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ASSESSMENT OF THE ADOPTION OF IFRS IN FOREIGN COUNTRIES IN COMPARISON TO THE ANTICIPATED RESULTS OF UNITED STATES IFRS ADOPTION

A Thesis
Submitted
in Partial Fulfillment
of the Requirements for the Designation
University Honors

Emily Schippers
University of Northern Iowa
May 2011

This Study by: Emily Schippers

Entitled: *Assessment of the Adoption of IFRS in Foreign Countries in Comparison to the Anticipated Results of United States IFRS Adoption*

has been approved as meeting the thesis or project requirement for the Designation University Honors with Distinction

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Mark Bauman, Honors Thesis/Project Advisor

5/6/11
Date

Jessica Moon, Director, University Honors Program

Abstract:

The importance of discussing implications of adoption of International Financial Reporting Standards (IFRS) in the U.S. is imperative to financial investors, audit committees, and corporations' management as IFRS may potentially impact earnings quality and the consistency of financial statements which in turn may influence earnings per share of that particular organization. As the standards are set to converge to IFRS tentatively in 2015 for the United States, it is essential to have some indication of what types of hindrances and differences will be a result of adopting a new set of financial reporting standards. This can be accomplished by examining other countries that have already been mandated to replace their domestic generally accepted accounting principles (GAAP) with those of the International Financial Reporting Standards in order to predict what implications will be evident to United States corporations when the adoption becomes mandated by the Securities and Exchange Commission (SEC) in 2015.

Through my research and examination of impacts of IFRS adoption in Hong Kong, the European Union, and Australia it can be concluded that the U.S. will experience similar results to these countries with immaterial effects on the financial statements. Since the U.S. has been engaged in early convergence efforts consistent with the countries evaluated, financial impacts of IFRS adoption will be minimal. Although financial impacts will be minimal, the U.S can expect to experience beneficial consequences such as less managing of earnings, reduced cost of capital, and a higher accounting quality as experienced by the other countries. It is crucial for the United States to begin early convergence efforts to minimize any material differences that may arise between IFRS and U.S. at the time of adoption.

Introduction

Currently, the SEC has delegated its authority to set accounting standards in the U.S. to a private sector organization called the Financial Accounting Standards Board (FASB). U.S. GAAP are used in preparation, presentation, and reporting of financial statements by publicly held companies as well as many privately held companies. U.S. GAAP follow a rules-based approach that provides a set of specific guidelines to follow when accounting for transactions and preparing financial statements while leaving little room for interpretation by management. Many advocates of a rules-based approach to accounting argue that it is more effective in large, complex economies such as the U.S., and it provides less need for explanation in the financial statements (McGladrey "Principles"). While the SEC has delegated its authority to set accounting standards, it is still the enforcing body of U.S. GAAP.

International Financial Reporting Standards are standards set by the International Accounting Standards Board (IASB) in an effort to conform all accounting standards throughout the world into one set of global standards. The IASB is a committee independent of any government oversight based in London which consists of 15 members from nine different countries including the United States. The IASB believes the adoption of IFRS by all countries in the world will allow for better comparison between companies' financial statements from country to country. As the economy is turning to a global market, the IASB believes a universal set of accounting standards will ease the confusion between financial statements of different countries.

While many executives from large corporations within the U.S. recognize it is becoming a global market and financial reporting among some countries needs

improvement, some do not believe the U.S. is one of those countries. The U.S. is considered to be at a high accounting quality level, and many throughout the U.S. do not believe we need to make any changes. According to a recent survey conducted by PricewaterhouseCoopers, 23% of respondents believed U.S. GAAP was already of high enough quality without the adoption of IFRS, and 37% believed the costs associated with implementing IFRS would outweigh the potential improvements.

