for full adoption is endogenous in the sense that it depends on firms' decisions regarding IFRS adoption in the first stage. The key aspect of this transition model is that the move to IFRS is conditional on the (voluntary) adoption patterns of U.S. firms and, hence, a market outcome before the remainder of the firms is forced to adopt IFRS. It allows setting the timetable based on the observed adoption patterns. The key underlying assumption is that the adoption patterns provide insights and further information on firms' cost-benefit trade-offs and, hence, reveal the preferences of U.S. firms for IFRS adoption.

The two-stage approach has the potential to create positive cascade effects. Allowing low-cost-of-IFRS firms to adopt early can convey positive externalities on other firms that have not yet switched. For instance, auditors learn how to smoothly transition to IFRS, which reduces the transition costs for firms that adopt IFRS at a later date.

The aforementioned advantages of the two-stage approach have to be weighed against the fact that such an approach introduces uncertainties for firms, investors, and other stakeholders. This is because the final decision and the timing of the mandated switch to IFRS are not fixed, but depend

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on firms' behavior.[23] To mitigate this uncertainty, policymakers could specify the terms of such a "flexible switch to IFRS" scenario by (1) allowing a certain group of large firms (e.g., S&P 500 firms) to choose between GAAP and IFRS in a preset time frame (e.g., within three fiscal years); and (2) setting a threshold that, if achieved, automatically triggers the next stage (e.g., if more than 50 percent of the large firms choose to adopt IFRS, then require adoption for the remaining large firms, else repeat stage one), which in essence allows firms and market participants to form and revise expectations about the likelihood of IFRS adoption.

Finally, we note that the initial set of firms that are given a choice of IFRS adoption should be chosen sufficiently large because learning effects and possible network benefits from adopting IFRS are more likely to materialize if a larger fraction of U.S. firms adopts the new set of standards (e.g., Waehrisch 2001; Meeks and Swann 2009). Thus, the current SEC proposal that only makes a small number of firms eligible for early IFRS adoption could be self-defeating because the economies of scale and network effects may not be evident for such a small group.

Scenario 7: Create International U.S. GAAP (I-GAAP)

The prior scenarios present various combinations of IFRS and U.S. GAAP. To conclude, we attempt to widen the accounting standards debate and offer another scenario that proposes a more proactive U.S. strategy to influence the direction of global financial reporting. In this scenario, the United States would help create a newly revised set of accounting standards, "International U.S. GAAP" (I-GAAP), which can be adopted by other countries and, as such, competes with IFRS. We realize that there are few large countries left that have not committed to IFRS and that it would be difficult and costly for IFRS countries to switch to a yet another new set of accounting standards in the near term. For this reason, we discuss the "I-GAAP" scenario primarily as a thought experiment to illustrate an interesting range of issues with IFRS adoption in the U.S. and global accounting convergence.

First, a "one-size fits all" and truly global set of IFRS may (in the long run) not meet the capital market needs of the U.S. and other "outside investor" economies with similar capital markets and institutions (see related discussion in Compatibility of IFRS with U.S. Regulatory System, Legal Environment, and Economy in Part I of this series). Therefore, the United States could take the lead to develop a competing set of standards to meet the specific requirements of capital market-oriented economies. As U.S. GAAP would serve as the basis for I-GAAP, they would have many features that are proven to be compatible with "outside investor" economies and compatible with U.S.-style institutions.

Second, in the past, many international companies voluntarily prepared their financial statements in accordance with U.S. GAAP. Thus, these companies viewed U.S. GAAP as a viable alternative to IFRS. However, foreign governments and regulators were reluctant to officially adopt U.S. GAAP as they have little direct influence and there is no formal representation on the FASB. In contrast, the IASB allows national regulators and constituencies to have a say in the formulation of IFRS. An "I-GAAP" scenario could address this problem by (1) avoiding the perception or reality of being a set of "U.S.-only" standards; (2) creating accounting standards in consultation with other I-GAAP member countries; and (3) opening up a reformulated FASB (an "I-FASB") to include representatives from other member countries.

Third, a critique of IFRS is that any country can adopt this set of high-quality standards, regardless of their ability to properly implement and enforce them. As a consequence, the stan-

[23] In fact, there is also the possibility that IFRS may never become mandatory for all firms in the United States, raising the issue of what "early IFRS adopters" are required to provide in the future. Even if they were allowed to continue to report under IFRS, this outcome may impose future costs on "early IFRS adopters" because they would be outliers in a U.S. market where the majority of other firms presumably still use U.S. GAAP.

