# The Convergence of US GAAP and IFRS

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**ABSTRACT**

With technological advancements and high demand for goods and services worldwide a global economy has become commonplace, and by extension a need for a comparable financial reporting system. This research aims to provide an overview of the two most relevant accounting standards (US GAAP and IFRS) in use today and examines how these standards operate as well as serve the needs of their respective stakeholders. Additionally, this research addresses three specific areas of accounting revenue recognition, inventory valuation, and leases - and examine the implications convergence of these accounting standards would have on investors, management, and other stakeholders. The revenue recognition section will explain the steps to recognizing revenue under the new standard. The inventory section will examine the existing similarities and identify areas preventing complete convergence. The leases section will compare the previous leasing standards under US GAAP and IFRS to the new guidance. Finally, this research addresses the overall feasibility of the US attaining complete convergence to IFRS.



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# I. INTRODUCTION

## *A. Background*

Businesses of different sizes and industries all have one thing in common -- accounting. It allows companies to monitor operations, raise capital, measure financial performance, and forecast the future, among many other things vital to an organization's longevity (FAF, 2017). An accounting standard establishes rules for how companies are expected to handle and report their financial operations, much like the rules of a baseball game. In other words, an accounting standard is similar to an umpire enforcing rules of baseball in the game of business. An accounting standard provides an understandable scorecard for users of the financial statements to determine which companies are winners.

During the industrial age -- a period known for rapid business growth -- there was a lack of conformity among world-wide accounting standards. For example, an accounting standard used in Germany was completely different than the accounting standard used in Canada. There were various economic treatments for similar transactions. Businesses at this time were not globally minded, due mainly to technological limitations of the period. Businesses used and developed accounting standards specific for closed market application. After WWII, markets expanded into a global economy with Multinational Entities ("MNE"). Users of financial information had trouble gauging the financial position of foreign companies because the accounting rules were different (Lam, 2015). Without a standard set of rules, the playing field was unfair, and not all scorecards reported the same thing.

Consequently, countries with developed economies have sought for a global, unified accounting standard. For obvious reasons, having a single set of international accounting standards has potential to improve accounting standard quality, increase international financial statement



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comparability, and stimulate capital growth for global businesses. Put differently, when all players are playing by the same set of rules, competition increases and the game is elevated.

While there are numerous accounting standards used throughout the world, there are two, the United States Generally Accepted Accounting Principles "US GAAP" and International Financial Reporting Standards "IFRS", that are the most widely used among the world's leading economies. The two Accounting Standards have substantially the same game rules, but with many subtle differences. By comparison, it is similar to the rules of baseball and softball. The problems arise when teams from each league (or economies) play each other. The two standards are more alike than they are different (EY 2016). To address the problem of following different rules, but playing the same game, the idea of developing a unified, globally comparable accounting standard that incorporates the components of both US GAAP and IFRS has emerged. This is generally known as Convergence.

Convergence should not be confused with adoption, which suggests the abandonment of one standard in favor of the other. Each set of rules has its strengths and weaknesses. Discarding one set of rules for the other does not respect the advantages of the one standard and fails to address the shortcomings of the other (Nobes & Parker, 1980). In other words, it does not advance the game. Furthermore, adoption is an unattractive option because the cost is more significant than convergence, without a corresponding benefit (Johnson, 2008).

The process of complete convergence is expected to take decades, although, in recent years, it has gained momentum. According to Deloitte (2017), approximately 96 countries require IFRS for all publicly traded entities with an additional 25 nations that permit IFRS for country-centric companies. With an increasing number of countries using IFRS, there is increasing pressure on the



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US as the world's leading economy to do the same, despite the disadvantages of adoption (Lamoreux 2011). Figure 1 illustrates the inevitable trend in favor of IFRS.

***<<< Insert Figure 1 >>>***

The true consequences of convergence have become a highly debated topic for professionals in the accounting world. Convergence poses a significant impact, both positive and negative, on stakeholders such as investors, creditors, businesses, preparers of the financial statements, governmental entities, academics, as well as the global economy. The decision by the US to move to IFRS will heavily influence several other countries with significant economies who have not yet moved to IFRS, like Japan and India (Hail, L., Leuz, C., & Wysocki, P. 2010 p366-368).

For those reasons, this paper will focus on the US and its path towards converging the international accounting standard. The purpose of this research is to provide a summary of standard accounting practices in the US and internationally, as well as an explanation and interpretation of recent pronouncements. Additionally, the feasibility of a complete convergence will be evaluated.

***B. US GAAP Overview***

In the US, the Securities Exchange Commission (SEC) is a government agency whose mission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. It is responsible for the supervision and regulation of all public companies in the US securities market. As such, the SEC mandates use of US GAAP as the accounting standard for US entities. US GAAP is a rule-based accounting system with its underlying objective being to provide financial information that is both relevant and reliable to its users. It utilizes highly specific rules, which map how to approach almost every accounting situation across vastly different industries.



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A group called the Financial Accounting Standards Board (FASB) creates the US GAAP rules or Accounting Standards Codifications (ASC). The FASB is a not-for-profit organization whose mission is to develop financial accounting and reporting standards that provide useful information to investors and other users of financial reports (FASB, 2017). In essence, the FASB strives to ensure economic activity of US companies is reported accurately and without bias. Although ASCs are not considered the law, they are authoritative because the SEC uses its jurisdiction, as a government entity, to support and enforce US GAAP in the US.