Regardless of opinions expressed by executives within the United States, the FASB and SEC have tentatively set the U.S. to adopt IFRS on January 1, 2015. Along with this implementation there is much speculation and apprehension about the consequences associated with this change related to costs and benefits to organizations. By the time U.S. companies issue their first IFRS-prepared set of financial statements, the American Institute of Certified Public Accountants (AICPA) estimates large publicly traded companies could incur costs as great as $32 million or 0.125% of revenue which results in a significant cost. With approximately 90 nations and countries already having fully adopted IFRS, the United States is behind in global harmonization but may benefit from the experiences of other countries in preparation for its own adoption.

The more prepared and knowledgeable accountants in the United States can become on the consequences of post-IFRS, the better position they will be in to educate companies on these impacts. By analyzing Hong Kong, the European Union, and Australia and their adoption of IFRS, I intend to gain an insight of the possible effects the United States will experience when it adopts IFRS. It is my intent to parallel the

experiences of these countries to forecast the potential impact IFRS may have on financial statements and reporting in the United States.

Hong Kong

Prior to the adoption of IFRS in Hong Kong, companies were using Hong Kong Financial Reporting Standards (HKFRS) set by the Hong Kong Society of Accountants (HKSA) with the input of the Financial Accounting Standards Committee. On January 1, 2005 Hong Kong adopted International Financial Reporting Standards which resulted in much stricter standards for companies to follow compared to their previous standards. While Hong Kong had been preparing for the adoption by converging some of its HKFRS with proposed IFRS in prior years, there was still a great deal of change involved with the full adoption of IFRS. The adoption of IFRS caused many of the island entities surrounding Hong Kong to be subject to accounting and auditing standards they were not accustomed to before the adoption of IFRS, but it now allows them to benchmark themselves against other international markets and allow for a greater level of consistency among financial reporting (Evans 23).

When Hong Kong adopted IFRS initially, there were some differences between HKFRS and IFRS that caused confusion and dissension among financial statement preparers. These differences between reporting standards required public companies to prepare two sets of financial statements: one following the requirements of IFRS and the other following HKFRS. One area that had a significant outstanding difference between the two sets of reporting standards was fair value hedge accounting. According to HKFRS, asset and liability accounts that were hedged at the IFRS date were

adjusted by an amount equal to the fair value of the hedging instrument at that date. Contrary, IFRS stated upon adoption, hedged items should be adjusted by the lesser of cumulative change in the fair value that reflects the designated hedged risk not previously recognized under standards prior to the adoption, or the amount that was accounted for in a deferred asset or liability (Cheong, Kim, and Zurbruegg). By requiring all hedged assets or liabilities to be accounted for using the fair value approach specified by IFRS, accounting for them became much more complex and subjective. These reporting differences caused discrepancies related to the fair value measurement of assets and liabilities at the time of IFRs adoption.

Another major difference and area of compliance between HKFRS and IFRS was in the area of goodwill accounting and impairment. Prior to any IASB involvement, Hong Kong standards specified that goodwill was typically written off against reserves upon acquisition or amortized against earnings (Carlin, Finch and Tran 4). However, once IFRS were implemented this was no longer allowed, and goodwill was tested for impairment instead of amortizing it. This difference resulted in many companies not following this specific IFRS guideline relating to the stricter impairment testing framework which raised questions as to whether this non-compliance could materially affect financial statements (Carlin, Finch, and Tran 5). While the Monitoring Board of the IASB is responsible for the monitoring of public capital markets, the IASB cannot specifically enforce or assess penalties to companies not complying with IFRS (Milestones). Enforcing IFRS is the responsibility of Hong Kong's government and how it chooses to regulate its public markets is an issue that is decided by the governing body of its stock exchange.

The exchange of assets between companies and how to account for the cost of that asset for the receiving entity was also an area that differed between HKFRS and IFRS. Under HKFRS, the cost of the asset received should be measured at fair value unless the transaction had no commercial substance or the assets exchanged had no reliable fair value. According to IFRS, all assets received in exchange must be recognized at fair value regardless of other circumstances. This extended use of fair value created much uncertainty when there were no consistent instruments to measure fair value of the assets exchanged (Cheong, Kim, and Zurbruegg).

