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**THE IMPLICATION OF US GAAP AND IFRS CONVERGENCE ON
AMERICAN BUSINESS**

2014

BY

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ABSTRACT

The purpose of this work is to discuss the ongoing process of convergence between IFRS and GAAP. It addresses some of the limitations of previous research related to this topic: namely, gives a more recent perspective than is currently available, and also discusses various aspects of the project in a single paper. This paper addresses the timeline of the project, the costs that it presents, the status of the convergence effort, and discusses possible outcomes of these efforts. This research compares, contrasts, and analyzes IFRS and GAAP in several key areas that were (or are still) keeping the standards apart.

INTRODUCTION

Accounting is said to be the language of business. Similar to the spoken word, there are different ways (different languages) used in different parts of the world. In the world of financial accounting, and more specifically, financial reporting, there are two general sets of reporting standards used by the major economies around the world: International Financial Reporting Standards (IFRS) and United States Generally Accepted Accounting Principles (US GAAP). There are two bodies responsible for these standards. The Federal Accounting Standards Board (FASB) for GAAP, and the International Accounting Standards Board (IASB) for IFRS.

There is a long standing debate over whether it would be in the best interest of the American business world to converge its accounting standards with those used by the majority of the rest of the industrialized world. There is even some debate over what the term convergence actually means. Some argue that convergence would mean the accounting standards would be based on the same standards and principles, while others say that convergence would mean that the same accounting outcome would be achieved, regardless of whether IFRS or GAAP were

used (Street, 2014). Convergence between the standards would provide a universal set of standards that would promote the comparability of financial reporting among businesses and across borders (Steinbach & Tang, 2014). However, changing accounting standards would be a major fundamental change for American companies that would differ from the way they have reported their business activities for most if not all of their existence. The costs of such a dramatic change, both financial and otherwise, could be immense. It is my belief that a single, converged set of standards would be ideal, but it is not likely to happen.

IFRS convergence is a hot button issue within the accounting discipline, and many scholars, businesspeople, and public accounting firms have weighed in on the issue. Generally, all parties agree that IFRS is a more principles based approach as opposed to GAAP, which is more rules based. One source commented that American accountants prefer this rules based approach to help divest themselves of as much liability as possible due to the high volume of lawsuits in the United States. The author goes on to say that the principles based IFRS allows more flexibility for its users than GAAP, in that it allows business professionals to use their experience and judgment to make decisions regarding financial reporting (Briginshaw, 2008). Related to the idea of GAAP being more rules based, it is also thought to be more conservative than IFRS. These philosophical differences between the ideals of the two standard setting bodies (FASB and IASB) mean that from the very beginning of the convergence project, it was easy to see that it was going to be extremely difficult to achieve full convergence.

In 2005, IFRS overtook GAAP as the most widely used set of accounting standards worldwide (Seay, 2014). As shown in figure one, the United States and Colombia are the only nations in the world pursuing IFRS convergence with no immediate plans. Notice in the diagram, most of the countries with no or unknown convergence plans are under developed

countries in Africa, countries experiencing political unrest in the Middle East, and communist Cuba. Those in favor of IFRS say that it is the “gold standard” for financial reporting in the global financial market, and that its increased use around the world places GAAP users at a disadvantage in attracting foreign investment (Seay, 2014).