The FASB's standard-making process is known as "due process" which means the FASB considers input from all sources before making a decision. This procedure is the most robust process for producing accounting standards because of its transparency and consideration to stakeholders. Stakeholders heavily scrutinize accounting pronouncements to ensure FASB appropriately evaluates their needs regarding the update. These stakeholders include groups representing financial statement preparers, company management, investors, creditors, accounting firms, and the academic community (FASB, 2013).

A change to US GAAP begins with a meeting agenda topic submitted by interested stakeholders. The FASB reviews topic submissions then either approve an item for the agenda or explains why the board will not pursue a particular issue in future meetings. Accepted topics of consideration, enter the "initial deliberation" to gauge the direction the topic will take. During this step, the Board may issue a "preliminary views" document to solicit initial feedback from constituents. Next, FASB meets with various advisory groups who may be affected by the change and have a roundtable discussion to gather more input. After discussion, the board will issue an "exposure draft" as a formal means of receiving public feedback on the proposed new guidance. Multiple exposure drafts may be necessary to accommodate input from all stakeholders. Finally,



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after discussing feedback, the board issues a final standard known as an Accounting Standards Update (ASU) or Accounting Standards Codification (ASC). Upon completing this step, the new standard becomes authoritative under US GAAP. Depending on the complexity of the ASC, the FASB may form a "task force" delegated to addressing adoption issues (FASB, 2013).

Although US GAAP aims to present information that is both relevant and reliable, FASB acknowledges that there is a trade-off between the two features. In Concept Statement 2: Qualitative Characteristics of Accounting Information, the FASB identifies relevancy and reliability as the two most important qualities that make information useful to investors (FASB 1980). Specific accounting pronouncements may favor one quality over the other. US GAAP standards show a clear preference in favor of reliability (Johnson, 2005). Case in point, the Historical Cost Method requires companies to record assets at the value the company actually paid. Historical Cost is viewed as a reliable-focused standard because financial statement preparers and auditors can vouch asset purchases to cash payments (Nickolas, 2015).

As the US Economy is highly diverse and the largest in the world, the US GAAP was developed and evolved to meet its high demands, so naturally it is the most detailed standard in existence. So detailed in fact, many people from other countries view it as overly complicated and unnecessary (Shamrock, 2012). Accounting scandals such as Enron -- a once publically traded Company with revenues over $100 billion that falsified company revenues, mislead investors, and colluded with external auditors -- played a big part in shaping US GAAP to rigorously protect the needs of the investors through focusing on the reliability of financial information. For fraud to occur there must be an opportunity, incentive, and rational; otherwise known as the "fraud triangle." Professional judgment allows accountants to determine the appropriate accounting treatment based on experience and training. US GAAP guidance provides concrete rules as a



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means of limiting opportunities for professional judgment (Baker & Hayers, 2004 p767-785). In the history of accounting fraud, many cases are caused by management taking advantage of professional judgment opportunities and interpreting transactions according to what was most beneficial to the company's financial position. That said, other economies have not experienced the same level of accounting fraud as the US. Consequently, other countries have never needed the same level of detailed rules.

Experts in the accounting field have suggested that it would be far less cumbersome and costly for the US to transition to a less complicated accounting system than it would be for the rest of the world to adopt the overly complicated standard of US GAAP. It will be easy for the US to implement IFRS because they already have high-quality enforcement of current rules (Nobes & Parker 1980). If a global standard were to be possible, it is the US who must converge to the less stringent IFRS. However, should the US abandon US GAAP, they would also abandon the accounting rules designed to mitigate professional judgement (Hail et al., 2010, p30). The US would forefit the biggest strength of their domestic capital market – reliability.

***C. IFRS Overview***

As an international standard, the International Financial Reporting Standard (IFRS) does not have a single law-enforcement-body comparable to the SEC, which is responsible for enforcing US GAAP standards. Instead, each country that uses IFRS is responsible for independently implementing the standards in their respective territory. However, there is a Monitoring Board made up of representatives from capital market authorities, which provides guidance for accountability between the IFRS Trustees and public administration (IFRS Foundation, 2017).

The International Accounting Standards Board (IASB) is the standard-setting body comparable to the FASB. They are a not-for-profit group responsible for developing and



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promoting IFRS compliance through issuing International Accounting Standards and Updates (IAS). The IASB's mission, similar to other accounting standards board, is to develop accounting standards that are transparent, accountable, and efficient for financial markets around the world (AICPA, 2011). The IASB's process for creating and updating existing accounting standards and updates is nearly identical to FASB's system of Due Process, with the caveat that its influence extends internationally. In fact, the IASB modeled their standard making process after the FASB's, because of it’s the efficiency, effectiveness, and transparency.

Since the International Accounting Standards Board standards and updates are used by over a hundred countries, each with vastly different political and regulatory systems. Thus, it has not shaped IFRS with a high level of detail like US GAAP. The IFRS’s flexibility allows countries of different sizes, economies, and governments to easily adopt the standard. To illustrate, Germany which has a highly influential globalized economy has vastly different needs and resources than Kenya which is still undeveloped, yet both can enforce IFRS in a way that best fits their country. The IASB is well aware of these various needs of its constituent participating countries and takes thoughtful consideration of how its standards and updates will affect them. To this end, IASB manages its Standards and Updates through a Principle-Based accounting system.