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dards lose their ability to signal a country's commitment to high-quality financial reporting (Ball 2006; Leuz, 2010). I-GAAP could overcome this problem and achieve credible high-quality reporting by admitting only countries that meet certain strict requirements with respect to the implementation, enforcement, and auditing of financial reporting.

Fourth, the IASB includes representation from stakeholders around the world. A concern about the IASB is that, over time as other countries grow in importance, the influence of the United States and, hence, its say on the form of future IFRS would diminish (see also the related discussion in the preceding section on Political Ramifications of IFRS Adoption in the United States). In contrast, I-GAAP and the IFASB could be comprised of countries that have similar policy goals to those of the United States.

Fifth, if the United States retains U.S. GAAP, it may become isolated from other countries in its accounting practices. Under the "I-GAAP" scenario, a broader set of countries could use the same set of accounting standards as the United States, increasing potential network benefits. Moreover, because I-GAAP-member countries also commit to certain implementation, enforcement, and auditing requirements, the comparability of reporting practices among I-GAAP firms is further reinforced.

Finally, there are a number of potential limitations of the "I-GAAP" scenario. It can impede global convergence to a single set of accounting standards. Moreover, it might (1) encourage localized accounting cartels, (2) reinforce regionalized financial markets, (3) increase trade and investment barriers between regions, and (4) could be perceived as giving the United States undue influence relative to other member countries. Nonetheless, we believe that the pros and cons of this scenario highlight important issues regarding the future of global accounting convergence.

CONCLUSION OF PART II AND FUTURE RESEARCH OPPORTUNITIES

This is the second article of a two-part series analyzing the economic and policy factors related to the potential adoption of IFRS by the United States. In Part I (see Hail et al. 2010), we draw on the academic literature in accounting, finance, and economics to analyze potential economic consequences of IFRS adoption for U.S. firms, investors, other stakeholders, and the U.S. economy as a whole. In this part, we extend our analysis to related policy issues and political factors, and outline several scenarios for the future of U.S. financial reporting standards in light of the current global movement toward IFRS. Our policy and political analysis shows that there are important economic and political considerations with respect to the standard-setting process. More specifically, our analysis yields the following key insights:

1. Switching to IFRS would essentially confer monopoly status to the IASB. In general, monopolies tend to curb innovation, slow down progress, and are prone to political lobbying. Having a choice between U.S. GAAP and IFRS would help limit those tendencies, but only to the extent that firms (within a country) can choose between standards. Competition between regional or national monopolies is less likely to be effective. In addition, changes in the capital and product markets, and not just regulatory competition, can be an important force for innovation in accounting standards.
2. IFRS adoption has political benefits, signaling a willingness by the United States to cooperate internationally. At the same time, there are political challenges to global standard setting. Countries have different goals for financial reporting, arising from the differences in their institutional frameworks; and they will likely influence the IASB toward their respective goals, which could lead to standards that are less suited for the U.S. environment. Therefore, the governance structure of the IASB is of central interest to various U.S. constituents.

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3. Maintaining legislative power for the accounting standards in the form of an endorsement process for IFRS provides a safeguard against future developments in standard setting that are not in the interest of the United States. However, national endorsement mechanisms tend to slow down the process of standard setting, impede changes in standards, and could even lead to national or regional versions of IFRS.
4. The United States could add specific disclosure requirements on top of IFRS. Supplemental disclosure requirements do not (directly) hurt the cross-border comparability of U.S. reporting, allow for a customization of IFRS to the U.S. environment, and help achieve the desired level of transparency by U.S. firms and for U.S. investors. Such a disclosure overlay could provide an opportunity for the United States to assert its leadership in the area of capital market-oriented reporting (while outsourcing much of the formal setting of the accounting standards to the IASB).
5. However, these additional disclosures do have some costs. There are direct costs to firms such as preparing and auditing the disclosures. Such additional requirements also affect firms' reporting incentives and thereby, indirectly, influence reporting practices and reporting quality. Therefore, these additional disclosures can have adverse effects on the comparability of U.S. accounting numbers.

The key policy and political insights from this article complement the key economic insights presented in Part I. Given the close links, we stress that both parts of this series should be evaluated together. We also point out that the two articles do not advocate a particular decision or policy, but instead are intended to lay out the economic and political trade-offs related to the SEC's decision about IFRS adoption in the United States.