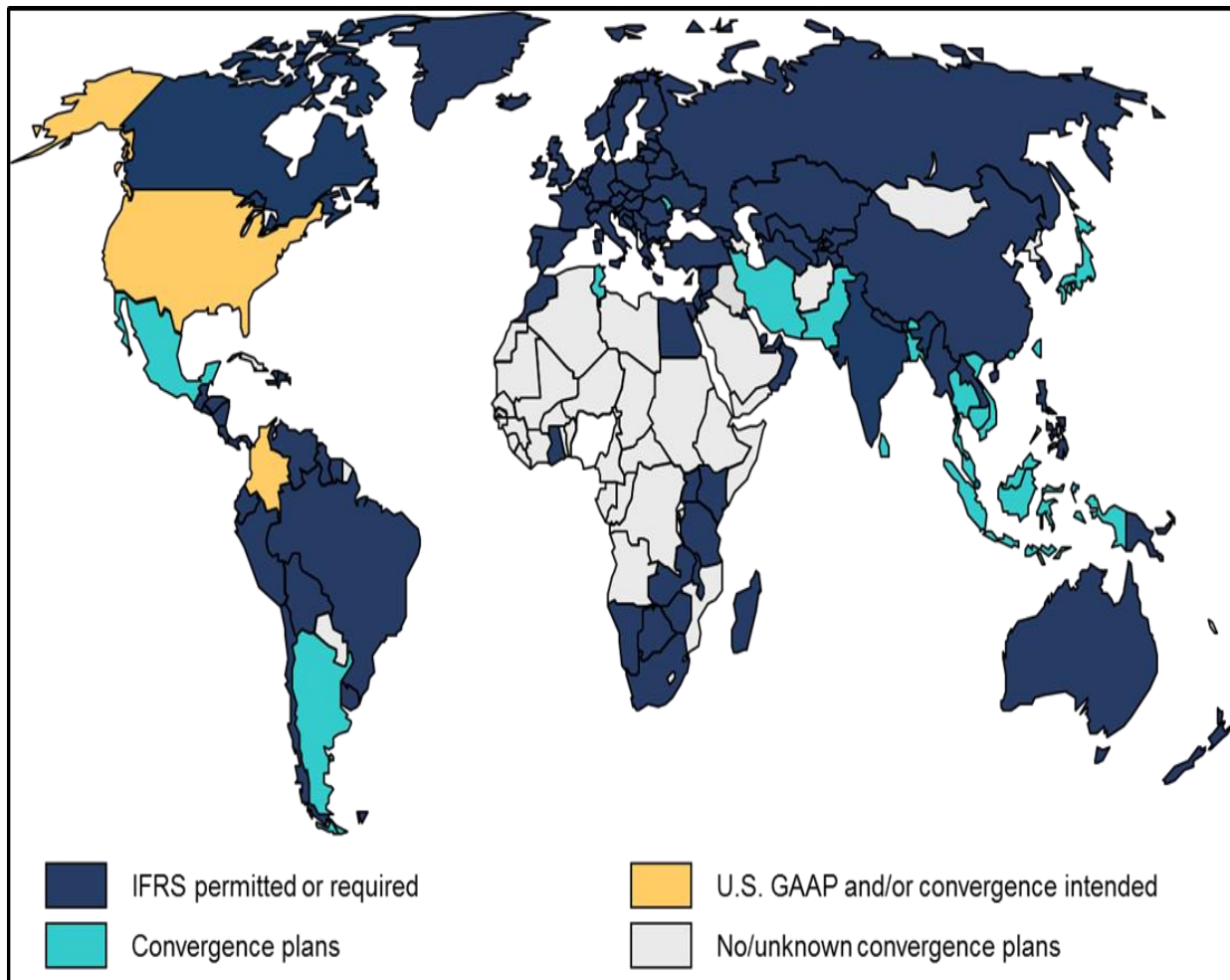


Figure 1- From Donna Street

Broken down by market capitalization, US GAAP is used by approximately 40% of the world, IFRS is 41%, and the remaining 19% using other standards (other nations’ generally accepted principles) (Street, 2014). The United States is responsible for roughly 35% of world market capitalization by itself (Fosbre, Fosbre, & Kraft, 2009). This means that it may be in the

best interest of both sides to converge standards, so that the business world is speaking the same language. There is some discrepancy among researchers over what the exact impact of convergence would be on company's bottom lines, but it is widely agreed that IFRS produces higher earnings than US GAAP, mainly because it is far less conservative (Briginshaw, 2008). A 2006 study found that IFRS produced earnings anywhere between 9 and 530 % higher than GAAP. Of course, this begs the question, if net income were to increase under IFRS, why is the convergence process still ongoing? This question will be addressed later in this paper.

TIMELINE OF THE CONVERGENCE PROCESS

As time has passed in the journey towards convergence between IFRS and US GAAP, the project has been delayed over and over again. No researcher can pinpoint an accurate date for when the process will be complete, or even if it will be completed, due to the numerous setbacks along the way. The need for a single set of standards dates as far back as 1950, when Harry McDonald, Chairman of the SEC at the time, said in a speech, "There is a need for an international language of accounting" (Street, 2014). The process was officially initiated in September of 2002 at a meeting in Norwalk, Connecticut where the FASB and IASB pledged to make their best effort to make their existing standards of financial reporting compatible and maintain that compatibility once achieved. This pledge became known as the Norwalk Agreement (Fischer & Marsh, 2012). In February of 2006, there was a memorandum of understanding issued between the two standard setting bodies. The memo reaffirmed the commitment to convergence, set guidelines on how to approach the talks, and presented goals to be accomplished by the end of 2008. It was updated in September of 2008 to delay the goals through 2011 (Street, 2014). As of now, convergence is still not complete.