A Principle-Based Accounting System, like the one IASB, has adopted, provides guidelines, not rules, under generally accepted practices. Principle-based accounting systems give discretion to accounting professionals allowing them to decide which accounting policy is most relevant to their situation (Hail et al., 2010). In other words, it is heavily reliant on professional judgment and allows for significant variation in interpretation of these principles depending on the situation and circumstances of the transactions. Consequently, the freedom of discretion has made



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for the smooth, widespread adoption by many countries, which was, in fact, the anticipated outcome.

In contrast, the US GAAP is rule-based, in which standards are rigid and narrowly defined. The stark difference between the two -- a Principle-Based Accounting System and a Rule-Based Accounting System, is in the value of the information it provides investors (Shamrock, 2012). The freedom allowed under a principle-based accounting system raises concerns that accountants can determine accounting policy based on what is most beneficial to the entity's financial standing.

To counter concerns that following IASB's Principle-Based Account System may intentionally mislead investors and other stakeholders, IFRS emphasizes that accountants must use the accounting interpretation that provides the most relevant information. This is shown in IFRS through the use of the Fair Value Method (FVM), over Historical Cost Method provided on the rules-based accounting system, to determine the value of an asset reported on the balance sheet. The Fair Value Method sets forth the criteria in which companies are to report their assets as what they are currently worth in the market. In other words, the value the company would receive if they were to sell an asset in the open market (Nickole 2015). IFRS favors this method because it provides investors with relevant information in determining the current financial position of a company. The US must tolerate use of professional judgement in order to adopt IFRS.

## II. RELEVANT STANDARDS

### *A. Revenue Recognition*

Revenue, a company's total income, is arguably one of the most important key performance indicator investors used to evaluate companies. It represents the most substantial number on the Income Statement and has the most dramatic effect on profitability for corporations (Ciesielski, 2017). The more extensive a company's revenue, the larger the potential is for profit. In May of



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2014, FASB and IASB jointly published the converged standard as ASU 2014-09 and IFRS 15 respectively. The new rule will be required for public companies in the US for periods beginning on or after January 1, 2018. Since revenue is a core discipline of accounting, companies have a transition period to adopt the new standard (FASB & IFRS Foundation, 2014).

The new revenue recognition standard is considered one of the most critical recent pronouncements. It guides companies which have contracts with customers. The purpose of this new rule is to ensure entities recognize revenue according to what they are entitled to under their contract with customers. In essence, it eliminates different accounting treatments for similar transactions across various industries. Under the new standard, companies must recognize revenue based on the transfer of promised good or services. As simple as it sounds, there is a 5-step process that an entity must complete recording revenue. First, the company must identify existing contracts with its customers. The agreement must have measurable terms and conditions to gauge whether the good or service has been fulfilled. Second, the organization must identify performance obligations in the contract. This step allows companies to understand what they must do to recognize revenue. The performance obligation must be both capable of being distinct and identifiable within the contract. The third step under the revenue recognition standard is to identify the transaction price. In other words, how much the organization should expect to receive in exchange for their goods or service. When determining transaction prices companies should consider various pricing methods based on their industry. Fourth, the company must allocate the transaction price to the performance obligations identified in the previous steps. The fifth and final stage to recording revenue requires the company to recognize revenue when the performance obligation is satisfied. Once the company fulfills its performance obligation as outlined in the contract, they can record the revenue regardless of when the customer pays (FASB, 2014).



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The new revenue standard has the largest impact on company management. For some companies, this new standard will uproot long-standing business procedures pertaining to revenue recognition. In some cases, it may alter the way a company bills its clients. Depending on the significance of the change, managers may need to redesign business procedures, which results in decreased efficiency. Employees will take time to learn how to record revenue under the new procedure. Additionally, management may incur costs associated with implementing a new procedure, for example, removing an old enterprise resource system and replacing it with one that can accommodate the new procedure. Company management must also take time away from normal operating hours to educate the staff accountants on the new policy and revenue cycle procedure (PwC 2017). The FASB has created the Revenue Recognition Task Force to assist companies with implementing the new standard. The main purpose of this group is to address specific questions and concerns that arise as companies adopt ASU 2014-09 (FASB, 2014). Overall, this new standard causes a variety of problems for company management with little positive impact. The revenue section of table 1 provides a summarized cost/benefit analysis of convergence in revenue recognition.

*<<< **Insert Table 1** >>>*

Investors and creditors will also be impacted by the new revenue standard. It allows them to fully compare revenues between companies filing under US GAAP and IFRS without worry of a significant difference in revenue procedure. Granted, this policy only affects companies that use contracts, but it is a significant step towards complete convergence. Investors are the key benefactors of the new revenue standard because it eliminates an important difference in accounting policy that investors use to evaluate companies (EY 2016).



