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EXECUTIVE DIGEST

One world — One accounting

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1. Tower of Babel accounting

The biblical story of the Tower of Babel explains the source of the many languages spoken throughout the world. According to the account, humankind shared one common language prior to the Tower of Babel, facilitating communication and cooperation. To stop the building of the tower, God splintered this single language into multiple languages such that workers could not communicate with each other. As intended, labor on the tower subsequently ceased.

This "confusion of language" traditionally has described the state of international financial reporting. Companies historically have been required to produce financial statements based on country-specific financial reporting standards. As a result, individuals who invest in companies from different countries must contend with financial statements based on different financial "languages." In fact, investors analyzing financial statements from different countries face a worse situation than did workers at the Tower of Babel in that financial statements often *appear* to be the same across countries when they really are not. Financial statements are all denominated in monetary terms and tend to have similar categories across countries. However, the rules used to arrive at the categories and numbers often differ by country. Thus, users of financial statements may believe that the statements reflect the same financial language, but the "words" often have different meanings depending on the country from which the statements originate.

The increased international movement of capital has spurred interest in a worldwide common financial reporting system. It has become common for institutions and individuals to invest outside of their home country, as evidenced by the fact that approximately two-thirds of U.S. investors own securities of foreign companies (Scannell & Slater, 2008). Similarly, many firms now list on one or more foreign exchanges in addition to the stock exchange in their home country. In recognition of the international movement of capital, many countries are adopting or have adopted a version of the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). The IASB is an independent standard-setting board headquartered in London, England and operates as a not-for-profit, private body. Currently, over 100 countries require or allow the use of IFRS (Securities and Exchange Commission, 2007).

Recent actions by the Securities and Exchange Commission (SEC) indicate that U.S. financial reporting is likely to move to IFRS in the near future. The SEC currently requires U.S. companies to report under Generally Accepted Accounting Principles (GAAP) as determined by the U.S.-based Financial Accounting Standards Board (FASB). Until recently, the SEC required foreign companies with securities traded on U.S. exchanges to present a reconciliation between income as reported on the company's domestic financial statements and income as calculated under GAAP. The SEC rescinded this requirement in 2007 for companies using IFRS to prepare their

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financial statements (Securities and Exchange Commission, 2007). In November 2008, the SEC presented a roadmap for the transition of U.S. financial reporting to IFRS. This roadmap indicates that the SEC will allow some U.S. companies to use IFRS for financial reports as soon as 2010, and will require all U.S. companies to use IFRS by 2014 (Scannell & Slater, 2008). However, the new SEC chair, Mary Schapiro, has indicated that she does not feel bound by the existing roadmap, and has announced that the SEC plans to make a final decision in 2011 about U.S. companies moving to IFRS (Millman, 2009).

The actions taken by the SEC suggest that companies, auditors, and investors in the U.S. could soon face implications of the move from GAAP to IFRS. All three groups will incur costs associated with the transition, and presumably at least some of the groups will eventually benefit from the move from GAAP to IFRS. In this article, we discuss the benefits and costs of the move to IFRS for these groups. We first focus on potential benefits of moving to IFRS by illustrating the costs associated with having multiple financial reporting regimes. We then discuss the differences between GAAP and IFRS and the implications of these differences for companies, auditors, and investors. Finally, we highlight several issues associated with the transition from GAAP to IFRS.

2. Does the financial reporting regime matter?

Will U.S. investors benefit from having a common worldwide set of financial reporting standards? One way to address this question is to look at an example of how investors may be hurt currently by the presence of multiple financial reporting regimes. Consider the case of an investor who has identified two healthcare companies as potentially attractive investments based on information other than financial statements: GlaxoSmithKline PLC and Smith & Nephew PLC. GlaxoSmithKline (GSK) is a pharmaceutical company located in England, with a product portfolio including drugs for asthma, diabetes, heart disease, and epilepsy. Smith & Nephew (S&N) also has its headquarters in England and produces medical devices for orthopedic reconstruction, orthopedic trauma, and clinical therapies. Although both companies reside in the same country and are governed by the same financial reporting standards, we examine these companies because they provided reconciliations between financial reporting under IFRS and GAAP up through 2006.

Our hypothetical investor might choose to compare the performance of these two companies based on their return on equity (ROE), a measure of a company's ability to produce a return on funds contributed by investors. Stockholders often compare a company's return on equity against the returns of other potential investments to determine whether their investment in a company is performing satisfactorily (Pratt, 2006). Table 1 presents the net income, stockholders' equity, and return on equity for 2006 for the two companies, as prepared under both GAAP and IFRS.

