The Effects of International Financial Reporting Standards Convergence within the United States

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Catherine Williams

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Introduction

The desire for commonly accepted accounting standards worldwide was acknowledged long before the formation of the International Accounting Standards Board in 1973; however, the movement toward national acceptances of such standards has only been observed within the past decade with implementation or commitment to implementation by the European Union and other countries such as Australia, Hong Kong, New Zealand, Canada, Japan, Chile and Korea. Not immune to the pressures of worldwide change, the United States Securities and Exchange Commission issued a ‘Roadmap to IFRS’ in 2007 stating their intentions to require IFRS rather than GAAP for public companies within their governance. The roadmap set 2011 as the time in which they would make the official decision for implementation as early as 2014 so long as preparation efforts and the strengthening of international standards have proceeded to their satisfaction at that point in time.

The purpose of this paper is to study the history of the international standards; and the motivation for achieving a common standard set worldwide; the major differences between the international standards and the currently required GAAP standards within the United States; and what accounting firms and companies are doing to prepare for such a transition. Furthermore, I attempt to understand the monetary effects that IFRS will have on financial statements in the transition from GAAP and the implications such a transition could likely have on whether the ultimate goal of common standard sets can be achieved.
Chapter 1

In 1973, after promptings from many nations to utilize common accounting standards in order to ease the exchange in the expanding global capital market, the International Accounting Standards Committee formed. It was to be based in London and include professionals from various countries and set out in hopes of becoming the unique set of international rule makers. Even with such wide spread support from participating nations and a strong desire for common standards, many countries were averse to adopting the created set of international standards as their own on account that they were deemed the “lowest common denominator” set of standards. As some countries such as the United States were working towards a refinement of standards which would promote comparability and reduce the amount of flexibility in reporting while increasing the likelihood of similar transactions being accounted for similarly, these standards as they were at the time seemed a step in the wrong direction.

When discussing the hesitation to converge it is important to recognize, beyond the loose nature of the international standards, the reason behind the specific standards chosen by each nation and why they differed from one country to another in the first place. The hesitation to accept the International Financial Reporting Standards (IFRS) would likely be tied to this reason as well. Many nations had their own set of Generally Accepted Accounting Principles (GAAP) which was tailored to fit their specific objectives. For many reasons, it is evident that objectives are likely to vary among nations. In research regarding the motives behind choosing accounting standards and the issues with adopting common international standards, it was stated that:

‘Accounting reporting and disclosure standards and practices do not develop in a vacuum but reflect the particular environment in which they are developed.’ Accounting principles and practices are generally influenced not only by environmental factors such as history, values and culture, but also by the stage of that society's economic development and
accounting system....Three specific researchers identified five key environmental influences relating to the economic system, the political system, the legal system, the educational system, and religion (Zarb and Pagiaivas).

Considering the range of focus and perspective on each of the aforementioned influences among nations, it is easy to understand how national standards can differ among countries and how there was much resistance to IFRS in their current state. For example, within the United States the legal system has a strong foundation in the business operations and interaction. As expressed at an NYU roundtable meeting regarding global accounting standards, “many roundtable participants worried that the U.S. legal system — also blamed for the complexity of U.S. GAAP — might trip up global accounting standards too. Under the U.S. legal system, they said, auditors feel they must adhere closely to preset rules in order to avoid being sued” (Katz). Given that being sued is a valid threat in American business culture, financial reporters as well as auditors prefer the detailed rules of GAAP to the looser-based principles approach of IFRS.

Despite the obstacles interfering with the worldwide acceptance of a single set of standards, there was still consensus among national standard setters that a common standard set was to be the ultimate goal toward achieving an increased volume and efficiency of global capital flow. The supporting belief was that eliminating multiple sets of reporting standards would decrease risk and encourage the growth of international investing and capital formation. First, homogenization would ease the process by which companies can list on foreign exchanges as well as domestic in order to build capital. Second, it would improve comparability of financial reports among similar companies around the globe and require investors to comprehend only one underlying language of financial reporting, allowing them to make better informed decisions and be more apt to participate in a global capital market. With the technology that exists today, geographical boundaries hardly present a barrier for communication and business and the effort
to standardize financial reporting is hoped to be conducive to the free flow of capital among nations to support continual growth.

There was no successful movement taken until 2001 in creating a structure and set of standards more conducive to varying needs. In 2001, the IASC restructured their organization. They created an oversight board, the IASC Foundation, which was a Delaware-based corporation run by trustees and financed by voluntary contributions. They were deemed responsible for collecting funds each year to finance their standard setting, as well as appoint members to and oversee the new International Accounting Standards Board (IASB), International Financial Reporting Interpretations Committee (IFRIC), and the Standards Advisory Council (SAC). All three committees ultimately report to the IASC; however each plays an integral role in the overall process of setting and interpreting international standards.

The IASB acts as the independent standard setting committee for the IASC, similar to the Financial Accounting Standards Board (FASB) in the United States, and is funded and overseen by the IASC. The SAC is responsible for acting as liaison between professionals and the IASB in suggesting topics for their agenda and discussing existing proposals. The IFRIC is responsible for helping professionals interpret the international standards that are put in place. Working with professionals and observing the confusion and difficulties in implementation, they are also in a position to suggest revisions or modifications to standards in order to improve consistency or minimize operational difficulties (Epstein and Jermacowicz).

The IASB has a formal due process for setting standards that consists of six steps. The first is to set the agenda by researching recommendations made and obtaining a majority vote from IASB members. Recommendations for items can come from the IASC trustees, the SAC,
the IFRIC, as well as other professional bodies. Once an item is placed on the active agenda, the IASB appoints a team to carry out the project planning, composed either solely of IASB staff or jointly with other standard-setting bodies, depending on the subject matter. Third, a discussion paper is published that gives an overview of the issue and allows for commentary to be made by professional bodies, accounting firms and other interested parties. After the issue is discussed by the IASB they publish an exposure draft which is the formal proposal for a specific standard or a modification to an existing standard. Fifth, the IASB considers the results from the exposure draft and either publishes a second exposure draft or simply drafts the standard. A Pre-Ballot Draft is released for external review by the IFRIC, after which a near final draft is placed online for public view to allow for any final feedback regarding the issue and conclusions drawn. After this is complete the new standard or revised standard is issued. After standards are issued, the IASB meet regularly with interested parties or other standard setting bodies to discuss the impact of the standard as well as any unanticipated issues, (IASB).

Until recent years most countries remained under their national standards which limited the companies that could list on their exchanges and hindered the ability to receive international investment for companies. For instance, the United States previously required international or foreign companies not using U.S. GAAP to reconcile their Net Income and Stockholders’ Equity to GAAP in order to gain SEC approval to list in the United States. This was costly and burdensome for the companies. Through international acceptance of a common standard-set, it is hoped that markets will be able to realize the benefit of greater financial development than ever possible within a cohesive global market. This will be possible through an increased volume of listings on all national markets as accounting standard homogenization allows for decreased transaction costs as reconciliations and translations will no longer be necessary. Also, it would
presumably increase the volume of capital investment as markets become more transparent and liquid to both domestic and foreign investors.

Significant headway was made in the direction of international acceptance in February of 2001 when the European Commission proposed that all companies listed on a regulated market within their member states be required to report consolidated statements in accordance with International Accounting Standards. This proposal was endorsed by the Lisbon European Council as a “key element of the creation of an integrated financial services market” (European Commission). The European Union passed the proposal in 2002 stating the transition would be made by 2005. With this effort to ease investing and growth in Europe’s capital market, the European Commission also emphasized their hope that the United States would soon accept European companies reporting under International Standards to list in their market without having to reconcile to U.S. GAAP.

Also in 2002, the Norwalk Agreement was made between the IASB and the U.S. Financial Accounting Standards Board (FASB). In the agreement both boards resolved to work together to minimize differences between the two sets of standards, IFRS and U.S. GAAP, and together create a higher quality set of common standards. A few significant projects they resolved to work on included the topics of business combinations, performance reporting and revenue recognition. In 2003 Australia, Hong Kong and New Zealand committed to the adoption of IFRS continuing the movement toward global acceptance and increasing the pressure on countries which had not yet decided on convergence.