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***B. Inventory***

The treatment of inventory has stood as a distinct roadblock separating US GAAP and IFRS and has discouraged convergence for many US companies. However, there are a few basic similarities between the two accounting standards. Under both standards, inventory is defined as assets held-for-sale and used in ordinary business operations. They are expected to be sold within one year or the next business cycle, whichever is longer. Costs associated with inventory items include all direct and overhead expenditures incurred preparing the inventory for sale (EY, 2016). Additional, selling, storage, and other administrative costs are not included in inventory costs under both US GAAP and IFRS. It is important to have a well-defined classification for significant line-items such as inventory because it ensures companies are not including things that should not be considered inventory. Additionally, both models use cost-flow assumptions as a means for inventory valuation. Companies frequently purchase inventory throughout the year and often at different prices. Cost-flow-assumptions are essentially a method of estimating inventory costs to accurately reflect what was actually purchased. In theory, the company would record each unit of inventory for the cost they paid. However, this measure proves expensive and impossible to achieve when companies purchase large quantities of highly differentiated products. The inventory section of table 2 compares the similarities and differences of inventory costing method guidance under US GAAP and IFRS.

<<< ***Insert Table 2*** >>>

US GAAP permits organizations to value their inventory using Last-In-First-Out (LIFO), First-In-First-Out (FIFO), or weighted-average method. IFRS, on the other hand, prohibits the use of LIFO under the cost flow assumption. The LIFO method assumes that the inventory sold during the period is valued at the units that were most recently purchased. Application of the cost flow



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assumption shows that under LIFO a company is assuming its inventory with the highest cost was sold during the current period. It essentially overestimates a company's cost of goods sold and lowers pre-tax income, resulting in a lower tax expense. Furthermore, it is common practice for companies to use LIFO for financial reporting purposes and FIFO for internal reporting purposes. Managers purchase inventory based on FIFO valuation because it is more relevant to their decision making. Likewise, LIFO is more beneficial for financial reporting because the corporation saves millions on taxes it would otherwise have to pay. As a result, US companies refuse to switch to IFRS since they would be forced to forgo a sizeable tax break. Use of LIFO has sparked debates among politicians as being a "tax loophole" that if disallowed would help significantly reduce the budget deficit. The figure below illustrates the comparison of EBIT under US GAAP and IFRS for companies with operations in both US and abroad.

***<<< Insert Figure 2 >>>***

Recently, more and more companies have decided to abandon LIFO in favor of FIFO or weighted average method for financial reporting. The AICPA surveyed 449 large public companies and found that only 163 plan to use LIFO. This represents a 10% decrease in the use from the previous year (AICPA, 2011). There are a few reasons causing companies to discontinue the use of LIFO. First, companies want continuity among their inventory valuation methods across all segments of the organizations. Many multi-national entities have operations in multiple jurisdictions that require different reporting standards. Since some jurisdictions require IFRS, they have decided to cease use of LIFO altogether. This decision saves the company time and costs of reconciling inventor to a different method. Additionally, FIFO represents a more accurate value of inventory than the other valuation methods because it reflects the current cost of inventory on the balance sheet. It provides investors a more useful inventory value to understand and compare when



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evaluating the income statement. The main benefits of LIFO are drawn from volatile inventory prices. If inventory prices increase sharply that allows the company to report a higher inventory cost to deduct from their income statement. Recently, inflation has been relatively steady and low. Low inflation of inventory prices essentially negates benefits of using LIFO, because the difference in inventory cost under FIFO or weighted average would be negligible (Hughen 2011).

Convergence of US GAAP and IFRS under inventory valuation would inevitably disallow the use of LIFO inventory valuation method. This change has a significant impact on many US companies, which make it a difficult transition to accomplish. The companies it would have the greatest detriment are US companies only operating on domestic soil; specifically, those companies with large inventory turnover and highly volatile inventory costs. Not only will those companies be required to forfeit thousands, if not millions of dollars in taxes, but they will also incur costs associated with adopting a new business process, training employees, etc. MNEs will see minimal negative impacts from convergence because they have already adopted business processes and prepare financial statements according to FIFO. The US government will receive a large increase in corporate tax income from companies no longer able to deduct over estimated inventory costs. Currently, FASB and IASB have no intention of pursuing convergence for this topic (EY 2016).

***C. Leases***

A lease is a contract by which one party makes available land, property, or equipment to another party for a specified time, usually in return for a periodic payment. Leases are utilized by many companies and provide many benefits to both lessees and lessors. For a lessee (the party that uses the land, property, or equipment), they provide a way to obtain use of the property, without depleting the company's cash. Leases are often signed without money down, which is desirable for



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startups and developing companies. Additionally, leases mitigate the risk of equipment malfunctions because in many cases residual value passes to the lessor. Leasing agreements also contain less restrictive provisions than other debt obligations, allowing a company more flexibility than purchasing an asset. From the lessor's perspective, leases provide profitable interest margins and stimulated sales. Additionally, leased assets have high residual value when returned to the lessor. Leases are highly advantageous to companies and used across a variety of industries (KPMG, 2015).

Both US GAAP (ASC 842) and IFRS (IAS 16) provide guidance for lessees and lessors and generally categorize leases as either a capital lease (also known as financing lease) or operating lease. Similar to most other parts of US GAAP and IFRS, the framework for ASC 842 and IAS 16 are generally the same; however, differences arise with ASC 842 providing industry-specific details, while IAS 16 does not.