Convergence was supposed to be completed by 2011, but as time has went on, the process has been pushed back further and further. The next conference between the FASB and IASB will be held in 2015 (Lozada Rivera, Robles Arbelo, & al., 2014). One source reported that in 2010, the SEC envisioned 2015 as the earliest possible date for IFRS adoption (McEnroe & Sullivan, 2014). This now seems highly unlikely, as there would need to be quite an epiphany between the sides before or during the previously mentioned conference. In 2009, an Indiana Professor predicted most public firms would need to publish IFRS financial statements by 2016. More recently, in a July 2012 report, the SEC said that they were not willing to issue a time table for the switch to IFRS (Lin, 2013). Finally, some researchers are not confident that convergence will happen at all. One article is quoted as saying, “It is becoming apparent that the differences between GAAP and IFRS are greater than previously thought and may be irreconcilable” (Reed & Pence, 2013). Figure two details the pessimistic downward spiral of convergence that the SEC has considered since 2007.

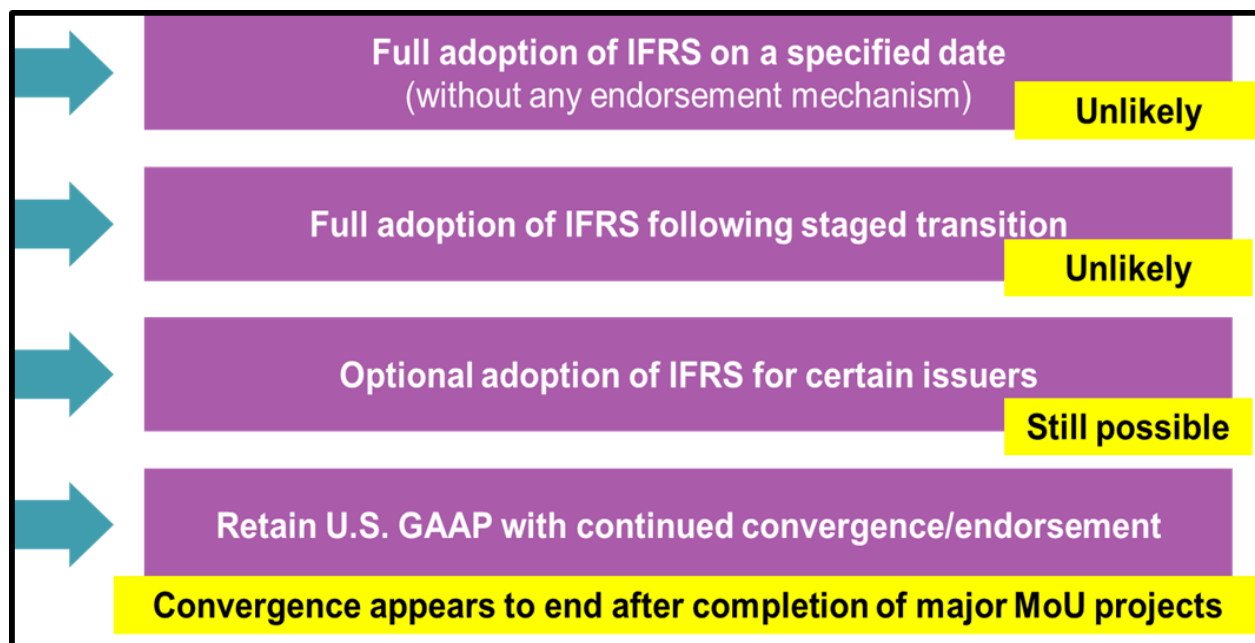


Figure 2- From Donna Street

COSTS OF CONVERGENCE

There are two general answers to the previously discussed question as to why convergence has not yet been achieved when it can be agreed that IFRS reports higher earnings. First, according to a group of professors from New Jersey, international entities are afraid that a converged set of standards under which the United States Securities and Exchange Commission (SEC) was a regulating body or had substantial input would give the United States economy too much power (Fosbre, Fosbre, & Kraft, 2009). Second, the costs that companies would incur in making the transition would be enormous. They would include the costs to train the workers and costs to implement new computer systems among other things. One source said that the SEC estimated the costs of transition could be over \$30 million for some companies (McEnroe & Sullivan, 2014). This estimate represents costs for small to average sized companies. Another source said that it would cost between 0.5 to 1 percent of annual revenues (not income) to make a full switch to IFRS. This could be between \$40-60 billion for companies in the S&P 500 (Lin, 2013). The costs that companies would incur in regards to convergence are not limited to monetary costs.