In 2007 the United States Securities and Exchange Commission proposed a roadmap for convergence between IFRS and U.S. GAAP. The Roadmap consisted of seven milestones, four
of which would be observed through 2011 and if the results proved satisfactory the SEC committed would consider implementing mandatory IFRS filings for public companies as early as fiscal year ending December 31, 2014. The first milestone is an enhanced quality and comprehensiveness of IFRS through the IASB and FASB's continued work to converge. The second milestone includes consideration of the accountability and funding of the IASC foundation ensuring that the IASC has a means of funding which would continue to sustain the IASB as an independent body to issue and interpret standards. The third milestone is the improved taxonomy of XBRL (Extensible Business Reporting Language) to allow benefit from the reporting of IFRS in XBRL. The fourth includes the consideration of the amount of ground that has been covered thus far made in educating users, investors, auditors and professionals in IFRS as well as incorporating it into college curricula and the CPA exam.

The final three milestones are courses of action that will be taken upon satisfaction of the first four. The fifth stipulates an early, limited use of IFRS that would allow them time to receive feedback from users and decide whether full use of IFRS is the correct path. The sixth milestone prompts the determination of whether or not to proceed with rulings to require public registrants to use IFRS dependent upon the satisfaction with the results of the first four milestones. The final milestone is the phase-in of mandatory IFRS usage for all public companies. The SEC has planned to complete this over a three-year period, beginning December 31, 2014 with large accelerated filers and moving through the remainder of companies by order of size (KPMG).

As the United States was seriously considering the possibilities and laying out the roadmap to convergence, China committed to adopting standards in line with IFRS; as well, Brazil, Canada, Chile, Japan and Korea committed to either adopt or converge with IFRS. In
light of widespread movements toward IFRS, the SEC announced in 2007 its removal of the reconciliation requirement for foreign companies who were reporting under IFRS.
Chapter 2

While it is easy to understand the desire for convergence to common international standards, it is important to first understand the differences that exist and how that will affect current practices. Upon comparison, the founding purpose and goals of financial reporting are very similar between the IASB and the United States’ FASB. The IASB actually inherited a less detailed Conceptual Framework derived from that of the United States. In conjunction with the ideas of the FASB, the international Conceptual Framework states that “the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions,” (IFRS). As well, it is the goal of both boards that financial statements exhibit the following qualitative characteristics: understandability, relevance, reliability and comparability. While differing in layout and presentation, the financial statements used are essentially the same: statement of financial position (balance sheet) and the Statement of Comprehensive Income (income statement), as well as a Statement of Change in Equity and a Statement of Cash Flows.

Given the similarity among the broad underlying principles of financial accounting and reporting, there is not much conflict between international and U.S. standards. However, significant differences do exist within the form of the standards that each body has set as well as the availability of interpretations given by each body and the allowance for deviations from the stated rules. Many professionals and authorities feel that there are still many issues to be addressed in order to bridge the gap while maintaining a superior single set of standards before any changes are made to the requirements for reporting.
International Financial Reporting Standards are a broad set of rules created to provide reporters a means of carrying out the goals within the Framework while being, “generally more focused on objectives and principles and less reliant on detailed rules and interpretations than U.S. GAAP,” (Omberg). There are currently many opportunities to depart with the stated international standards to use alternate methodologies in the name of more fairly representing transactions. The concern this sets for U.S. regulators is that GAAP standards have been created as such to eliminate the necessity for departure and, while still requiring much judgment to be used, rule makers have worked over the years to narrow the interpretation within the standards.

To understand how differences exist between the two standard sets, it is best to analyze the standards one against the other on an individual basis. There are two types of differences that will be observed between the standard sets through analysis of specific accounting topics and their related reporting requirements. Within this paper, standards affecting the required reporting for Long Term Operating Assets will be observed. As will be addressed, the differences between the two standard sets affecting these items could potentially have significant effect on the Balance Sheet as well as the Income Statement for companies dependent on the final single standard that emerges.

The first type of difference to be analyzed is the case in which each standard refers to the same type transaction and requires the same accounting treatment; however each standard provides different amounts of flexibility for management to judge which treatment best represents the transaction, thus allowing for the same transaction to possibly be reported separately under two different companies. A perfect example of the two separate standards leading to the same accounting can be observed through the comparison of lease reporting requirements under IFRS and U.S. GAAP.
Lease Accounting

Both standards result in the classification of either a Capital (Finance under IFRS) lease or an Operating lease. Further, both methods require that Capital leases are treated as assets with related debt on the balance sheet and Operating leases are treated as off-balance sheet financing in which, similar to a rental situation, the periodic payments are expensed as they are realized.

To this extent, the standards agree exactly. However, it is in the determination of what constitutes a lease to be capitalized where one can observe the difference. IAS 17 includes the international guidance regarding leases. It provides eight criteria which would suggest the existence of a capital lease. The criteria use vague terms such as, “major part of the economic life,” and “substantially all of the fair value,” and it is left to management’s judgment to assess the lease against the criteria and determine how it is to be classified, (IASB 17) The general idea is to observe the substance of the transaction rather than the form of the contract. If in substance, the risks and rewards of the asset are being transferred, then it will be capitalized; however, management has the leeway to determine which leases constitutes a substantial transfer.

In this instance, GAAP also requires that the accounting reflect the substance of the transaction; however its test requires more specific focus on the terms of the contract. SFAS 13 provides four specified criteria in which if any one of them is met, the lease must be capitalized. There is still a significant amount of judgment involved under GAAP; however the criteria are very specific in detailing “75% or more of the economic life,” and “in excess of 90% of the fair value,” (FASB 13). In comparison to the wording of IAS 17, GAAP is much more specific in quantifying its definition of a capital lease and therefore, it is easy to see how the same lease could be treated differently under each set of standards. Lease accounting is among the items on
the list to be addressed by the IASB and FASB in their convergence efforts. It is still unclear what the two boards will decide as to which current standard will be closer to the final standard chosen. Depending on their decision, companies may have to reassess past judgment made when reporting such lease transactions. This in turn can result in increased need for restatements or retroactive adjustments to the financial statements.

The other type of difference between the two standard sets includes standards that require differing results entirely for a given transaction. We will be observing this through three Long-term Operating Asset items: depreciation of Property, Plant and Equipment; Impairment of Long-lived Assets; and Research and Development.

**Depreciation of Property, Plant and Equipment**

Currently, GAAP requires that companies capitalize the historical cost of an asset at inception and allocate the cost over the estimated useful life of the asset. The acceptable depreciation methods are strictly defined as systematic and rational forms of allocation of cost, and not a system of valuation of the asset over its life. The chosen method of depreciation must be disclosed within the financial statements and if changed for any reason at a period in the future, the change is dealt with as a change in accounting estimate. This allows the change to be reported proactively as the remaining unallocated cost is divided over the new estimated remaining life and no adjustment is done to prior periods.

IAS 16 governs the international guidance on the issue. It requires that a depreciation method shall be chosen that reflects the pattern in which future economic benefits are expected to be realized, similar to GAAP. However, the method must be evaluated every year to determine continued relevance and a change in method results in a change in accounting principle. This
requires that the company report the change retroactively which means adjustments must be made to prior periods as well, as opposed to the GAAP standard that allows proactive adjustment to a change in method. Further, it requires a “components” approach to the depreciation of property, plant and equipment. This means that “each material component of a composite asset with different useful lives or different patterns of depreciation is accounted for separately for the purpose of depreciation,” (Schroeder, Clark and Cathey). While GAAP allows assets to be componentized and depreciated separately, it does not require it nor do companies often elect to use it, (Ernst & Young page 15).