Capital leases are leases where ownership of the leased asset is transferred from the lessor to the lessee over the term of the lease, meaning over time the ownership of the property becomes the lessees. These are reported as an asset or liability on the balance sheet. Currently, both standards recognize a capital lease after satisfying one of the four following criteria: (1) transfer of asset ownership at the end of the lease term, (2) a bargain purchase option, (3) use for a "major part" of the asset's economic life, or (4) present value of minimum lease payments greater than "substantially all" the assets fair value. ASC guidance goes into further detail to describe exactly how much economic life (75%) or asset fair value (90%) is required to meet the criteria, but for the most part, both models follow the same general framework.

The new updated structure has a similar method to determine whether a lease is operating or financing. The first criteria, transfer of asset ownership and, end of the lease term, continue



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unchanged. The second criteria, regarding bargain purchase option, is modified to situations in which the lease grants an option to purchase the asset and is reasonably expected to exercise, instead of a bargain purchase option. The fourth criteria is modified to specify that if the present value of sum of (1) the lease payments and (2) any lease residual value guarantee not reflected in the lease payments equal or exceed substantially all the assets fair value, then it must be classified as a capital lease. Additionally, a fifth criteria states that the asset is specialized and not expected to have an alternative use (FASB and IFRS Foundation, 2016). The leases section of table 3 compares the definition of a lease and capital lease requirements under US GAAP and IFRS before convergence to the new standard.

***<<< Insert Table 3 >>>***

Operating leases, on the other hand, occur when the lessee obtains the right to use an asset but does not take actual ownership. These are reported as revenue (for the leaser) or expenses (for the lessee) on the income statement. Operating leases are a common area where companies attempt to utilize off-balance sheet financing, which is an appropriate way to exclude certain liabilities from their balance sheet. For example, companies will exclude the remaining lease liability, and instead, expense lease payments as incurred to minimize the amount of liabilities reported on the balance sheet. Previous leasing guidance has drawn criticism for not disclosing all liabilities associated with the leasing agreement. Companies would enter into an operating lease and investors had no way of knowing all future liabilities associated with that lease because it is expensed on the income statement. Consequently, a difference in standards with regards to lease type classification could have a significant impact on an organization's bottom line (EY, 2016).

Under new guidance released by FASB and IASB, leases recorded by lessees and lessors must reflect their economic subsistence and their according definitions of assets and liabilities.



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The subject of leases has seen favorable progress as the FASB recently released ASU 2016-02--Leases (Topic 842). Under this new pronouncement companies are required to disclose assets and liabilities related to leases on the balance sheet. This eliminates the option of off-balance sheet reporting, which many companies currently utilize. This guidance is promising because it sets precedence for accounting pronouncements where FASB and IASB can improve quality of their standards while making steps towards convergence (Journal of Accountancy, 2016).

Although the new classification tests follow the same general process as before, it requires a significant amount of more judgment. The FASBs previous criteria was clearly defined, using quantitative measurements that management could easily understand. Under the new classification tests, it is discretionary in how a “major part" of an asset’s useful life or "substantially all" of an asset's value is determined. It is argued that this could lead to a misclassification of lease type. At the end of the day, the new leasing guidance will mainly affect companies that engage in off-balance sheet financing. The new guidance aims to improve the transparency and comparability of leasing disclosures on the balance sheet.

## III. CONCLUSION

### *A. Feasibility of IFRS Convergence*

Convergence of US GAAP and IFRS has made a significant amount of progress regarding improving comparability, most especially over the past decade, after all, two-standards of the standards are far more alike than they are different (EY, 2016). They share the same fundamental principles, while only exhibiting differences in the details. Of the twenty most economically significant countries in the world, (otherwise known as the G-20), eleven countries have mandated the use of IFRS for all businesses, while there are only three counties in the G-20 that disallow the use of IFRS. Globally, of the 175 jurisdictions that record economic activity, 96 mandate the use



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of IFRS for all companies (Deloitte, 2017). There is undoubtedly a strong movement for countries to adopt or converge to IFRS. But the question remains, is it feasible for the United States, the largest, most influential economy in the world, to adopt or converge to IFRS?

***<<< Insert Figure 3 >>>***

IFRS's principle-based accounting system is considered to be its biggest strength, but it can also be viewed as its biggest weakness. As mentioned earlier US GAAP is a rule-based accounting system, providing highly specific guidance for almost every economic transaction. Whereas IFRS is a principle-based accounting standard, which allows flexibility when applying accounting concepts. Companies of various industries and sizes can apply IFRS principles without issue. Instead of having specified rules like US GAAP, it allows management to make judgment decisions to determine the most relevant accounting treatment. The underlying issue between the two Accounting Standards is that two managers, in the same industry, could account for similar transactions differently, based on differences in judgment, and both would be correct (Burgstahler and Dichev, 1997). This leads to obvious differences in the financial statements making IFRS difficult to compare to IFRS. This is a huge red flag for the US because it means IFRS will not meet the needs of US investors.