While the preceding are a few of the many differences between HKFRS and IFRS that came into effect during the adoption of IFRS, they are examples of important discrepancies that had to be dealt with before Hong Kong companies were able to fully comply with International Financial Reporting Standards as well as their own Hong Kong Financial Reporting Standards. After the implementation of IFRS, all of Hong Kong and surrounding entities were still required to prepare their annual financial statements according to IFRS as well as HKFRS with a mandatory disclosure explanation on the differences between the mandatory international standards and domestic Hong Kong Financial Reporting Standards.

As of January 1, 2010 Hong Kong proposed a few minor changes to requirements of HKFRS that resulted in HKFRS and IFRS following all of the same standards. According to the Charltons Law Newsletter, due to the complete convergence between HKFRS and IFRS, companies were no longer required to disclose the reconciliations between IFRS and HKFRS as before since there were no

longer any recognizable discrepancies between the two. This amendment allowed for fewer disclosures as well as less confusion among users of the financial statements.

The only measurable variance in financial ratios as a result of the adoption of IFRS in Hong Kong was a slight increase in volatility in ratios caused by the increased use of fair value (Chen, Tang, Jiang, and Lin 270). Since IFRS relies heavily on the use of fair value measurements relating to assets and liabilities which can fluctuate greatly from year to year, the financial ratios were not as consistent with years prior when Hong Kong was using the historical cost approach. While volatility of ratios experienced a slight increase after the implementation of IFRS, Hong Kong did not encounter many other significant differences related to their financial ratios and earnings. This was a result of HKFRS preparing for the change by becoming more consistent with IFRS in years prior to the full adoption of IFRS by continuously revising their HKFRS which allowed for less drastic changes in accounting standards when IFRS was finally adopted.

Overall, while the convergence of local standards to the International Financial Reporting Standards was initially difficult to enforce and regulate because of the already poorly regulated market and reporting standards, Hong Kong encountered few major financial differences when adopting IFRS. Since they had been preparing in prior years to update their HKFRS to be more consistent with the impending IFRS, the conversion was much smoother than if they had used an "all in" approach and adopted IFRS without any previous convergence efforts among their accounting standards. Although Hong Kong did make a few minor improvements to its HKFRS after the implementation of IFRS, its standards are now fully consistent with all IFRS regulations. While Hong

Kong may now be following IFRS, their financial reporting is still often considered low in accounting quality due to poor preparer incentives and ramifications as well as economic and political factors influencing managers and auditors (Chen, Tang, Jiang, and Lin 222). With the government still not being particularly strict in its enforcement of IFRS, financial statement preparers often have few consequences and less incentive to adhere strictly to IFRS guidelines.

European Union

Under European Union (EU) Regulations, all EU firms have been preparing their consolidated financial statements in accordance with IFRS since 2005 (Bruggemann, Hitz, and Sellhorn 3). Prior to the adoption of the mandated use of IFRS, many countries followed their own generally accepted accounting principles that differed from the proposed IFRS regulations. Many European companies focused their accounting on developing financial statements for income tax purposes. They also made extensive use of the historical cost approach compared to IFRS' emphasis on fair value measurement.

Similar to Hong Kong discussed earlier, the European Union began revising many of its local GAAP prior to the implementation of IFRS in an attempt to lessen the impact when the actual adoption of IFRS became mandated. As with most countries, Europe's main concern was the unintended consequences on the financial markets during the transitional period when IFRS financial statements were first issued. To combat this looming disruption, in 2003 the Committee of European Securities Regulators (CESR) began issuing a recommended phased transition process to lessen the initial drastic impact of converting to IFRS.