While GAAP requires systematic depreciation of historical cost, the international standard allows an alternative method to depreciation of historical cost. Companies can elect to revalue an asset at its market value periodically. Increases are recorded in stockholder’s equity and decreases are recorded in current period expenses. However, when an asset is revalued, the company must also revalue all assets in that specific group (i.e., property, plant or equipment). Given that the standards allow for different asset valuation and cost allocations, not only will the balance sheet differ depending on which standard was used but it will also affect the reported income and retained earnings. Convergence will force U.S. companies to re-evaluate their depreciation methods as well as calculations and in many cases, disaggregate assets that are currently being depreciated as one unit. Furthermore, any changes that must be made will be done retroactively, affecting all prior periods. Companies will also need to begin evaluating their assets yearly to assess the need for a change in useful life thus requiring retroactive adjustments. The international standard is much more costly and time consuming, but also allows for various approaches to cost allocation of fixed assets. This will likely have significant effects on
companies’ reporting of assets as well as net income and allow greater flexibility as opposed to the GAAP standard under which fewer methods of cost allocation for fixed assets exist.

**Impairment of long-lived assets**

Both standards provide similar indicators that impairment of an asset exists; as well, each requires that an impaired asset be written down and the loss recognized. However, there are significant differences that exist in the dictation of how impairment is to be reviewed, measured and recognized. FAS 142 and 144 dictate that a review for impairment of assets be done whenever events or circumstances exist that are indicative of the carrying amount being unrecoverable. While they provide many examples of occurrences that are indicators of impairment, it is left to the judgment of the company to determine the need for review. When the need arises, GAAP stipulates that a recoverability test be performed first. This would test the carrying amount against the future undiscounted cash flows generated from the use and eventual disposal of the asset. If the carrying amount is greater, an impairment amount is then calculated by taking the difference between the carrying amount of the asset and the fair value of the asset. The asset value is then adjusted on the balance sheet and the impairment loss is recognized on the income statement. According to GAAP, assets can only be adjusted downward and never up (Ernst & Young page 19).

IAS 36 dictates the international reporting standard for impairment. It requires companies to assess long-lived assets for impairment at each reporting date. This does not mean that each asset needs to be tested, but rather that the asset classes are assessed to determine if any indications of impairment are applicable, and if so, then the individual assets would need to be tested and impairment calculated. The indications of impairment listed under IAS 36 are similar
to those given by GAAP. Under IFRS there is no test for recoverability, rather if indications exist then there is a calculation of impairment loss between the carrying amount and the higher of i) the fair value less cost to sell and ii) the value in use (discounted future cash flow in use, including disposal value) (Ernst & Young page 19).

For companies currently reporting under GAAP, changing to IFRS will require companies to begin testing their long-lived assets for impairment every period rather than just as events or changes are thought to have occurred. Also, they will no longer have to perform the initial recoverability test as mentioned above; rather, they will just calculate the impairment to be recognized. The major difference in measuring the impairment is that under GAAP one would test for impairment by comparing carrying amount to the undiscounted future cash flows; while IFRS requires that carrying amount be compared to the discounted (present value of) future cash flows. This will create a threshold much tighter than that used by GAAP and therefore will cause, in many cases, impairment to be taken where none was necessary in the past.

Also of great importance, IAS 36 allows for the reversal of impairment losses when it is evident that the value of an asset has been recovered. The value can be written back up to the newly estimated recoverable amount, to the extent that it does not exceed the initial carrying amount adjusted for depreciation. Being that this is prohibited under GAAP, it could also be the source of many adjustments to financial statements upon convergence.

**Research and Development**

Research and Development is an intangible asset, however the difference between the two standards will have significant impact on companies that are heavily invested in research and development of products. Under both GAAP and IFRS, costs related to the research phase of
research and development is to be expensed in the period incurred, without exception. However, under FAS 142, all development costs must be expensed in the period incurred as well, except for computer software that is generated for external use. It may be capitalized only once there is technological feasibility established in accordance with FAS 86. Once capitalized, it is to be amortized over its estimated useful life unless there is no foreseeable limit to the period in which the asset is expected to generate net cash inflows to the entity. In that case, it is given an indefinite life and not amortized (Ernst & Young page 16).

Conversely, IAS 38 allows development costs to be capitalized when, “technical and economic feasibility of a project can be demonstrated in accordance with specific criteria including: technical feasibility, intent to complete the asset, ability to sell the asset in the future, as well as others,” (Ernst & Young page 16). This guidance governs all research and development, including computer software. Similar to GAAP, all capitalized costs are then required to be amortized over their estimated useful life. This standard will greatly impact industries that are heavily invested in R&D such as software, pharmaceutical and biotechnical. These companies are currently expensing all costs related to their product development; however, under convergence they will be able to reclassify their projects that meet the IAS 38 criteria as assets. This will result in the reversal of expenses in prior and current years and capitalization of those costs. Further, there will need to be a retroactive implementation of amortization costs for those assets capitalized. This will potentially have significant impact on the financial statements of these companies dependent on how FASB plans to have such convergence carried out.

The issues discussed above are only a few of the differences that can be identified between IFRS and GAAP, and alone already account for significant differences in balance sheet affects and operating results. While the IASB and FASB are working to converge some of the
major issues, there is still much to consider regarding how the differencing standards will effect one’s financial statement preparation as well as reported results. Professionals within the United States would clearly prefer to see the international standards be addressed more seriously and closely mirrored to GAAP before considered for convergence. If the roadmap set out by the SEC as well as the convergence projects on the part of the IASB and FASB are considered satisfactory, that might be what results.

However, there is sensitivity on this matter as the changes that will be made to IFRS in order to fully converge with U.S. GAAP must be conducive to all other nations who report under IFRS or will report under IFRS in order to maintain a single standard set. As was explained in a Financial Executives International Exclusive, “there will not be a universally accepted set of global accounting standards if home-country standards are mis-labeled ‘IFRS....’ The SEC generally likes IFRS, but what the SEC does not like is what Ethiopis Tafara, director of the SEC Office of International Affairs, referred to [as] ‘nationally-tailored versions of IFRS that will plunge us back into a Babel of national GAAPs.’,” (Illiano).
Chapter 3

The literature on U.S. GAAP and IFRS are 25,000 pages and 2,500 pages respectively. Accordingly, there are many differences that exist between the two standard sets from the amount of detailed interpretation offered for standards given to the manner in which transactions are required to be reported. In the preceding chapter, I have focused on the effects of Long Term Operating Assets (LTOA) through the transition from GAAP to IFRS. While the items I discussed do not represent all of the differences that exist between the two sets of standards, I have highlighted those that have a high likelihood of being significant changes to both the Balance Sheet and Income Statement of a company that is asset and/or research intensive. However while certain standards appear to create large differences in theory, such differences might not be observed in practice. Conversely, those standards that don’t seem as significant a difference between GAAP and IFRS might prove otherwise when implemented.

In order to make some inferences regarding the quantitative effects of IFRS implementation on GAAP financial statements I have selected three large public pharmaceutical companies and three large public technology companies; all of which report under IFRS and, previous to 2007, included reconciliations to GAAP in their annual 20-F filings. The reasoning for my choice of industries is that both rely heavily on research and development and are presumably asset intensive. I have studied their reconciliations from IFRS to GAAP for fiscal year-ending 2006 and attempt to make some inferences as to whether there appear to be trends that will occur in the transition within industries, particular financial statement line items in general or in the broad movement of net income and shareholders’ equity as a whole.

Understanding that this data represents differences that occur when transitioning from IFRS to GAAP while the paper is studying the effects of transitioning from GAAP to IFRS, there
are a few clarifications that need to be made before drawing any conclusions. There are essentially four possibilities when comparing the two standard sets, as can be seen in the chart below. Either: the standards are the same and no significant difference will be observed as will be the case for many standards that do not differ significantly between the two standard sets; the standards are completely different and thus a difference will be observed either way as will be discussed with respect to the treatment of development; IFRS is more restrictive concerning a particular transaction and thus significant differences will occur in the transition from GAAP to IFRS as is the case in the depreciation of fixed assets; or GAAP is more restrictive and thus significant differences will occur in the transition from IFRS to GAAP but not necessarily the other way around, as will likely be the case in lease classifications.