The flexibility of IFRS leads to manipulations of earnings and less useful information for investors. Because Management who is responsible for preparing the financial statements are often compensated based on company performance, there is an incentive for managers to make the company look attractive to investors using the financial statements. As the US has learned in the past, from cases like Enron and WorldCom that allowing managers flexibility will lead to economic fraud disasters. Limiting opportunity for fraud is a far greater concern for the US



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economy than improved comparability. Thus, there is no underlying reason the US should converge to IFRS. (Jeanjean and Stolowy, 2008)

FASB has shown reluctance to complete the convergence project. They have continually delayed the target completion date. The last target completion date named by the FASB was over eight years ago. It seems that with every accounting fraud or financial downturn, the convergence project is put on hold to deal with the more pressing issues at hand. This could indicate a need for more rules and regulation, instead of less like IFRS. While the SEC has continued to express their support of convergence, they have dedicated little time progressing this initiative. In 2002, the target completion date was delayed to focus on implementation of the Sarbanes Oxley Act. Similarly, in 2008 the SEC and FASB further deferred convergence to ensure successful implementation of the Dodd-Frank Act. The SEC and FASB have made it clear that they are more concerned about protecting investors than continuing serious progress on IFRS convergence. In 2008, former SEC Chairman Christopher Cox asserted that IFRS convergence was a thing of the past, after previously having expressed support of the project by releasing the roadmap for transitioning to IFRS with a completion date by 2014. Cox (2014) declared that little meaningful progress has been over the past several years which leads one to conclude the incapability of the project's completion. However, it is noteworthy that since 2014 the US has allowed foreign reporters in the US to file under IFRS rules. US investors and public companies have shown little interest to expanding for complete adoption.

For most companies, the decision to support IFRS convergence comes down to a simple cost-benefit analysis. Corporations incur the bulk of costs associated with the convergence process. They are responsible for picking up costs of training their employees on the new accounting standards. This would be difficult to afford for small and medium-sized companies will limited



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resources (AICPA, 2011). Also, companies may need redesign business processes to accommodate IFRS. For a large organization, this could disrupt well-established business procedures costing significant amounts of money. Although it is difficult to quantify the exact costs of transitioning to IFRS, managers across many disciplines have reached the same conclusion; the perceived costs of converging to IFRS are more than the perceived future benefits.

Since the US is the largest economy with the most complex capital structure, their transition to IFRS would look a lot different than previous countries. The IASB is not giving enough consideration to economic factors in the US as well as the needs of US investors. They must accommodate the unique needs of the US more than they would an average stakeholder. Issues of reliability and fraud prevention are most concerning to the public who is hesitant about the transition to IFRS. The IASB's unwillingness to address concerns of the US investors undermines the primary purpose of the FASB, SEC, and other accounting-standard entities (FASB 2013).

Above all, an accounting standard must meet the needs of its users. It not only must be reliable but also have the ability to adapt to meet the ever-changing needs of the public. If users both internally and externally cannot rely on the information provided by the financial statements all else is useless. Managers will have difficulty assessing monthly budgeting costs and forecasting future revenues accurately. Investors will lose confidence in the markets and companies will struggle to raise capital. Ultimately, the best accounting standard is the accounting standard that fits the needs of its users. For the US, that standard is and will continue to be US GAAP.



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## TABLES

***Table 1: Costs & Benefits of Convergence***

| Costs | Benefits |
| --- | --- |
| **Revenue Recognition** | |
| • Lack of industry specific guidance for complex industries Ex: software vs construction (US GAAP)<br>• US companies incur costs training employees on new principles (US GAAP)<br>• Fewer specific rules could allow more opportunity for fraud à investor risk (US GAAP)<br>• Revenue Recognition Transition Resource Group | • Removes inconsistencies/weaknesses in revenue requirements (US GAAP)<br>• More robust framework for addressing revenue issues (IFRS)<br>• Improved comparability of revenue across entities, industries, jurisdictions, and capital markets (US GAAP & IFRS)<br>• More relevant info for user of F/S (US GAAP)<br>• Simplify preparation of financial statements(FASB 2014) |
| **Inventory** (*Costing Methods)* | |
| • Many US companies would need to change their inventory reporting method for tax purposes and forfeit a tax break a large income tax liability<br>• Could uproot businesses ERP system and cost millions | • Companies switching from LIFO to FIFO would report higher profits<br>• Increase government revenue from companies paying more taxes<br>• Improved comparability |



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| Leases | |
|---|---|
| • Less specific criteria for classifying leases<br>• Could significantly affect the amount of assets and liabilities a company reports on their balance sheet | • Investors can better understand a company's leasing obligations<br>• Improved harmonization for companies leasing assets internationally |



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***Table 2: Similarities & Differences***

| Similarities | Differences |
|---|---|
| **Revenue Recognition** *(before convergence)* | |
| • Principle was the same; revenue is recognized when it is earned | • US GAAP was overly complex and would treat similar economic transactions differently based on industry<br>• IFRS lacked industry specific guidance for complex transactions |
| **Inventory** *(current)* | |
| • Define inventory as assets held for sale in the ordinary course of business, in the process of production for such sale or to be consumed in the production of goods or services<br>• Cost basis of accounting for inventory; cost of inventory includes all direct and over expenditures preparing inventory for sale.<br>• Most SGA costs excluded (EY, 2016) | • LIFO is acceptable under US GAAP and consistent cost formula for all similar inventories is not explicitly required<br>• LIFO is prohibited under IFRS and all similar inventories must have use the same cost formula (EY, 2016) |
| **Leases** *(before convergence)* | |
| • Focus on classifying leases as either capital or operating<br>• Separate accounting for lessee and lessor | • IFRS applies leasing guidance to other assets beyond PPE<br>• US GAAP has more detailed requirements than IFRS specifying transfer of ownership |