2.1. Example 1: Comparing companies on different standards

What happens if the investor compares the financial results of these two companies based on different reporting standards? If GSK's financial statements are prepared under GAAP and S&N's financial statements are prepared under IFRS, GSK will show a 2006 ROE of 12.9% as compared to a more attractive ROE of 34.3% for S&N. If the situation is reversed, however, and an investor compares IFRS-based financial statements for GSK to GAAP-based financial statements for S&N, GSK's ROE of 58.6% will appear much more attractive than the 31.8% ROE for S&N. This example suggests that one financial reporting standard (in this case, GAAP) may be more conservative than the other (IFRS) in terms of the net income reported for the two companies.

While simple, this example provides a real-world illustration of the potential problems investors face

Table 1. GAAP vs. IFRS

	2006					
	Net Income		Stockholder's Equity		Return On Equity	
	IFRS	GAAP	IFRS	GAAP	IFRS	GAAP
GlaxoSmithKline PLC*	5,498	4,465	9,386	34,653	58.6%	12.9%
Smith & Nephew PLC^	745	709	2,174	2,227	34.3%	31.8%

* *Net Income and Stockholder's Equity amounts for GlaxoSmithKline PLC in millions of Euros.*
^ *Net Income and Stockholder's Equity amounts for Smith & Nephew PLC in millions of U.S. dollars.*
Sources: GlaxoSmithKline PLC (2007), Smith & Nephew PLC (2007)

when comparing a U.S. company reporting under GAAP to a foreign company reporting under IFRS. If investors fail to understand that the companies' financial statements are not based on common standards, they can be fooled into thinking that one company is performing better than another simply due to less-conservative financial reporting standards. Although both companies report earnings, these numbers may reflect different constructs. Just as a person ordering a biscuit in a restaurant in the U.S. would receive a product that is very different from a biscuit ordered in a restaurant in the UK, so could an investor viewing earnings for a U.S. company get something quite different from earnings for a UK company.

2.2. Example 2: Comparing companies on the same standards

The logical solution to the Tower of Babel accounting problem is to require that all companies use the same financial reporting standards. But, will changing to one set of financial reporting standards solve the problem? Looking at Table 1, if we compare financial statements prepared using IFRS, GSK shows a 2006 return-on-equity of 58.6% while S&N reports a 2006 return-on-equity of 34.3%. Based on the simple ROE investment criterion, an investor would choose to invest in GSK over S&N. Alternatively, if we compare the performance of these two companies based on financial statements prepared under GAAP, GSK reports an ROE of 12.9% while S&N reports an ROE of 31.8%. Under this scenario, S&N is the more attractive investment.

From this example, it becomes clear that different sets of standards can lead to different decisions. Under IFRS, GSK appears to be the more attractive investment; under GAAP, though, S&N seems the more appealing of the two. Thus, financial reporting standards are the lens through which investors evaluate a company, and the type of lens used can make a big difference in investors' perception of reality. As the world moves to a single international set of standards, investors will no longer be fooled by the use of different lenses for U.S. versus foreign companies. Going forward, two things are clear: (1) the choice of lens still matters, and (2) it is important to understand how the view of the financial landscape will change with the switch from a GAAP lens to an IFRS lens.

3. The gap between GAAP and IFRS

In order to navigate the transition to IFRS, it is important that investors understand how IFRS differs from GAAP. Although the FASB and the IASB have been collaborating on recent financial reporting standards, differences still remain between GAAP and IFRS. Next, we describe some of the qualitative differences between GAAP and IFRS, the magnitude of these differences in terms of the impact on earnings (quantitative differences), and evidence examining whether one set of standards is superior to the other. (For an in-depth discussion regarding the latter two points, see American Accounting Association Financial Reporting Policy Committee, 2008).

3.1. Qualitative differences between GAAP and IFRS

One important difference between GAAP and IFRS relates to the level of detail and specificity in the standards. This difference manifests in a number of ways, including more standards, more implementation guidance, and more bright-line rules under GAAP than under IFRS. We discuss each of these differences in turn.

GAAP contains more individual standards than does IFRS. The FASB and SEC tend to issue more special-industry standards and allow more exceptions for specific transactions than does the IASB. For example, regarding revenue recognition, GAAP contains "extensive detailed guidance for specific types of transactions that may lead to differences in practice," while IFRS uses one underlying principle for revenue recognition and does not contain as many additional standards with detailed guidance (PricewaterhouseCoopers, 2007, p. 6). Overall, IFRS standards encompass about 2,500 pages, while new codification of GAAP standards will take up about 17,000 pages (Cohn, 2009). This difference suggests that managers and auditors will face less complexity in assessing which standard applies to a particular transaction under IFRS than under GAAP. However, managers and auditors will need to use more judgment to determine how to apply the general principles in IFRS to a particular transaction.