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<td>Development</td>
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<tr>
<td>No Change</td>
<td>Lease Classifications</td>
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In my study of the reconciliations, I found it most useful to categorize the adjustments into increases to IFRS equity and income, decreases to IFRS equity and income and then the net impact which results in the net income and equity under GAAP. Further, I separated the items into LTOA differences and other differences. The broad categories for LTOA include: Goodwill; Property, Plant and Equipment; Research and Development; Product Rights and Leasing. Other changes included broad categories of: Pensions; Income Taxes; Business Combinations; and Other, which includes investments, compensation, restructuring costs and items deemed as other by the company. For the remainder of the chapter I will discuss significant findings in first the
income statement reconciliations and second the equity reconciliations, followed by the recognition of similar studies done and the overall conclusions I have drawn from this exercise in relation to the motivations of my analysis.

**Income Statement Reconciliation from IFRS to GAAP**

Looking at the income statement effects, three of the six companies observed a decrease in net income under GAAP and three reported relatively minimal net change. The three observed declines were in excess of 17% of IFRS reported net profit and the net declines due only to LTOA accounted for at least 24% of IFRS reported net profit. Specifically, goodwill and research and development accounted for the significant adjustments of the three companies. For the most part research and development created a decline (roughly 20% or more) as expected. However in the case of one of the companies that observed minimal net change under GAAP income, it had a significant effect opposite of what was expected. This occurred because the particular company had acquired large amounts of in-process research and development in the previous years and thus in the reversal of all the current portion of related amortization, they were able to exceed the offsetting expense adjustment for current development and recognize an increase in net income.

Of initial surprise, the pharmaceutical companies observed significant effects through research and development reconciliations where the technology companies observed little to no effect. However the three pharmaceuticals appeared to frequently engage in the acquisition of acquired in-process research and development, allowing for volatility in the amount of development being capitalized and amortized each year. In comparison, it could be presumed that the technological companies included mostly internal research and development with stable
budgets year over year as well as the inclusion of software which is treated the same under IFRS and GAAP, allowing for minimal net effects of adjustments to net income. Through study of the applicable notes to the financial statements, it appears that each company has their own method for moving developed products into capitalized assets subject to amortization, consequently timing will play a big role in when and how the companies are then effected by the change in standards when reconciling to GAAP.

Goodwill accounted for a large decrease (229%) in GAAP income for one company due to unique adjustments necessitated by the company's transition from French GAAP to IFRS in 2002 that then must be reversed under reconciliations to U.S. GAAP. Aside from this instance, Goodwill did not provide any significant net effects on the income statement reconciliations.

**Income Statement transition from GAAP to IFRS**

In the transition from GAAP to IFRS, it is still safe to assume that there will be significant improvements in the net income of affected companies due to the allowance of capitalizing development under IFRS. As far as my observations have come, it is still inconclusive as to how much the effect will be for each company and the timing as to when the differences will actually be seen in terms of the stage of their product developments as well as the volatility of their development budgets each year as was seen as a significant factor in the reconciliations observed herein. In relation to the differences in PP&E, IFRS is more restrictive in the requirements for depreciation of fixed assets, so the major portion of differences to occur would not be seen in the data herein but rather in the IFRS conversion process. Given the fact that companies will be required to componentize their assets and separate the economic useful lives, there is likely to be significant effects on the income statement as well as to equity as the
change in accumulated depreciation will be retrospective. A factor that can be seen in the data herein but not of significant effect is the difference in terms of the capitalization of interest related to financing the development or acquisition of fixed assets. While capitalization is allowed under GAAP, it is not under IFRS thus resulting in a decrease to IFRS net profit as the capitalized interest will need to be expensed. Overall, I would expect to see the same direction of net change from GAAP to IFRS which would result in an increased net profit for companies after the transition. As observed through my sample set though, I don’t believe that we can make assumptions about how much each company will be affected. Clearly, some industries will see greater changes than others dependent on the transactions that take place in their operations, but even still there is some degree of uncertainty within an industry as to how individual companies will react. I observed greater changes in the pharmaceutical companies than in the technological companies, mainly due to the research and development differences mentioned previously. However, while there was one technological company that was significantly affected, there was also one pharmaceutical company that recognized minimal effects. Thus, I would conclude that while the differences in the two standard sets are unchanging, companies will react differently on an individual basis given the unique nature of their transactions and use of judgment in reporting apart from every other company.

**Equity Reconciliation from IFRS to GAAP**

Looking at the Equity reconciliation, all six companies observed a net increase in total equity under GAAP in comparison to reported equity under IFRS. Three of the increases were significant with net increases greater than 13% of IFRS with net increases in excess of 15% of reported equity due to the net of LTOA related adjustments. Significant increases were seen through adjustments related to goodwill, product rights and business combinations. Four of the
six companies observed adjustments related to goodwill and business combinations in excess of 12\% of IFRS reported equity. These adjustments were all related to differences in accounting for business combinations and acquisitions. While acquisitions were accounted for as either mergers or poolings of interest on their current statements, they had to account for them under purchase price accounting in order to reconcile to GAAP, as pooling of interest is not allowed under GAAP. This caused the acquisitions to be valued at their fair value as of the date of acquisition and thus additional goodwill to be recognized under GAAP. It is important to understand that while IFRS does not allow pooling either, these companies had acquisitions on their books under the pooling method due to standards used prior to their conversion of IFRS. Under IFRS 1, having been deemed costly to the company relative to the benefit of the users of the financial statements, amongst a few other items companies are allowed to choose not to retrospectively restate their reporting of business combinations in prior years (Deloitte & Touche, “First Time” 11).

One company observed a 113\% increase in equity due to product right adjustments. The significant increase was created through the reversal of acquisitions and disposals of in-process research and development and other licenses and patents under GAAP, as they were previously capitalized under IFRS. The company noted that under GAAP there were higher attributed carrying costs for the rights and the reversal of the disposals of these product rights created a net increase in equity.

**Equity Statement Transition from GAAP to IFRS**

Looking across the sample set, other differences appear to be unique to circumstances and reporting decisions made within each company and it is thus difficult to draw general conclusions about the effects that will be seen even as related companies transition to IFRS.
Given the accumulated effects of depreciation method changes and development capitalization with related amortization charges, it is still presumable to expect a similar overall movement in equity and thus a decline in total reported value under the transition to IFRS. Accounting for business combinations appears to have significant effects on LTOA in transitioning to GAAP. I would presume that from GAAP to IFRS most companies will retain their purchase price accounting for acquisitions which would mitigate those related differences that were seen above. In observation of the reconciliation from IFRS to GAAP, we have recognized that while income decreases under GAAP equity appears to increase which does not seem logical that they would each move in separate directions. From my observations, the major contributor in the increase in equity is the restating of business combination related reporting which will not be seen in the movement from GAAP to IFRS.

Related Studies

Other studies have previously been done that have made use of the study of 20-F reconciliations to GAAP prior to 2007. In both reports discussed below it is mentioned as well that differences and significant items fluctuate over the samples according to size, industry and individual reporting methods among other reasons. Some of the topics discussed by the authors that pertain to my study will be highlighted below.

Plumlee and Plumlee (2008) observed the information supplied in 20-F reconciliations in argument against the suspension of requiring them to be reported by private foreign filers in the United States, (Plumlee). In review of the quantitative results through their observation of 100 companies, their conclusion was in agreement to mine as to the average increase in Net Income and decrease in Equity from GAAP to IFRS. Further, in observation of their categories for PP&E
and Intangibles (including Goodwill) they found that 55 and 67 of the 100 companies reported an average increase of 15.3% and decrease of 10.4% in Net Income under GAAP, respectively (Plumlee 19). While my sample does not provide any significant increases to Net Income due to PP&E related differences, there are similar decreases due to Goodwill that can be seen in three of the companies.

In regards to equity changes over the same two categories, they found that 64 and 70 of the 100 companies reported an average decrease of 1.8% and increase of 11.2% in GAAP equity, respectively (Plumlee 20). Two of the sample companies in my data report similar decreases to equity due to PP&E related differences. While five of the six sample companies exhibit increases in equity due to goodwill related differences, the proportion of increase varies significantly over the companies.