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| | |
|---|---|
| • Similar terminology<br>• Classification depends on transfer of substantially all risks/rewards incidental to ownership<br>• Similar qualitative and quantitative disclosure requirements | • No classification tests for leases under IFRS, thus all leases use financing lease method.<br>• No specific guidance regarding collectability of lease payments |



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***Table 3:US GAAP and IFRS Principles***

| US GAAP | IFRS |
|---|---|
| **Revenue Recognition** *(Revenue from Contracts with Customers)* | |
| *ASU 2014-09 Topic 606:* "an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services." (FASB 2014) | *IFRS 15:* "The core principle in that framework is that a company should recognize revenue to depict the transfer of promised goods or services to the customer in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services." (IFRS 2014) |
| **Inventory Costing Methods** | |
| *U.S. GAAP, ASC 330-10-30-9:* "Cost for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors, such as first-in first-out (FIFO), average, and last-in first-out (LIFO)." | *IAS 2:* requires the use of specific identification for inventory segregated for special projects. All other inventory must be accounted for using FIFO or weighted-avg. method. LIFO is explicitly prohibited under IFRS. |
| **Leases:**<br>*a) Definition of a lease*<br>*b) Criteria for Capital (Financing) vs Operating* | |
| *ASU 2016-02 Topic 842:*<br>a) Lease is a contract that conveys the right to control identified PPE for a period of time in exchange for consideration; control meaning customer has both right to (1) | *IASB 16 Leases:*<br>a) Finance leases transfer substantially all risks and rewards incident to ownership. All other leases are classified as operating leases |



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| | |
|---|---|
| substantially all economic benefits (2) direct use of the asset<br>b) Must meet one of the following conditions:<br>1. Transfer of ownership to the lessee<br>2. Bargain Purchase option<br>3. Lease term is 75% of the remaining economic life<br>4. (1) Present value of minimum lease payments are > or = 90% of asset cost (FASB 2016) | b) Lease contract must meet one of the following criteria:<br>1. Transfer of ownership to the lessee<br>2. Purchase option<br>3. Lease term is a major part of the remaining economic life<br>4. (1) Present value of lease payments and (2) residual value equal to or greater than all the underlying asset's value<br>5. Asset has no alternative use (IFRS Foundation 2016) |