Sources differ as to exactly how much time it would take to implement a new IFRS accounting system. One put the time period between 18 and 24 months, saying that most of this time would be spent on extensive employee training (Fischer & Marsh, 2012). Another said that switching systems would cost most companies between two and three years of effort and 5% of revenue. The same source mentions that if IFRS is adopted in the United States, there will need to be a retraining period for financial managers and accountants to become acquainted with the new standards (Thomas, 2009). The first steps have been taken in recent years to prepare for a

possible convergence, with IFRS being tested on the uniform CPA (Certified Public Accountant) Exam.

Much of the research conducted previously in regards to reporting standard convergence has focused on academia. One scholar discussed that business schools would need to educate their students on IFRS to prepare them for their careers, but before they could educate students, the teachers would also need to be educated (Thomas, 2009). Another researcher said that students recognize that it is likely they will have to know IFRS at some point in their career and felt that they lacked training in IFRS, believed that their education would be outdated, and would feel overburdened attempting to master two different sets of standards (Tyson, 2011). In the textbook used for the intermediate financial accounting courses at Coastal Carolina University, which is the basis for the curriculum, IFRS is briefly touched upon at the end of each chapter. Generally IFRS content is condensed into four to five pages, and is not a focus of lecture and classroom discussion. The faculty has been placed in an awkward spot between looking forward to what could happen in the future and teaching what the student would need to know if they started their career immediately.

Auditors, the professionals responsible for examining a firm's financial statements to ensure that they fairly represent the financial activity of that firm in accordance with the appropriate accounting standards for the region in which they operate, would perhaps be tasked with the most difficult learning period. They would need to learn every aspect of the converged standards, as opposed to organizational accountants who are generally responsible for smaller pieces that come together to make up the financial statements. They would need an ever longer training period, which could potentially slow down financial operations for their clients. While there is some discrepancy in the exact measurements on the impact of convergence, it is clear

that it would be a costly process for businesses, businesspeople, and future businesspeople in America.

MAJOR ISSUES HOLDING UP CONVERGENCE

Introduction to Issues and Inventory Valuation

Although there are many differences, both philosophical and practical, between IFRS and US GAAP, there are a few accounting topics that have really slowed down the convergence process that are the focus of this research: inventory valuation, impairments, leases, revenue recognition, and financial statement presentation. Of these five items, four currently remain unresolved. Perhaps the most important difference between the two standards is inventory valuation, specifically the fact that IFRS does not permit the last-in-first-out (LIFO) method of valuing inventory. This method is used by approximately 36% of companies to value at least some part of their inventory (Reed & Pence, 2013). LIFO assumes that the most recent units purchased are the first units sold. Due to the economic theory that says prices are always rising in the long run, this increases the cost of goods sold (an expense). First-in-first out (FIFO), average cost, and specific identification are the only inventory valuation methods permitted by IFRS (Kieso, Weygandt, & Warfield, 2013). Under FIFO, the first units purchased (those purchased the earliest) are the first units sold. Average cost computes the mean purchase price of all inventory items on hand and applies that figure to the units sold and the units that remain in ending inventory. Specific identification matches the exact cost of each unit that is sold in a transaction. This is the only method that follows the physical flow of goods, and is usually not practical.

The incentive for firms operating under GAAP to use LIFO to value inventory is the fact that this method lowers taxable income (because cost of goods sold expense is higher), resulting

in a lower tax liability for the firm (Reed & Pence, 2013). Switching inventory methods would increase taxable income for the company (Briginshaw, 2008). This would definitely be in effect for the year following the year convergence was achieved. The Internal Revenue Service (IRS) could potentially issue additional penalties if companies did not amend their cost of goods sold for the full year in which the change was completed if the effective date was not January 1.

LIFO is thought to be a better method of valuation by accountants in America.