The study also concluded on trends within the six industries they observed. In regards to Net Income effects the Heavy Construction, Finance, Manufacturing, Services and Wholesale industries observed net mean decreases of 13%, 13%, 17%, 15% and 37%, respectively. In contrast, the transportation industry observed a 26% increase due mainly to PPE and investment in financial asset related effects. In regards to Equity effects the same industries observed net mean increases of .2%, 19%, 28%, 37%, 49% and 1%, respectively.

Another study was done by Henry et al. (2008) to determine the impact of the convergence efforts by the IASB and FASB on the gap between net income and equity across GAAP and IFRS. In their study of 75 European cross-listed companies, they found that overall Net Income (Equity) tends to be higher (lower) under IFRS in comparison to GAAP. While they observed shrinkage in the gap after some of the convergence efforts have been implemented,
they claim there is still a significant gap in Net Income. They mention specifically that while Goodwill is of the items on the list to be converged further between the two standard sets, there still appeared to be a significant impact on reconciliations due to differences in standards regarding Goodwill and amortization, (Henry et al).

Summary of Findings

Overall I was able to see net decreases in income from IFRS to GAAP and net increases in equity from IFRS to GAAP, which are consistent with the net effects observed in the related studies referenced above. Differences related to goodwill, research and development, product rights and related amortization can be expected to be as significant an effect on the transition from GAAP to IFRS. However, there are also differences existent in the reconciliations I studied that will not likely effect GAAP transitions to IFRS such as the business combination adjustments. Further, there will be other adjustments recognized that are not observed in the reconciliations studied such as those related to depreciation adjustments given the greater restrictions placed on related IFRS standards.

I was unable to observe direct quantitative effects on current GAAP statements related to LTOA due to the inconsistency of transactions across various companies and the complexity of the financial statements and related notes themselves. While we can look at the reconciliations done in previous years for a general indication of what to expect, as mentioned previously, we cannot rely on these reconciliations to show us exactly what effects the transition will have. Therefore, while I can observe that LTOA did have significant effects on reconciling IFRS income and equity to GAAP income and equity and presume that they will likely have significant effects on the reverse transition as well, I cannot conclude on specific line item effects
to be expected by companies. As I observed in my studies, even two industries that are LTOA
intensive observed very different reactions to specific financial statement line item adjustments;
more specifically, even companies within an industry did not observe exactly similar
significance within adjustments. Rather it is dependent on the transactions exercised by the
company and specific judgments used within reporting that will determine their reaction to the
change in standards. Unfortunately that will not be observed completely until the physical
implementation takes place, leaving a great deal of uncertainty as to the expectations of new
financial statements for companies following the transition to IFRS.
While the advantages of common accounting standards to a global capital market have previously been highlighted as well as some examples given regarding differences among national standard sets; other important factors in observing the possibility of convergence include the costs of changing accounting standards within a nation and the necessary preparation efforts to make such a complex task successful. The FASB, SEC and management of public companies are clearly major players in this entire decision-making and implementation process; however public accounting firms also have a large role.

PricewaterhouseCoopers, Deloitte & Touche, Ernst & Young and KPMG (the Big Four accounting firms) are integral in managing the resources necessary to serve as independent auditors for many of the large, complex and often multi-national companies. Furthermore, they also have the resources to publish interpretation and implementation guides to supplement standards and aid management in accurately applying especially the more detailed standards.

Given the exposure these firms have to the use of even the most technical of accounting issues and the amount of research and awareness they must then maintain to be able to serve their clients, the Big Four prove very useful in helping the governing bodies and standard-setting committees in addressing issues and providing feedback on the setting or revising of standards. In the past year the efforts of the Big Four have been seen, along with the efforts of other large public accounting firms, in holding conferences, giving lectures and in publishing guides for industries and companies as to the implications IFRS will have on their reporting and the necessary preparations that must be made. In the midst of all of these preparations however, the
question still remains for many as to whether or not the proposed conversion will actually occur in the near future.

Per the earlier discussion on the SEC’s roadmap to IFRS, the roadmap was proposed in 2007 and progress is due to be reviewed in 2011 to determine how to move forward with the plans to converge. However, as the period for public comment was meant to end on February 19, 2009, it has since been pushed back by the SEC due to requests from many companies to allow them more time to look over the proposal and give their feedback. While some simply do not favor the idea of changing to IFRS, there are many who want the extension simply because it is hard to understand just yet all of the implications this conversion will have on companies from costs to daily operations. The controller of United Technologies, Corp. commented, “The transition from U.S. GAAP to IFRS is not an accounting standard adoption exercise but rather a global project, impacting every facet of a company's operations,” (Johnson).

As public commentary will be of importance in the decision-making, ultimately it is the SEC who will make the final call. At present the SEC is deeply involved in working through the current financial crisis within the United States and the serious impact it is having on the public companies which they govern. A serious question for them to consider when the time comes is whether companies’ financial situations are conducive of incurring the necessary costs at this time. With these concerns now at the top of their priority list as well as a new SEC chair, Mary Schapiro, there is discussion over whether the 2011 assessment will lead to further postponement of implementation altogether. Schapiro has been known to be less enthusiastic about the movement to IFRS than former chair, Christopher Cox. In the past month after pushing back the deadline for public comment, she has said, “I will take a deep breath and look at this entire area again carefully and I will not necessarily feel bound by the existing roadmap that is out for
public comment," (WebCPA). She has also voiced her personal concerns regarding the independence of the IASB and the lack of detail within IFRS compared to GAAP, (Johnson).

While the timeline for required implementation is still unsure, it is the opinion of many authorities and reporters that IFRS is a necessary move for the United States to make. The SEC has disclosed that there are now two-thirds of U.S. investors that own securities issued by foreign companies reporting their financial information in IFRS. Given how integrated the world’s capital markets have become, it increasingly important to establish a single set of standards, (Feldman). The United States, though it has worked over the years to develop what many would say are a superior set of standards, is due to miss out on the growth of capital flow as more countries move to some form of IFRS and investors become better able to compare foreign competitors one with another while their U.S. counterparts remain under different reporting methods. USA Today reporter, Edward Iwata stated, “Whether U.S. companies like it or not, the new era of global accounting appears unstoppable, and businesses that ignore the International Financial Reporting Standards will fall behind,” (Iwata).

Despite conflicting opinions toward the international standards, the United States can remove some uncertainty regarding the effects of conversion as it is fortunate to have the example of other nations such as Europe who have already converted to IFRS. From the observation of Europe’s transition in 2005, public companies as well as governing bodies can estimate timelines for preparation and conversion; formulate measures that might improve the process and allow for a smoother transition; as well as gauge the costs that will be incurred to achieve a final changeover.
As it currently stands, the requirement for IFRS adoption begins with fiscal year-ending December 31, 2014 for most large accelerated filers, companies with market capitalization of at least $700M, and for the rest of the public companies over the following two years according to size. First-time filing requires three years of operations reported under IFRS, which for the first group of companies would be fiscal years 2012-2014. The hope within the United States has been that they have given companies and accounting firms ample to prepare themselves to be able to have their financial statements reported under IFRS for three consecutive years when their date of inception comes.

Rather than have to report three years of IFRS at one time, companies could ease the burden by preparing themselves to start stating their financials in both GAAP and IFRS for the two years leading up to their actual date of inception. For example, in the case of large accelerated filers that are tentatively scheduled to have three consecutive years of financials reported under IFRS as of fiscal year 2014, they would need to be ready to prepare one set of financial statements under IFRS by year-end 2012. Leading up to that point however, there are many actions that a company must take to prepare ready themselves.

First and foremost, management and finance professionals will need to learn the new standards and how they are different from GAAP. Further, if and how these changes will affect their reporting and subsequently their quantitative targets set for performance or compensation purposes. Given that the root operations of a company will not be changing, but their financial statement presentation will be somewhat, this might have an effect on their quantitative results of operations in comparison to GAAP. On the technical side, all communications and software systems are currently set up for the application of GAAP standards and in compliance with the applicable requirements therein. It will take time not only to learn what needs to change but also
to redesign or redefine the systems in coordination with the new standards. This process alone is very lengthy and costly to companies. Finally, all staff that is tied to accounting and reporting will need to be trained to work with the new standards as well as the change in communications and software systems.