Directions and Challenges for Future Research

Our analysis has highlighted and summarized academic research that provides insights into the possible economic consequences of IFRS adoption in both the United States and other parts of the world. However, there are a number of important issues that prior academic research currently does not answer about the effects and outcomes of financial reporting regulations such as IFRS. This provides ample research opportunities. However, there exist also several obstacles for researchers who wish to investigate these unanswered questions. Thus, to conclude this article, we outline several of these opportunities and challenges.[24]

A key challenge for empirical research in the area of international accounting is that, while one can observe the outcomes of a *chosen* set of standards and regulations, one generally cannot observe the outcomes of competing (yet dismissed) alternative standards and regulations in a given jurisdiction. For example, while we can attempt to measure the economic outcomes of IFRS adoption in the European Union in 2005 (such as a lower cost of capital, increased liquidity, or improved investment decisions), we cannot observe the possible outcomes of alternative regulatory scenarios such as: (1) EU members maintaining their domestic GAAP; (2) EU members adopting another set of standards such as U.S. GAAP; or (3) coexistence of competing sets of standards in the EU (e.g., Sunder 2002, 2010). Without an explicit consideration of counterfactuals, it is difficult to ascertain whether the observed post-2005 economic outcomes are the result of IFRS adoption or the result of other economic forces that exist in a dynamic global economy. For the same reason, it is difficult to draw unequivocal inferences about the superiority or optimality of IFRS, relative to other (unobservable) regulatory scenarios.[25] Thus, future research should think

[24] Leuz and Wysocki (2010) also discuss general research challenges and opportunities related to regulation and mandatory financial reporting and disclosure.

[25] As discussed in Part I and also summarized in the related survey by Leuz and Wysocki (2010), firms' financial reporting and disclosure activities are influenced by a host of factors including market forces, incentives, and institutional factors,

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hard about constructing appropriate counterfactuals and about finding research settings that offer comparisons. For example, settings in which multiple standards coexist within a jurisdiction so that direct comparisons can be made across alternatives would be of particular interest. In addition, researchers might examine cases in which firms have the option to opt out of their home reporting and enforcement regime and adopt the regulations of another country (see, e.g., the discussion of the cross-listing literature in Part I).

Another major opportunity is that we know relatively little about the *mechanisms* through which a set of reporting standards and disclosure requirements lead to the economic outcomes mentioned above. For instance, in Part I of this series, we present research findings suggesting that improved or more comparable financial reporting can have various economic benefits and discuss to what extent such effects could result from adopting IFRS. In this regard, it would be useful to have evidence whether economic outcomes resulting from changes in the set of accounting standards operate through (1) the intrinsic stand-alone quality of the standards (*quality effect*); (2) the ability to compare financial statements across a large set of firms and countries (*comparability effect*; e.g., De Franco et al. 2009); (3) the existence of spillover and network effects from many users of a single set of standards (*externality and network effects*; e.g., Waehrisch 2001; Meeks and Swann 2009); or (4) the fit of the accounting standards with other institutions in a jurisdiction as well as the complementarities that arise from this fit (*compatibility effect*; e.g., Leuz 2010; Wysocki 2010). Such evidence would be very helpful to policymakers and standard setters in designing and implementing financial reporting regulation and accounting standards. However, isolating and identifying these mechanisms is also a major challenge to the research design.

A related research opportunity is to provide evidence on the *relative* contribution of accounting standards to the quality of observed financial reporting. As discussed extensively in Part I, firms' reporting practices are shaped by many factors (e.g., home-country legal and market institutions). Accounting standards are clearly not the only, and probably not even the dominant factor. At the same time, it would be premature (and likely false) to conclude that accounting standards play no role for the quality of firms' reporting practices. Thus, the relative contribution of accounting standards is an open and important issue for future research that could help standard setters and regulators decide how to allocate their efforts and resources.

Finally, prior research on IFRS has generally focused on the financial statement presentation and recognition requirements (i.e., items contained in the income statement, balance sheet, and statement of cash flows) in isolation from other aspects of the financial reporting and disclosure system. Given that investors and other stakeholders collect and process information from multiple sources, a narrow focus on accounting rules and IFRS financial statements might miss the broader effects of and interactions with other regulations and institutions that affect the corporate information environment in a country or market. Therefore, opportunities exist for future research to define, capture, and quantify the mosaic of a firm's information environment (of which IFRS are just one component), as well as to analyze how this broad mosaic affects reporting and economic outcomes.

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aside from accounting standards and disclosure requirements. Therefore, it is often difficult to ascertain the individual impact of (changes in) accounting standards because these many factors interact with each other and they are often difficult to disentangle from each other.

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