One important aspect to note when discussing the impacts to financial statements with regard to the mandated implementation of IFRS is the proximity of local GAAP and IFRS before the adoption. Impacts were generally found to be smaller when companies had been working towards revising their local GAAP to be more consistent with the impending IFRS. With the consistencies between the two reporting standards, companies often experienced minimal changes and trends when converting to IFRS as compared to the previous local GAAP.

Prior to the adoption of IFRS in Europe, there was controversy surrounding two key standards: IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 32 *Financial Instruments: Disclosure and Presentation* (Armstrong 6). Provisions in these two new standards could potentially have a direct and material effect on banks or any companies holding a large number of financial instruments. The main debate surrounding IAS 39 dealt with the recognition of derivatives held at fair value and the corresponding changes in fair value recognized as profit or loss. Another controversial aspect of IAS 39 was the limited use of hedge accounting. By not permitting hedge accounting for certain interest risks, banks in particular experienced a significant change from their domestic GAAP as they had previously hedged the interest risk associated with core demand deposits (Armstrong 7).

After the implementation of IFRS in 2005, companies were uncertain of the true consequences the adoption had, if any, on their financial statements and financial ratios. A report by Peyret and Rueff followed a study focused on four significant financial metrics: revenue, net income, equity, and financial indebtedness. The study found no considerable differences related to the income statement, and any impact on revenue

was mainly due to reclassification differences between debt and equity with little impact on the operating profit (Peyret and Rueff). The only consequence discovered related to income and operating profit was a slight trend in profit increase caused largely by the discontinuation of amortizing goodwill under the new IFRS (Peyret and Rueff). According to this survey, they discovered no significant changes in equity and financial indebtedness.

In a study conducted by Aubert and Grudnitski in the examination of the effect IFRS adoption had within European countries on financial ratios such as return on assets (ROA) and return on equity (ROE), they were able to gather evidence supporting an overall 2.8% increase in ROA in all industry sectors computed under IFRS as compared to local GAAP. When delving into the consequences of this increase in ROA, they were unable to find the exact cause of this increase, but they did explore some of the key consequences related to the increase. After discerning the percentage changes between ROA calculated under IFRS and local GAAP, Aubert and Grudnitski examined "whether market-based quality of earnings were more value relevant and timely, and discretionary accruals were of higher quality when constructed under IFRS"(Aubert and Grudnitski 24) than local GAAP.

For my research paper, the two areas of concern relate to the value relevancy and timeliness of quality of earnings. After evaluating all the evidence gathered, Aubert and Grudnitski were unable to find any evidence directly supporting the increased value relevancy and timeliness of quality of earnings under IFRS compared to local GAAP (Aubert and Grudnitski 20-21.) Thus, according to this specific research study, while there is no specific accounting change that explains the ROA increase under IFRS, it

cannot be concluded that more value be placed on the quality of earnings for a company merely because it is prepared under IFRS.

In a study performed by Chen, Tang, Jiang, and Lin (2010), known hereafter as Chen, regarding the impacts of IFRS in the European Union, they conclude that accounting quality has increased based on the implementation of IFRS. While this term may be relative and rather vague, they operationalize the concept by selecting two categories of accounting quality measures: earnings management and timely loss recognition (Chen, Tang, Jiang, and Lin 229). By selecting and analyzing data of specific European Union countries and comparing this data pre- and post- IFRS implementation, Chen found evidence supporting the accounting quality improvement after IFRS adoption.

An excerpt from his journal article summarizes significant findings related to an increase in accounting quality as a result of IFRS adoption:

*"There is less of managing earnings toward a target, a smaller magnitude of absolute discretionary accruals, and higher accruals quality after IFRS adoption. However, firms engage in more earnings smoothing and less timely recognition of large losses even after IFRS adoption" (*Chen, Tang, Jiang, and Lin *223).*

IFRS as compared to local GAAP offers far fewer accounting alternatives for management which may in turn be the driving force in the decrease of management's ability to manage earnings toward a target. While economic and political factors may influence management to manage earnings, IFRS provide them with less opportunities or options to do so. Also, IFRS regulations are very straight-forward and direct as compared to the more vague and ambiguous local GAAP which previously allowed

companies to manage earnings (Chen, Tang, Jiang, and Lin 223). With the increased scrutiny and knowledge of public stakeholders on the guidelines of IFRS, there is more pressure for companies to accurately and honestly report their financial performance.