University of Dayton professor, Donna Street, has estimated that companies should give themselves two to three years to prepare for reporting under IFRS, mainly to complete the technical changes and training mentioned above, (Feldman). Similar timeframes have been estimated by others who simply do not want to see convergence being rushed upon companies, regulators and investors. The European Commission announced their intent to adopt IFRS in 2003 with a deadline for convergence of year-ending December 31, 2005 for their listed companies. However, in order to have comparable years under the same standard the actual transition date for IFRS reporting was January 01, 2004. Steven Brice, Chairman of the Technical Committee for the London Society of Chartered Accountants, commented that this abrupt decision left, “the majority of European companies reacting to IFRS, as opposed to proactively structuring their business to lessen the impact that IFRS would have,” (Brice). The roadmap to IFRS was proposed in 2008 which gives even the first wave of filers enough time, under the estimates given above, to train and prepare themselves. However, the uncertain nature of final convergence has left many companies, especially those averse to the idea of IFRS, hesitant to spend too much time or money on preparations at this stage of the process.

In hopes of allowing for better processing of implementation, many efforts have long been underway to spread knowledge of the new standards. It has previously been discussed how important it is for management and finance staff to be trained for operating under the new standards, however there are many other parties to consider as well. Regulators, CPAs and
investors will need to understand the global accounting principles in order to continue in their professions and make informed decisions. Also, college faculty will need to understand and incorporate IFRS into course textbooks and learning criteria leading to the CPA exam which will need to be revised to incorporate the material as well. Over the past few years accounting firms have been publishing documents that detail the differences between U.S. GAAP and IFRS as well as the plans between the IASB and FASB to close some of the most significant gaps in the near future.

Furthermore, many firms have created special teams to head up research and preparation for IFRS. With the big four firms’ greater amount of exposure to IFRS previously through their international clients and availability of resources, they are working toward training other public accounting firms on the new standards and resulting change in audit processes.

With the coming of new standards, accounting firms will need to remodel their accounting process and procedures which includes software updates and across the board training on the new system of operations. Furthermore, as IFRS has not previously been an option for U.S. companies governed by the SEC, it has scarcely been taught in Universities to this point or included in the CPA exam. While some public accounting staff, as mentioned above, may have been made familiar through work with clients they will still need to be trained sufficient enough to qualify them to audit such reporting in more widespread practice by their clients.

As training is passed on to all accounting firms, it will be their responsibility then to ensure that their public clients are trained sufficiently and have made the necessary adjustments to begin reporting in compliance with the global accounting standards. The Big Four have also
released documents tailored toward individual industries to aid companies in understanding specifically what changes they will need to focus on, as well as many of the larger firms are holding training sessions for their clients to ease the transition and ensure that these companies will be ready when the time comes.

The more difficult task will be to prepare equally important parties but those less directly connected to the chain of financial reporting, which would be investors. It is pertinent that investors be adequately informed as well as the underlying goal of obtaining a single set of global standards is to increase comparability and eliminate the geographic boundaries of capital markets. If investors lack the knowledge of the global standards, then the efforts will not result in as great a response as possible or as is expected. While the 2500 pages of IFRS standards as well as the many documents that have been released by accounting firms highlighting the changes are available to the general public, companies and regulators have less control over ensuring that the necessary training is done to bring investors up to speed.

While the amount of reporting and publication available regarding the explanation of the new standards, necessary preparations and estimated timelines for doing such is exhaustive; perhaps the more important information, being costliness, is rarely mentioned or speculated. Simply looking back at all of the necessary preparatory efforts mentioned heretofore and also considering all of the last minute, unforeseen tasks that will come up and the process moves forward, it is easy to guess that this will be done at nothing less than great cost to the parties involved in implementation and regulation. Companies will need to incur the costs of updating or acquiring new software, training management and employees as well as reporting under both IFRS and GAAP for at least two of the three initial years of IFRS reporting. According to Deloitte & Touche, "The cost to switch from U.S. GAAP to IFRS is estimated in some cases to
range as high as $30 million for each U.S. company at a time when careful consideration needs to be given to imposing costs of such nature on U.S. industry,” (Deloitte “Global Convergence”).

Given the status of the current United States economy following a financial crisis of such magnitude, many companies are struggling to maintain operations with the decline in lending and consumption that has occurred; forcing such steep costs on them in order to implement new reporting standards is definitely an issue that companies are reacting negatively to especially in light of the current circumstances. All things considered through the preceding discussion, it is presumable that there is a good possibility of the IFRS roadmap being postponed further into the future to allow more time for preparation as well as financial and economic recovery; however it is the tone of many, as mentioned previously, that IFRS is an eventual necessity for the United States to cooperate with in order to maintain competitiveness and commonality among the many other nations who have already adopted or committed to adopting IFRS or some form of the international standards.
Chapter 5

Economic theory and other hypotheses such as that of efficient markets would lead us to believe that the agents and users of financial statements can see through the reporting methods used and understand the true underlying health of a company, thus allowing market prices to accurately reflect the value of a company at any given time. These models would assume not only that users are perfectly rational but also that there is no cost associated with investment in capital markets and that a company’s financial position is transparent regardless of their reporting method. If this were in fact true then a change in accounting standards would have no effect on capital markets and thus render the entire purpose for a change in standards unattainable. However, in the discussion below I would argue that the assumptions made in these models are far too hypothetical and do not reflect the true behavior of markets or the users of financial statements. There are two ways in which I argue these models would not hold true, one in which we would see favorable results from a transition to IFRS and one in which we would see unfavorable results.

More specifically, the first scenario is one in which we can observe the achievement of the overall goal of common standard sets among nations which would be expansion of the global capital markets through the ease in comparability for investors and in effect increased supply of financial capital. The second scenario would be one in which the transition creates more uncertainty and costly adjustments to companies and users of the financial statements and in effect hinders the growth of global capital markets at least for a period of time. For the remainder of this concluding chapter, support of each scenario will be outlined, followed by the conclusions I have drawn regarding the current position on implementation of IFRS within the United States and the likely effects thereof.
**Favorable Scenario**

If in fact, IFRS is able to increase comparability and transparency over competing companies within the global market it is feasible to expect that there will be a resulting decrease in the cost of capital and thus an ease in the flow of capital and expansion of global investment and activity. Assuming that the rate of return demanded by an investor includes among other factors, the cost of information gathering and analysis as well a portion of risk that is associated with the information received, the choice of reporting standards can have an effect on the equilibrium rate of return and thus the cost of capital.

Currently, investors observing an industry that has competing companies in various countries and reporting under various accounting methods must either understand all of the methods being observed well enough to translate the financials into comparable states in order to make informed decisions on the best investment, or eliminate the option of investing in the companies reporting under standards unknown to them and face the risk of investing in the inferior of the companies available. Under either circumstance, the cost of analysis or the risk associated with incomplete information would presumably decrease the amount of financial capital that investors are willing to supply at each rate of return and consequently increase the cost of capital for the company.

Given a single standard set, companies across an industry regardless of location could possibly seek out investors in all markets. Likewise, as a result of a homogenous international standard set, investors could compare all competing companies with the knowledge only of the single standard set and be more confident of the information received through the financial statements. If this is the result of a global transition to IFRS as hoped, then there would
presumably be a decrease in the demanded rate of return by investors and thus the cost of capital for companies. Through observation of the equilibrium supply and demand of financial capital as a function of various rates of return, a decrease in the cost of comparison and risk of uncertainty would increase the aggregate supply of financial capital, resulting in an outward shift of the supply curve. A resulting decrease in the rate of return would presumably increase the quantity demanded of financial capital by companies and consequently increase investment and expansion of operations for companies. These activities would encourage and allow for expansion of the global economy.

However, this theory can really only hold if the standards being adopted by each nation are in fact the same standards all around and not in the form of many nationalized versions of IFRS. Furthermore, there are other effects of a change in accounting standards that must be addressed in determining if the above advantages can truly be observed either in the onset of the transition or even over time.