According to one source, LIFO profits are more stable than those generated by the FIFO method, and “LIFO produces a better measure of income and a higher quality of earnings” (Reed & Pence, 2013). This falls in line with the previously discussed fact that US GAAP is much more conservative than LIFO since net income is lower under LIFO. The same authors go on to say that incorporation with IFRS in this area seems to be the only reasonable solution, which allow for the United States to “carve out” the IFRS standard on cost flow assumption to allow for LIFO (Reed & Pence, 2013). Another material difference between IFRS and GAAP in regards to inventory valuation is the value at which inventory should be reported. IFRS requires lower of cost and net realizable value while GAAP requires lower of cost or market (Fischer & Marsh, 2012). Cost (under both standards) is what the seller paid to acquire the inventory. Under GAAP, the market price is “the cost to replace the item by purchase or reproduction” (Kieso, Weygandt, & Warfield, 2013). Under IFRS, net realizable value is the original cost less estimated costs to complete and sell. Net realizable value is a key component in the determination of market costs. It is the ceiling for the market cost (highest it could potentially be). The floor for market cost is the net realizable value less the normal profit margin.

Impairments

The next main difference between the two sets of standards is the method of measuring and recording impairments. An impairment occurs when the fair value of an asset (its worth on the open market) is less than its carrying value on a company's books. The two most fundamental differences between US GAAP and IFRS regarding impairments is the test to identify and measure an impairment and the fact that IFRS permits impairment reversal. Each set of standards seems to be superior to the other regarding certain areas of accounting for impairment. Therefore, a converged standard should be a compromise, incorporating the best ideals from each side.

One source details the benefits of both IFRS and GAAP relating to impairments. These researchers seem to favor the FASB's two step test of measuring impairments over the one step test utilized by the IASB. The first test measures if the fair value of the asset is less than its book value, and if it is, a second test is done to measure the impairment. The scholars say that IFRS measures an impairment without being sure that one exists. Additionally, these scholars like the IASB's stance on allowing reversal of impairments, because once an asset is written down due to impairment, the carrying value of the asset changes. If the market value increases after the write down, the assets are understated on the firm's balance sheet (Hamilton, Hyland, & Dodd, 2011). IFRS however, allows assets to be written back up so that the value on a company's books more closely represents their market value (Briginshaw, 2008). Under US GAAP, once an asset is written down due to impairment, it can never be written back up. Impairments are most often thought of in regards to fixed assets and goodwill, but can also affect financial instruments. According to one source, the issue of impairments has created a rift between the two standard setting bodies, and the FASB and IASB will have to control that rift in order to make progress on the convergence project (Etherdige & Hsia Yu Hsu, 2013).

Financial Statement Presentation

The next difference between the International Financial Reporting Standards and United States Generally Accepted Accounting Principles that is the focus of this research is financial statement presentation. The two most important financial statements are the balance sheet and income statement. The most obvious difference in this area is that IFRS does not prescribe a specific format for these two financial statements (Fischer & Marsh, 2012). Under US GAAP, assets are required to be stated first on the balance sheet, followed by liabilities and then owners' equity. Additionally, current assets must be stated before long term assets, and current liabilities must be stated before long term liabilities. Within the current assets section, assets must be presented in order of liquidity. Liquidity refers to how quickly the asset can be converted into cash.

GAAP also provides more stringent requirements with regard to the income statement. IFRS provides minimum requirements that must be presented, and leaves room for interpretation for how companies report other items. The six elements are revenue, finance costs, profit and loss from associates and joint ventures, tax expense, discontinued operations, and the profit or loss (bottom line). US GAAP prescribes two formats that may be used (single step or multi-step) and the SEC says that expenses must be presented by function (Fischer & Marsh, 2012). This means that GAAP income statements are much more detailed than IFRS statements. Also, IFRS does not define key points in the income statements that are commonly used for various measurements, such as income from operations and other non-operating income (Kieso, Weygandt, & Warfield, 2013).