Previous studies suggest that the timely recognition of large losses is a sign of higher accounting quality (Chen, Tang, Jiang, and Lin 236). In connection with IFRS, it would be assumed that with a higher accounting quality, losses would be recognized on a more timely basis after the adoption of IFRS. Contrary to their hypothesis, Chen concluded that large losses were actually recognized in a less timely manner after the adoption period (Chen, Tang, Jiang, and Lin 261). Causes for this unintended consequence were unknown.

Although IFRS did not improve the timely recognition of losses or earnings smoothing in the European Union based on this particular research study by Chen, it did assist in decreasing the ability of a company to manage its earnings toward a specific target. This was accomplished by strict regulations and less alternative choices for accounting methods. While IFRS did not improve accounting quality to the extent hoped for by the researcher in this study, it did demonstrate an improvement over previous GAAP.

As IFRS reduces the information asymmetry between investors and companies through an increased level of disclosure, experts have speculated that IFRS has resulted in a reduced cost of capital (Palea 3). In Palea's study of the European financial industry, she is able to present evidence that supports this speculated consequence. A basic economic theory reiterated by Palea addresses the reduction in cost of capital based on a firm's greater amount of disclosure which causes less

uncertainty regarding information presented to the investor. According to this perspective, information asymmetries create added costs as the investors are unsure of the accuracy and truthful representation of the financial statements by the sellers (Palea 6). In order for buyers to overcome this uncertainty related to the illiquidity of certain investments, companies must issue capital at a discount, which results in fewer proceeds and thus, a higher cost of capital. With more disclosure requirements as mandated by IFRS, the amount of information asymmetries and uncertainty have decreased resulting in a lesser discount when securities are issued by companies. As the discount is reduced, companies receive more proceeds from the investors, thus decreasing their cost of capital.

When examining the multiple studies performed by researchers including the above mentioned, it can be concluded that on an overall basis considering the effects on factors such as financial statement preparation and financial reporting, the adoption of IFRS has resulted in positive consequences for the European Union. Initially companies were opposed to the more mandated used of fair value accounting and limited use of hedge accounting, but after the implementation of IFRS was set into place there did not appear to be material impacts on the financial statements in relation to these changes. The only areas that may have slightly affected income included the discontinued amortization of goodwill and the more heavily used fair vale accounting model. While the use of fair value accounting did result in earnings being somewhat more volatile from year to year, it essentially allowed for a more true and transparent representation of the assets and liabilities of companies.

With the allowance of fewer alternative methods of accounting to be used by management, financial statements are much more consistent and there is less opportunity for a company to manage earnings towards a specific target. Cost of capital for many organizations has also been reduced with the increased level of transparency for investors among the financial statements. Overall, sufficient evidence has been provided to demonstrate IFRS's positive influence over the accounting quality of many firms with the European Union. This allows investors to place more reliance on financial statements issued by a company as well as allow the company to be more confident in how it uses its financial statements to benchmark against other competitors in the industry.

Australia

Along with the European Union's plan to implement IFRS, Australia also set in motion and adopted IFRS on January 1, 2005. The decision among the Australian Accounting Standards Board to adopt IFRS was consistent with hopes of many European companies adopting IFRS such as a lower cost of capital, lower costs for preparers and auditors as only one set of financial statements must be prepared, and more transparency for investors (Australian Accounting Standards "IFRS" 7). Australia also hoped to improve the international comparability of its financial reporting with that of other major countries. To prepare for the adoption of IFRS, Australia began a convergence process starting in 1996 and concluding in 2002 with the publication of the *International Convergence and Harmonization Policy* which depicted some of the major differences between IFRS and domestic GAAP (Australian Accounting Standards Board

"FRC"). The *Policy* also enacted major reporting changes in the areas of controversy to become more consistent with the impending IFRS adoption in 2005.