Less Favorable Scenario

The discussion thus far has outlined both the broad framework and the technical types of differences between IFRS and U.S. GAAP as well as the resources and preparation necessary to accomplish convergence in an efficient manner. The analysis in chapter 3 has outlined the major net effects on the financial statements that can generally be expected but has also shown that the quantitative effects of the conversion on a transaction or standard by standard basis are likely to vary by individual company as well as by industry. However, once again, we can look to the experience of European companies for an idea of what to expect.
Many European companies have observed a higher reported net income under IFRS in comparison to their previous standards. In observation of the European transition, Marie Leone on CFO.com stated that Moody's had reported in November 2008 that, “in general, companies making the change from local generally accepted accounting principles to IFRS record a 25-percent boost in net income and a ‘significant’ rise in earnings before interest, taxes, depreciation, and amortization,” (Leone).

Given the change in financial statements as prefaced both in chapter 3 and from the source mentioned above, will more favorable financial statements under the homogenized standards make U.S. companies more competitive with foreign counterparts for obtaining business? Given that the underlying operations of the company are unchanging in the conversion as well as the cash flows and customer service, it is difficult to see how a change in the appearance of their operations would be advantageous to their performance level unless it were to stimulate a restructure or improvement in the operations process or in regime.

Assuming that the consumer base and overall performance of the company remain fairly unchanged, one must now consider the effects on creditor and analyst perceptions. With GAAP currently being the only accepted accounting standards in the United States for all public and most private companies, uniform target ratios and financial indicators have been established according to GAAP reporting results in order to make the process of lending and analysis more efficient. This conformity of information gathering decreases uncertainty among lenders and analysts, lowering the risk of lending and consequently the cost to do so. Given the likelihood of IFRS having a significant impact on the reporting of at least some transactions for any given company, creditors and analysts will have to reassess the currently relevant ratios for measuring
the financial health of a company in order to adjust for the changes that will occur quantitatively that are due in no part to a change in the operational or financial position of the company.

CPA firm Crowe Horwath, pointed out that understanding the impact of IFRS, "requires analysis of virtually every legal contract, from debt agreements to performance-based salary agreements to leases, to determine the impact on the financial statements. For example, debt covenants with trigger events could come due early if the relevant ratios change under an IFRS conversion," (Rudolf and Marks). Financial statement interpretation for the use of requirements and related obligations of contracts will need to be adjusted accordingly between companies and their creditors as well as with their employees to reflect the differences that occur in reporting.

As mentioned above, debt covenants are an example of a possibly significant issue with conversion. Banks rely on many ratios for indicators of financial stability for use in covenants, such as the Debt to Equity ratio and the Current ratio. Both ratios make use of reported figures for assets, liabilities and stockholders' equity. Given the double entry system used in accounting as well as the reporting of accumulated net income in stockholders’ equity on the balance sheet, beyond the income statement effects mentioned above, the balance sheet will be affected as well. Through observation of Europe’s experiences, Moody’s concluded that there is resulting balance sheet "deterioration" through IFRS meaning that the same company would appear to be in better health in terms of debt and equity held under GAAP than under IFRS.

In Moody’s analysis of 30 of the largest European public companies, they concluded that the ratio of net debt to equity increased from 59 to 69%, (Leone). They further indicated that credit rating agencies such as themselves are aware and take into account the adjustments that are made under the change in accounting standards and in large part adjust for the difference that
would create within their analysis. However, that must require a great deal of time and resources to understand the effects of the transition and integrate them into the software and calculation processes in order to mitigate any artificial stimulation or depression of reporting results. Furthermore, if every company’s financial statements observe different reactions to the changes, then there must be judgment used in mitigating discrepancies on an individual basis rather than automated processes. Lenders will have to invest in similar improvements to their interpretation process for future loans and contracts, but also reassess any previously drawn contracts that might be triggered by the change in financial statement appearance of the borrowers. Returning to the example above regarding debt covenants, existent loans that have covenants allowing immediate recall of debt if the debt to equity ratio of the borrower exceeds a specified limit and IFRS affects that ratio, lenders will have to revisit the terms of those contracts and either alter the way in which they view the key ratios or find ways in which to mitigate the changes that occur to the financial statements.

To complicate the matter further, in the midst of handling the changes to public company financial statements, lenders and credit analysts are also tied closely to private companies and currently there is no talk within the FASB of requiring private companies to convert to IFRS. Therefore there is the possibility of bilingual accounting standards in the U.S. While public companies have been required to report under GAAP per the SEC, as pointed out by Virginia Tech professor, Patty Lobingier, many private companies have followed suit simply to remain competitive with the public companies of their industry. With the SEC’s movement toward implementing a requirement for public companies to now report under IFRS, it is uncertain whether private companies will choose to make the move as well. With fewer resources at hand it is difficult for private companies to analyze the impacts of IFRS and weigh out their options.
quantitatively; however Lobingier predicts that a movement to IFRS is a necessary move eventually. Beyond competition purposes, as the need for additional funding sources arises for owners as well as the possibility of foreign purchases of the entity, in part or whole, there will be a need for reporting under IFRS for comparability purposes. Lobingier further states that, “As U.S. public companies move toward IFRS, and the majority of all other countries already require reporting under IFRS, global knowledge, and possibly acceptance of, U.S. GAAP will decline,” (Lobingier).

The idea that GAAP may become less universally accepted as there is a large movement to IFRS would also create pressure for private companies to convert to some form of IFRS, even if not necessarily the full version accepted by public companies. However, the consideration of reporting under IFRS for private companies will likely be a process that takes place over years and on an individual time frame rather than a herd movement. In the interim, one must consider the consequences of the existence of two standard sets in use within the United States. With a three year phase-in of IFRS for public companies and private companies still reporting under GAAP, there will need to be considerations on how to maintain appropriate measures and indicators for both methods of reporting. More importantly, there will likely be a much less significant effect on comparability while GAAP and IFRS are both in use still within the United States.

In light of the previous discussion regarding the effects of a transition to IFRS on lending and analysis agencies, it would seem that it could at least be argued that for an undetermined interim period where both reporting methods are used, there will not be a decrease in the cost of capital. Taking into consideration the amount of resources that will be required to invest into research and implementation of new practices as well as maintaining the current practices there
must be a decline in efficiency that will be observed. Further, until the new standards are completely understood there will be an assumed increase in uncertainty and information risk taken by users. These effects both would put temporary upward pressure on the cost of capital, even if not indefinitely.

Finally, Moody's concluded on whether IFRS was able to achieve the much desired increase in comparability and transparency. In reference to their report Leone summarized, "statements prepared using IFRS are not necessarily any easier to compare. In some circumstances, the lack of comparability is blamed on a deficiency in standardization. In other instances, Moody's cites several 'seemingly inconsistent interpretations by companies and their auditors,'" (Leone). If this assessment were to hold true across users of financial statements in the United States, then the desired result cannot be observed. The ultimate goal as stated previously is to create a higher quality and more transparent set of financial statements that could be universally understood by all users, therefore removing geographic barriers to capital flow and investment. One major oversight in creating this single set of standards has been to consider the investors themselves. Through the use of a single standard set, companies will likely list on more foreign exchanges in an effort to expand their base of capital accumulation. However, if investors do not believe in the enhanced quality of reporting; if they do not observe better transparency through the homogenization, then there simply will be no observed decreases in the risks and costs of supplying financial capital and consequently no significant positive effect on the flow of capital.
Conclusion

Considering the possible effects mentioned to this point, it appears that there is still much thought necessary to be put into the idea of conforming to an international set of accounting standards in an effort to increase efficiency and expand capital markets. It is easy to see how an international standard set for reporting can benefit companies and users alike. However, in order for the model to hold that was mentioned at the outset of this chapter, nations must accept essentially the same set of standards without revising them or partially maintaining their own standard set as well. Furthermore, users must expend the necessary resources to understand the implications and revise their interpretation methods while still maintaining an efficient process of interpretation and analysis. They also must ultimately find the new standards to be more reliable and transparent thus mitigating risk and increasing the supply of financial capital. If these criteria are not likely to be met, the desired effect cannot be expected.