IFRS also prohibits extraordinary items, which provide companies a tax break under US GAAP (Fischer & Marsh, 2012). Under GAAP, extraordinary items are those events deemed unusual in nature and infrequent in occurrence that materially affect the finances of a company (Kieso, Weygandt, & Warfield, 2013). Examples would include natural events such as hurricanes, earthquakes, or tornadoes (assuming that the event occurs in an area that is not usually prone to these kinds of natural phenomena). In December 2007, the SEC unanimously passed a rule that allowed certain foreign business entities that are listed on the various United States stock exchanges to file IFRS financial statements to the SEC if they chose to do so. Many domestic firms argued that this same choice should be afforded to them as well (McEnroe & Sullivan, 2014). At the time, this seemed to be a huge step towards the eventual total convergence of US GAAP and IFRS.

Leases

The final issue differing between IFRS and US GAAP outlined in the memorandum of understanding that will be discussed in this research is leases. There are a few differences related to leases, the most obvious is that what is known as a capital lease under GAAP is called a finance lease under IFRS. When a capital (finance) lease is recorded, a company sets up the lease on its books as an asset or liability. The asset is then depreciated by the lessee and not the lessor.

Another major difference related to capitalization of leases involves the criteria used to determine if a lease is a capital lease or an operating lease. IFRS says to capitalize a lease if “substantially all” risks and rewards of ownership have been transferred to the lessee. GAAP, however, outlines strict requirements for lease capitalization. For example, one of the four

criteria that determines if a lease is a capital lease is the present value of the minimum lease payments has to be greater than or equal to 90% of the fair value of the leased asset. Another example is that the term of the lease has to be at least 75% of the economic life of the asset (Kieso, Weygandt, & Warfield, 2013). This is another example of how GAAP is more rules based and IFRS is more principles based.

The differences discussed above could potentially lead to a company capitalizing a lease under one set of standards and not the other. The difference between a capitalized and non-capitalized (operating) lease is huge. Under an operating lease, no asset or liability is recorded on the company books. Instead the rental payments are simply expensed as they are incurred. This is advantageous for company's because the debt ratio is not affected, which is a key metric investors use to make decisions. This causes firms to make every effort to avoid capitalizing leases whenever possible.

Other differences include under IFRS, the lessees use the implicit rate of interest in accounting for leases unless it is impractical to determine that rate. GAAP requires the incremental interest rate to be used unless the implicit rate is lower than the incremental rate and the implicit rate is known by the lessee. The implicit rate is the lessor's desired rate of return and the incremental rate is the rate that the lessee would expect to pay if they borrowed money from a financial institution to purchase the asset (Kieso, Weygandt, & Warfield, 2013). Also, under IFRS, gains on sale and leaseback transactions are realized at the time of the transaction while under GAAP, the gain is amortized over the life of the lease (Hughes & Sander, 2007). This affects the other non-operating section of the income statement. According to one source, a converged standard regarding accounting for leases could be issued in 2015 (Street, 2014).

Revenue Recognition

All four issues that were previously mentioned: inventory valuation, impairments, financial statement presentation, and leases, are still treated differently between IFRS and GAAP. However, as will be discussed later, the final issue, revenue recognition, has recently been solved. Revenue recognition refers to when a company makes the entry (or recognizes) to indicate that they have earned the proceeds from a transaction. The IFRS standard recognized revenue whenever a sale occurred, whereas under US GAAP, recognition was deferred until after the earnings process had been completed (Fosbre, Fosbre, & Kraft, 2009). This coincided with the FASB conceptual framework's matching principle, which says that revenues were to be matched with the expenses that helped generate them. Also, the IFRS standard did not require deferred payments to be discounted to the present value in the measurement of revenue, where GAAP did. Additionally, GAAP required companies to estimate sales returns and IFRS did not. Ultimately, since US GAAP is more rules based, it provided far more instruction regarding revenue recognition. There were over one hundred standards in GAAP regarding revenue recognition, and only two in IFRS (Bohusova & Nerudova, 2009).

In the case of long-term construction contracts, three methods of revenue recognition were permitted under US GAAP: the completed contract method, the cost recovery method, and the percentage-of-completion method. The completed contract method was prohibited under IFRS (Seay, 2014). The completed contract method recognizes revenue when the project is finished, the percentage-of-completion method allocates revenue to be recognized based on the percentage of the estimated total contract costs that were completed during the period, and the cost recovery method does not allow revenue to be recognized until the revenues exceed the total costs (until the project is profitable).

One researcher focused his study on the formation of a revenue recognition transition group between the FASB and IASB to help companies change to a converged standard. The group would be made up of members of both sides, and if it works well, it could provide a model that may be used in other areas of the convergence project (Cohn, 2013). This method will be put to the test very soon, because in May 2014, a mostly converged standard was agreed upon between the IASB and FASB.