IFRS also provides less guidance about how to implement standards with respect to specific transactions than does GAAP. The FASB provides several sources of implementation guidance, including FASB standards, FASB Interpretations, Staff Positions, and Emerging Issues Task Force Abstracts. The FASB website also welcomes technical inquiries about standards (http://www.fasb.org/inquiry/index.shtml). While the IASB does provide interpretations of standards, it generally provides less detailed implementation guidance and is less open to inquiries about how to implement IFRS (http://www.iasb.org/Home.htm). Again, this suggests that IFRS will require more judgment and allow

more discretion on the part of managers and auditors in terms of applying standards to particular transactions.

The last difference associated with the level of detail relates to bright-line rules. Some financial reporting standards under GAAP contain bright-line rules with specific cutoff points to determine the appropriate accounting treatment. For example, under GAAP, leases are capitalized as an asset with a corresponding liability if the lease term exceeds 75% of the leased asset's expected life (Financial Accounting Standards Board, 1976, para. 7). In contrast, the IFRS standard for lease accounting does not mention a specific cutoff point for lease capitalization; instead, it indicates factors which typically suggest that the lease should be capitalized. One of these factors is that the lease term is for the major part of the asset's economic life; however, the standard does not precisely define the term "major part" (International Accounting Standards Board, 2003, para. 10). As illustrated by the lease example, instead of providing detailed rules for determining an appropriate accounting treatment, IFRS generally outlines qualitative principles that managers should consider when choosing accounting treatments.

Another difference between IFRS and GAAP is that IFRS has a greater emphasis on fair value accounting than does GAAP. Fair value accounting uses estimates of the current market value of an item, rather than the item's original cost. Fair values are reliable measures of current value in the presence of an active market for the item. However, if the market is not active, the use of fair value accounting requires managers to make assumptions to arrive at a fair value estimate. If managers have incentives to bias financial reports, the use of fair values can lead to biased values for assets and liabilities.

Finally, the IASB disallows certain methods of accounting deemed acceptable under GAAP. For example, under GAAP, companies can choose among multiple methods for determining the cost of items associated with a particular sale. Most companies do not identify which specific unit of a product is sold in a particular sale, but rather use inventory cost flow assumptions such as "first-in, first-out" (FIFO), "last-in, first-out" (LIFO), and weighted average cost. All three cost flow assumptions are acceptable under GAAP; however, IFRS prohibits use of the LIFO method.

3.2. Quantitative differences between GAAP and IFRS

While GAAP and IFRS do have qualitative differences, it is unclear whether these differences lead to important variations in the magnitude of numbers reported on financial statements. Accounting research investigates this question by examining the differences in firms' net income between GAAP and IFRS for foreign firms that trade on U.S. stock exchanges. Haverty (2006) uses a small sample of 11 Chinese companies that are listed on the New York Stock Exchange and which issued reconciliations between GAAP and IFRS financial statements. He finds that 10 of the 11 companies in his sample reported IFRS earnings that differed from GAAP earnings by over 5% of their U.S. net income. The dollar magnitude of the differences ranged from $2.5 million to over $19.4 billion, based on exchange rates at the end of 2002. For a majority of these companies, net income under GAAP was higher than net income under IFRS.

Henry, Lin, and Yang (2008) evaluate GAAP and IFRS differences using 83 European Union companies that are cross-listed in the United States. Net income under IFRS was 52% lower than GAAP earnings in 2005, on average, and 26% lower in 2006. As suggested by the pattern of these 2 years, the authors found that differences in income between IFRS and GAAP are diminishing over time, consistent with efforts by the IASB and FASB to converge the two sets of standards.

Additional research shows that the capital markets value the informational differences between IFRS and GAAP contained in the reconciliations. Chen and Sami (2008) find that an abnormally high number of trades occur when firms issue earnings reconciliations between IFRS and GAAP, indicating that investors find the information relevant to their decisions to buy or sell stock. This finding suggests that each set of standards results in earnings that contain unique and relevant information for investors.

In general, research finds that net income differs across the two sets of standards. The direction and magnitude of the differences in net income across financial reporting regimes likely depends on the industry and business activities of specific companies. However, research finds that these differences are often significant and that financial statements prepared under each accounting regime contain unique and value-relevant information for investors.