As mentioned above there are likely major implications for companies, lenders and other users of financial statements that seem to be underestimated. Much time and resources will need to be invested in order for them to understand all of the effects and react appropriately in relation to automated systems, contracts and negotiations, ratings criteria, etc. before going back to normal business operations and regaining the efficiency achieved prior to the transition.

In review of the effects observed through the European transition there was a decrease in comparability among firms due to the variance in interpretation of standards as well as the underlying failure to maintain the same set of IFRS across nations. As was seen in the analysis of chapter 3, it is difficult to draw broad expectations of quantitative effects. Given also the knowledge of the amount of detail in standards that will be forfeited in a movement from GAAP
and the legal consequences that might result in such a litigious business world as exists in the United States, it is still too soon to fully understand the impact of the transition on U.S. companies, regulators and users of the financial statements.

Beyond the uncertainty that still remains regarding the effects of a transition, we must take into consideration the existent uncertainty in regards to a timeline of implementation as well. In light of the current economic downturn within the United States and the costliness to firms and other affected organizations, it is hard to believe that the timeline set forth before the onset of the financial crisis that was experienced will go forth unaltered. Moreover, the new chairman of the SEC who is still hesitant about the strength of the international standards and the independence of the IASB will certainly have a hand in ensuring viability and effectiveness of a transition to IFRS before moving forward with making such demands on public companies.

While significant headway has been made in the exposure of firms and users to IFRS and preparatory efforts are being outlined and scheduled to allow for successful transitioning within the United States, through data analysis and theoretical discussion it still remains an uncertainty as to what the extent of the effects of IFRS will be on financial statements and thus the reactions of investors and other users of the financial statement information. Given the likelihood of many unforeseen setbacks and obstacles, some of which have been mentioned in chapter 5, and of an actual decrease in comparability as was observed in Europe’s experience, it is more reasonable to follow a theoretical expectation of an increase in the cost of capital for at least an interim period of adjustment thus creating a hindrance of any expansion within the global capital markets. Furthermore, at present it is very likely that the implementation of IFRS will be at least postponed within the United States from the initial proposal of transitions as early as 2014.
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Reconciliation from Net Profit under FRS to Net Income under GAAP
Located in 20-F filings with the SEC
Fiscal Year Ending 2006

<table>
<thead>
<tr>
<th></th>
<th>Pharmaceuticals</th>
<th>Technology</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>GSK</td>
<td>Novartis</td>
</tr>
<tr>
<td>Net Profit under FRS</td>
<td>£ (Millions)</td>
<td>$ (Millions)</td>
</tr>
<tr>
<td>Increases IFRS Income due to LTOA</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>10</td>
<td>64</td>
</tr>
<tr>
<td>Property, Plant &amp; Equipment</td>
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<td>66</td>
</tr>
<tr>
<td>Research &amp; Development</td>
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<td>-</td>
</tr>
<tr>
<td>Product Rights</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>All Other Increases</td>
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<td>0.00%</td>
</tr>
<tr>
<td>Inventory</td>
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<td>103</td>
</tr>
<tr>
<td>Income Taxes</td>
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<td>125</td>
</tr>
<tr>
<td>Other</td>
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</tr>
<tr>
<td>Total Increase</td>
<td>793</td>
<td>14.72%</td>
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<tr>
<td>Decreases IFRS Income due to LTOA</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>0.00%</td>
<td>0.00%</td>
</tr>
<tr>
<td>Property, Plant &amp; Equipment</td>
<td>-</td>
<td>(66)</td>
</tr>
<tr>
<td>Research &amp; Development</td>
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</tr>
<tr>
<td>Product Rights</td>
<td>(111)</td>
<td>-2.06%</td>
</tr>
<tr>
<td>Leasing</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>All Other Decreases</td>
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</tr>
<tr>
<td>Pension</td>
<td>-</td>
<td>0.00%</td>
</tr>
<tr>
<td>Business Combinations</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Income Taxes</td>
<td>-</td>
<td>0.00%</td>
</tr>
<tr>
<td>Other</td>
<td>(316)</td>
<td>-5.86%</td>
</tr>
<tr>
<td>Total Decrease</td>
<td>(1,717)</td>
<td>-31.86%</td>
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<tr>
<td>Net Impact on IFRS Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>LTCR</td>
<td>(1,387)</td>
<td>-25.74%</td>
</tr>
<tr>
<td>Other</td>
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<td>8.59%</td>
</tr>
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<td>Total Net Impact on IFRS Income</td>
<td>(924)</td>
<td>-17.15%</td>
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<tr>
<td>Net Income under GAAP</td>
<td>4,465</td>
<td>5,150</td>
</tr>
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</table>
### Reconciliation from Stockhold Equity under IFRS to GAAP

Located in 20-F filings with the SEC

Fiscal Year Ending 2006

<table>
<thead>
<tr>
<th>Pharmaceuticals</th>
<th></th>
<th>Technology</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GSK</strong></td>
<td><strong>Novartis</strong></td>
<td><strong>Sanofi-Avantis</strong></td>
</tr>
<tr>
<td>£ (Millions)</td>
<td>% Total Equity</td>
<td>£ (Millions)</td>
</tr>
<tr>
<td>Total equity under IFRS</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9,386</td>
<td>100%</td>
<td>41,294</td>
</tr>
<tr>
<td><strong>Increases IFRS Equity due to LTOA</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Goodwill</strong></td>
<td>17,949</td>
<td>191.2%</td>
</tr>
<tr>
<td><strong>Property, Plant &amp; Equipment</strong></td>
<td>183</td>
<td>1.9%</td>
</tr>
<tr>
<td><strong>Research &amp; Development</strong></td>
<td>-</td>
<td>0.0%</td>
</tr>
<tr>
<td><strong>Product Rights</strong></td>
<td>10,634</td>
<td>113.3%</td>
</tr>
<tr>
<td><strong>All Other Increases</strong></td>
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<td>0.4%</td>
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<tr>
<td><strong>Pension</strong></td>
<td>-</td>
<td>0.0%</td>
</tr>
<tr>
<td><strong>Business Combination</strong></td>
<td>-</td>
<td>0.0%</td>
</tr>
<tr>
<td><strong>Taxes</strong></td>
<td>-</td>
<td>0.0%</td>
</tr>
<tr>
<td><strong>Other</strong></td>
<td>539</td>
<td>5.7%</td>
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<tr>
<td><strong>Total Increase</strong></td>
<td>29,340</td>
<td>312.6%</td>
</tr>
<tr>
<td><strong>Decreases IFRS Equity due to LTOA</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Goodwill</strong></td>
<td>-</td>
<td>0.0%</td>
</tr>
<tr>
<td><strong>PP&amp;E</strong></td>
<td>(35)</td>
<td>-0.4%</td>
</tr>
<tr>
<td><strong>Research &amp; Development</strong></td>
<td>-</td>
<td>0.0%</td>
</tr>
<tr>
<td><strong>Product Rights</strong></td>
<td>-</td>
<td>0.0%</td>
</tr>
<tr>
<td><strong>Taxes</strong></td>
<td>-</td>
<td>0.0%</td>
</tr>
<tr>
<td><strong>All Other Decreases</strong></td>
<td>-</td>
<td>0.0%</td>
</tr>
<tr>
<td><strong>Pension</strong></td>
<td>(54)</td>
<td>-0.6%</td>
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<td><strong>Income Taxes</strong></td>
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<td><strong>Other Comp., Inc., Other</strong></td>
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<tr>
<td><strong>Total Decrease</strong></td>
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<td><strong>Net Impact on IFRS Equity</strong></td>
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<td></td>
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<tr>
<td><strong>LTOA</strong></td>
<td>28,731</td>
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<tr>
<td><strong>Other</strong></td>
<td>(3,464)</td>
<td>-36.9%</td>
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<tr>
<td><strong>Total Net Impact on IFRS Equity</strong></td>
<td>25,267</td>
<td>269.2%</td>
</tr>
<tr>
<td><strong>Total Shareholders' equity under GAAP</strong></td>
<td>34,653</td>
<td>41,670</td>
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