On May 28, 2014, IFRS 15/ASU 2014-09 was issued. This was the first converged, mostly converged, or partially converged standard issued since 2011 (Street, 2014). The new standard applies to all sales (not lease) contracts except for those for insurance, financial instruments, nonmonetary transactions between companies in the same line of business, and certain guarantees that fall within the scope of other standards. The new standard outlined a five step approach for recognizing revenue. First, a contract has to be identified. Next, the performance obligations of all of the parties involved must be identified before the third step, the determination of the transaction price. The fourth step is allocating the price to the separate performance obligations, and the final step is to recognize revenue as the obligations are completed (PricewaterhouseCoopers, 2014). After a long stagnant period, this recent development gives those in the accounting community substantial reason to believe that IFRS and US GAAP will continue to move closer together at the very least.

CONCLUSION AND AUTHOR PREDICTION

In conclusion, convergence between International Financial Reporting Standards and United States Generally Accepted Accounting Principles has been a long and drawn out process. It is widely debated within the field whether convergence would be in the best interest of

American accountants. There would be high monetary and non-monetary costs involved in making such a switch, and the United States may have to sacrifice some political power with regard to standard setting in order for other countries to agree to a converged system. There are many differences between the two sets of standards, including inventory valuation, impairments, leases, and financial statement presentation (among other things). However, recently the two sides have agreed on a mostly converged standard dealing with revenue recognition. Table one summarizes the most important differences between IFRS and US GAAP.

| Issue | GAAP | IFRS | Status/Comments |
|----------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------|
| Inventory Valuation | FIFO, average cost, specific identification, and LIFO permitted; inventory reported at lower of cost or market | LIFO prohibited; inventory reported at lower of cost or net realizable value | GAAP not likely to abandon LIFO so full convergence is not likely |
| Impairments | Two step test for impairments; reversal of impairment loss prohibited | One step test for impairments; allows impairments to be reversed (written back up to fair market value) | Not yet converged, combination of best points of two standards would seem to produce the best outcome |
| Revenue Recognition | Previously: revenue recognition after earnings process was complete, completed contract method, cost recovery method, and percentage of completion method could be used for long term construction contracts | Previously: Revenue recognized when sale occurs, completed contract method prohibited | “Mostly converged” standard released in May 2014, outlined five step approach for recognition of revenue |
| Financial Statement Presentation | Specific format prescribed for financial statements | Minimum requirements for financial statements, leaves room for interpretation by | SEC allows some companies who have operations overseas to file financial statements in |

| | | | |
|--------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------|
| | | business professionals; extraordinary items prohibited | accordance with IFRS |
| Leases | Specific rules outlined for when to capitalize a lease such as the lease life being at least 75% of the economic life of the asset and the present value of the minimum lease payments must be at least 90% of the fair market value of the asset | A lease is to be capitalized when “substantially all” risks and rewards of ownership have been transferred | Convergence in progress, possible converged standard to be issued in 2015 |

Table 1 - Summary of Issues

With business being more globalized than ever, it is highly likely that US businesses have customers, suppliers, investors, or other stakeholders that prepare financial statements in accordance with IFRS (Hughes & Sander, 2007). Most of the research done in regards to convergence recommends something to be done to make the world’s largest economy more comparable to the rest of the world. In a summary of comments to the SEC compiled by the big four public accounting firm, PricewaterhouseCoopers, 84% of respondents favor a single set of accounting standards, and 66% favor full convergence with IFRS (Tyson, 2011).

The above statistics reiterate the belief within the field that something needs to be done to bring IFRS and US GAAP closer together at the very least, if not fully converged into one single set of global accounting standards. They also point out that there are several gaping holes that still remain between the two sets of reporting standards, more than ten years after the Federal Accounting Standards Board and the International Accounting Standards Board agreed to pursue convergence at their meeting in Norwalk, Connecticut. I believe that while costs of

implementation of a new set of standards would be immense, over the long term, convergence would be very beneficial to American business as a whole because it would allow companies to compare themselves with their international competitors, which is become increasingly more important as the business world becomes more globalized and competitive every day. The recent agreement between the FASB and IASB with regards to revenue recognition is a positive sign, because it shows that even though the process has been slow, and has missed deadline after deadline, the two sides are not giving up on the project.

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