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**FIGURES**

***Figure 1:***

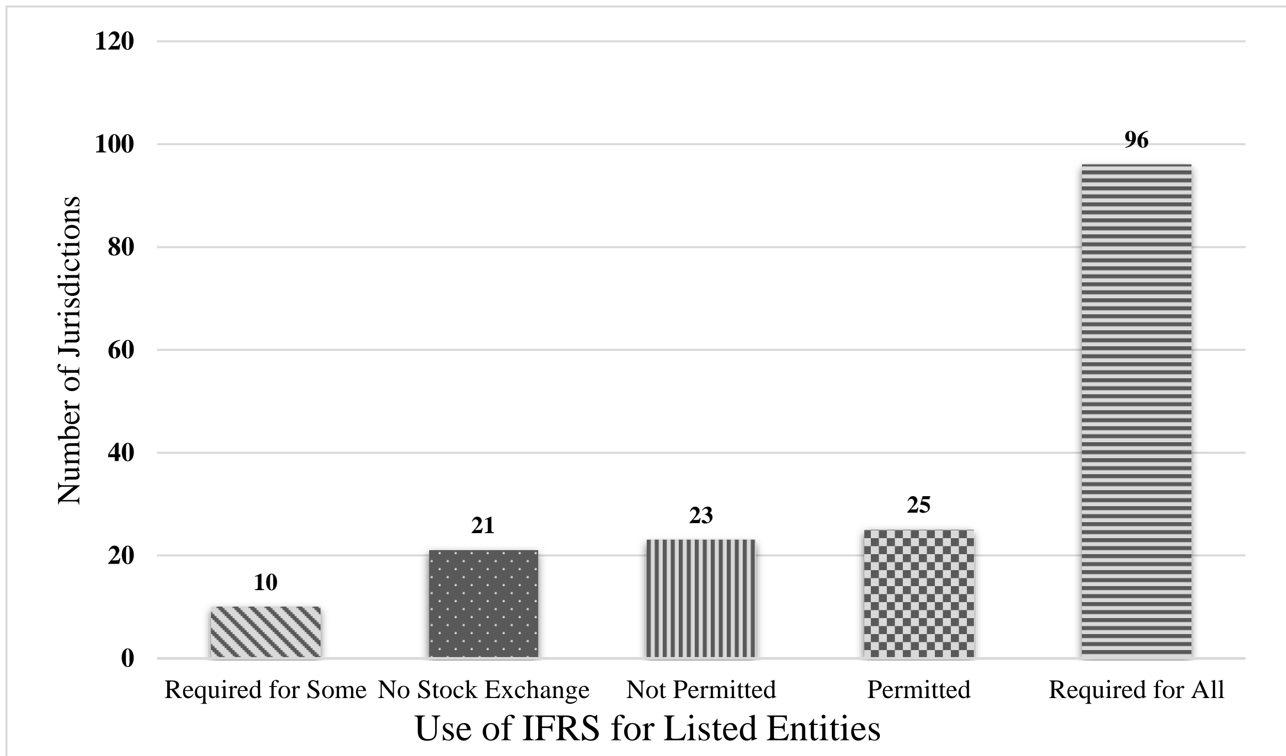


***Figure 2:***

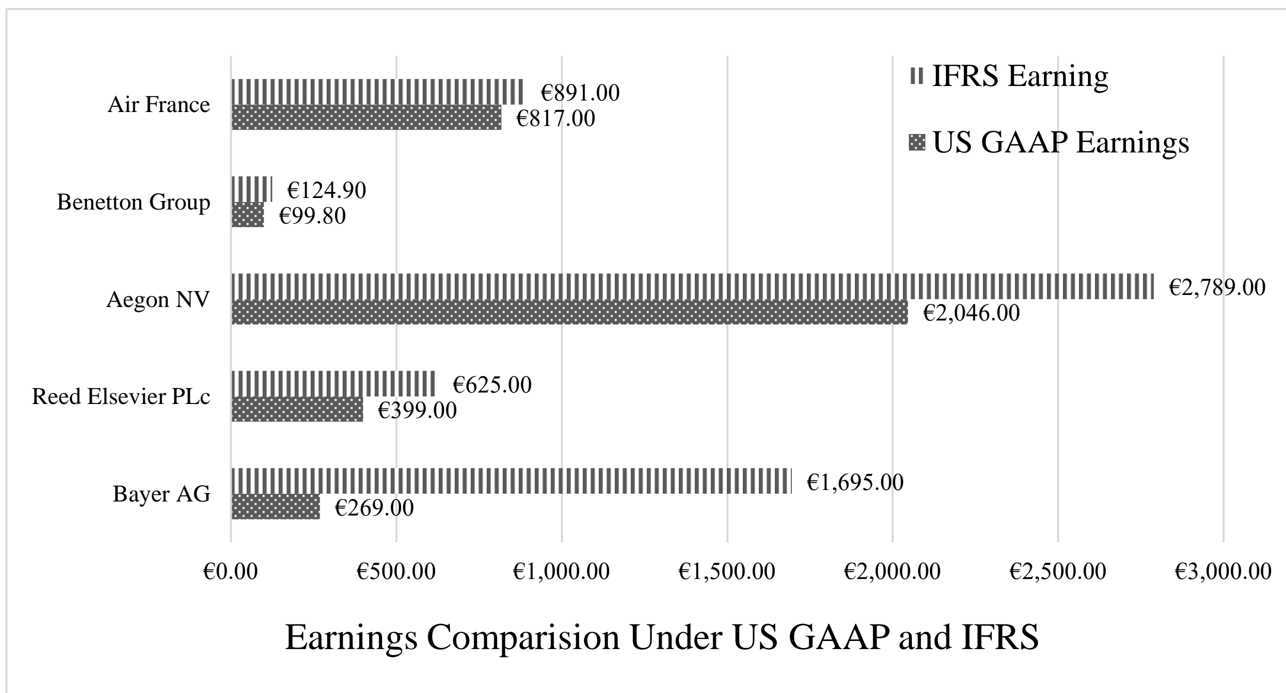




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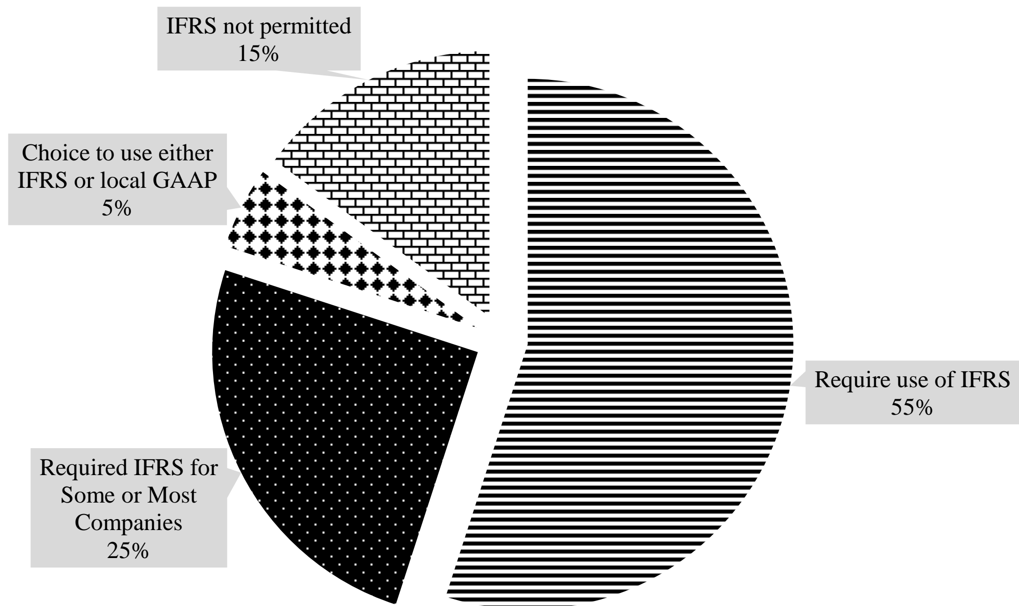
***Figure 3:***




Application of IFRS in the G-20



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