3.3. Is GAAP better than IFRS, or just different?

Standard setters indicate that the quality of financial reporting standards should be judged based primarily on two factors: (1) the relevance of the financial information in the standard to investor and creditor

decisions, and (2) the reliability of the financial information as measured by the extent to which it faithfully represents firms' economic position and performance (Financial Accounting Standards Board, 2008, pp. 17-26). Thus, addressing the question of whether GAAP or IFRS is of higher quality translates into whether one standard versus the other is superior in terms of relevance and reliability. Unfortunately, one of the primary challenges researchers face is measuring relevance and reliability. Researchers typically must infer relevance and reliability using proxies such as investor preferences (i.e., their willingness to invest in companies that use a particular set of standards for financial reporting), market perceptions of information risk, and the association between earnings and stock returns.

Bradshaw, Bushee, and Miller (2004) evaluate the relationship between a firm's accounting choices and ownership of the firm's stock by institutions such as insurance companies and pension plans. They find that U.S. institutions are more likely to invest in firms with financial statements that are prepared using accounting similar to GAAP. This result is consistent with investors exhibiting a home bias toward companies using U.S. accounting standards. The authors conjecture that institutional investors' preference for GAAP-consistent accounting occurs because the accounting is more familiar, which reduces investors' information processing costs. They also theorize that investors' familiarity with GAAP may lead to perceptions that the information is of higher quality. It is important to note, however, that this study does not directly compare perceived accounting quality under GAAP and IFRS (American Accounting Association Financial Reporting Policy Committee, 2008).

Leuz (2003) evaluates the quality of IFRS versus GAAP using a sample of German firms that are allowed to select U.S. GAAP, IFRS, or German GAAP for their financial reports. He examines information asymmetry, or the extent to which certain investors face an informational advantage relative to other investors. Higher quality financial reporting should reduce information asymmetry and, in turn, increase the liquidity of capital markets. Leuz finds little difference between U.S. GAAP and IFRS in terms of his information asymmetry measures, which include bid-ask spreads, share turnover, and the dispersion of financial analysts' earnings forecasts. His results suggest that market participants do not perceive differences in quality of financial reports prepared under IFRS and GAAP, or at least do not care about any differences that do exist.

Using a similar setting with German companies, Bartov, Goldberg, and Kim (2005) investigate if the stock market reacts differently to earnings depending on whether the financial statements are based on IFRS, U.S. GAAP, or German GAAP. The strength of the relation between earnings and stock returns indicates the extent to which investors perceive accounting earnings to reflect the firm's economic performance and future potential. The authors find that the relation between earnings and market returns is weaker for firms whose financial statements are prepared according to German GAAP than for firms whose statements are prepared according to U.S. GAAP or IFRS. However, the authors do not find any differences in the association between earnings and returns for firms using U.S. GAAP versus firms using IFRS. Similar to the findings in Leuz (2003), these results suggest that investors do not perceive differences in accounting quality between IFRS and GAAP.

Overall, it seems that U.S. investors have some preference for companies using GAAP; this preference may simply be due to investors' greater familiarity with GAAP. Moreover, research appears to suggest that large differences in quality between IFRS and GAAP do not exist, or at least that the capital markets do not care about the differences which do exist. Any perceived differences between GAAP and IFRS are likely to diminish prior to the transition to IFRS, due to the continuing convergence efforts of the FASB and the IASB.

A related issue is that the quality of financial reporting standards depends not only on the standards themselves, but also on the enforcement of the standards, which varies from country to country. Auditors enforce the standards prior to the release of financial statements, and regulators such as the SEC enforce them after the release of the financial statements. The level of enforcement affects how companies implement standards and the quality of their financial reports. In other words, investors may perceive IFRS financial statements issued from countries with extensive investor protection as being of higher quality than IFRS financial statements issued from countries with limited investor protection. Thus, effects such as the previously-discussed "home bias" may still exist if investors view enforcement to be stronger in the U.S. than in other countries using IFRS (Beneish & Yohn, 2008). However, the adoption of a single set of accounting standards should diminish differences in perceived accounting quality resulting solely from the standards employed.

4. Transition issues

Although many market participants agree on the need for international accounting standards, numerous issues remain regarding the transition

from GAAP to IFRS. Standard setters must consider the often considerable implementation costs which are necessary to make the switch. Also, because IFRS relies to a greater extent on manager and auditor judgment, both groups must be able to justify the accounting positions they choose.

4.1. Implementation costs

Users, managers, and auditors of financial statements all likely face significant implementation costs as the transition from GAAP to IFRS progresses. First, these parties must dedicate time and resources toward learning the new standards. Given the differences between the two sets of standards, this education will be no small task. Academics will bear part of the burden as they rewrite textbooks and revise courses to reflect IFRS, but a large portion of learning for managers and auditors will have to occur on the job. Indeed, major international audit firms are already providing continuing education courses on IFRS for their employees and for members of the academic community. Investors also will need to educate themselves about IFRS if they want to avoid informational disadvantages and poor investment decisions, due to an inability to understand financial statements.

Companies switching to IFRS will typically face additional costs beyond education. For example, computer information systems currently are based on GAAP. As part of the conversion firms will need to implement new systems based on IFRS, and accountants will need to devote additional time to learn to use these new programs. Proponents of IFRS, however, argue that large multinational companies will eventually save money by reporting under the same set of standards for all countries in which the company operates. Additionally, audit and systems firms may benefit from the transition as they take on additional engagements to help clients understand IFRS and implement updated financial reporting systems.

Finally, many contracts are currently based on GAAP standards and will need to be adjusted to incorporate IFRS differences. Debt agreements typically include covenants that contain financial benchmarks a firm must meet to avoid negative consequences, such as increased interest rates or immediate repayment. For example, a debt covenant may require a firm to maintain a debt to asset ratio that is no greater than 40%. As companies change to IFRS, they will have to consider renegotiating the benchmarks in their covenants to reflect the expected effects of the change to IFRS. Boards of directors also may have to renegotiate compensation contracts based on financial statement numbers. Executive bonuses typically are based on financial performance measures such as net income. For example, a bonus pool may be set at 10% of net income over $50,000,000. Boards of directors may need to reconsider both the bonus rate and baseline net income level, due to the change to IFRS.

4.2. Increased reliance on auditor and manager judgment

Perhaps one of the greatest challenges managers and auditors face regarding transition to IFRS is an increased need for professional judgment. Under GAAP, managers and auditors received heavy implementation guidance from the FASB as to several accounting issues. IFRS, though, is based on general principles and provides less detailed guidance about how to apply these principles to a specific transaction. Thus, greater professional judgment is needed to determine an appropriate accounting treatment under IFRS. In the past, when the appropriate accounting treatment under IFRS was unclear, managers and auditors often looked to U.S. GAAP for direction. Ironically, the move to IFRS in the U.S. will reduce the ability of managers and auditors in all countries to rely on GAAP for guidance when the appropriate treatment under IFRS is unclear.

Auditors and corporate managers have solicited much of the implementation guidance provided by the FASB; the U.S. legal environment has driven demand for such input. Managers and auditors are concerned that their professional accounting judgment will be second-guessed by attorneys and juries if future firm performance declines. Having implementation guidance provides a "right answer" that reduces the likelihood of this second-guessing. Implementation guidance also provides auditors with greater support for denying accounting treatments preferred by clients to achieve desired financial results. Both managers and auditors will have a reduced ability to rely on specific rules and implementation guidance as justification to support their choice of accounting treatments.

Other issues, beyond implementation costs and an increase in required professional judgment, are sure to surface as the progression toward IFRS continues. This dynamic environment provides opportunities for investors, companies, and audit firms to gain competitive advantages over their peers—but, the costs of achieving such advantages could be significant.

5. The change is coming?

The next few years are sure to result in extensive changes to the accounting environment, both in the

U.S. and across the globe. While the push toward international accounting standards has gained momentum, mixed opinions have been voiced about the transition from GAAP to IFRS. Proponents of this change highlight the potential to improve comparability of financial statements for companies from different countries. This contingent believes use of IFRS will smooth cross-border investing, and will help U.S. companies and capital markets compete worldwide. Opponents of the shift to IFRS decry the implementation costs required to make the change; specifically, they cite expenses related to educating market participants regarding differences in standards, and companies' preparation of employees and computer systems for the transition. Critics also contend that the IASB has not yet found a stable and independent source of funding, and that the SEC will be tempted to write its own guidance and interpretation of international rules, defeating the purpose of a single set of standards (Scannell & Slater, 2008).

While actions taken by the SEC suggest that the U.S. will soon adopt international standards, uncertainty about the conversion has recently arisen. This uncertainty has been roused by two factors: a new chair of the SEC and the current financial crisis. Christopher Cox, former chair of the SEC, pushed the movement to IFRS; however, Mary Schapiro, who now holds the position, has indicated that she does not feel bound by the existing roadmap and believes another assessment should be made regarding the decision (Millman, 2009). For its part, the financial crisis has placed numerous companies in precarious financial positions, and the time may not be right to saddle them with another burden.

The SEC has targeted 2011 as the year it will make a final decision about the movement to IFRS; as such, U.S. investors, managers, and auditors will have to live with uncertainty for a while longer. Even so, it appears likely that IFRS eventually will be the basis for financial reporting in the United States. Investors, managers, and auditors would be wise to start now in preparing for the change.

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