While only countries listed on the Australian Stock Exchange (ASX) were required to adopt IFRS in 2005, many large, private sector companies chose to adopt as well to provide a higher quality of financial information (Grant Thornton "IFRS"). In a study conducted by Grant Thornton in 2009, four years after the adoption of IFRS in Australia, Grant Thornton examined the intended and unintended consequences related to the adoption. During a survey, four out of five respondents expressed positive feelings towards the implementation of IFRS, but not surprisingly, 80% conveyed their desire for a simplification of the current IFRS requirements (Grant Thornton "IFRS").

Similar to concern in the European Union, many companies felt apprehension surrounding IAS 32 *Financial Instruments: Disclosure and Presentation* which set a stricter definition of equity and could result in certain shares and hybrid instruments now being reclassified as liabilities (Australian Prudential Regulation Authority 3). Australian companies also had concern regarding IAS 39 and the demanding requirements for fair value accounting and the limitations of hedge accounting which was previously a universally used accounting method for derivatives in Australia.

Few studies have been performed on the after effects of the adoption of IFRS in Australia, but one study by Dunmore, Adzis, and Tripe (2010), hereafter referred to as Dunmore, provides positive evidence that after the adoption of IFRS, income smoothing through the financial industry had decreased (Dunmore, Adzis, and Tripe 4). Income smoothing among banks occurred when bank managers allocated high loss provisions in profitable years to offset the losses that would normally occur in less profitable years

(Dunmore, Adzis, and Tripe 5). This income smoothing does reduce the volatility of income, but it is deceiving to the shareholders regarding the bank's true performance. IAS 39 was controversial within the banking industry as it regulated loan impairment by reducing selective accounting methods, particularly accounting for loan loss provisions for banks. Although Dunmore's research provides solid evidence that income smoothing did decline in the banking industry after the adoption of IFRS in Australia, there is no conclusive evidence that directly links the decline to IAS 39 or shows an income smoothing decrease in other industries (Dunmore, Adzis, and Tripe 17).

Taylor and Tower (2009) researched the effect of IFRS fair value accounting on tax implications and valuation of assets and liabilities used in conjunction with determining maximum allowable debt related to the thin capitalization within Australia. According to Taylor and Tower, "the Australian thin capitalization provisions are designed to ensure that Australian and foreign owned multinational entities do not allocate an excessive amount of debt to their Australian operations or investments" (Taylor and Tower 38). Attempts to limit debt are accomplished by limiting the debt deductions Australian entities can claim against their taxable income. The valuation of specific assets, liabilities, and equity which may be significantly different under IFRS compared to the previous historical approach used in Australia relates to the tax deductibility of interest payments (Taylor and Tower 50). Through a study involving 105 Australian companies, Taylor and Tower concluded that "there is a statistically significant increase in the ratio of interest bearing liabilities to a measure of safe harbor debt amount on transition to IRFS adoption" (Taylor and Tower 50). Their research unveiled an increase of 13.19% in this safe harbor ratio. Implications of this increase

have resulted in many Australian companies being denied value interest payment tax deductions as a result of the changing fair value measurement related to IFRS.

Consistent with the findings of adoption of IFRS in Europe, Australia did not experience material financial effects with their adoption of IFRS (Australian Prudential Regulation Authority). While there were some minor effects such as tax implications and a decreased amount of income smoothing, neither of these were shown to have a material impact on the financial statements. Similar to the European Union, Australia also experienced a decrease in managing of earnings by companies as the disclosure requirements required the financial statements to be much more transparent. No research has been performed yet regarding the reduced cost of capital post-IFRS adoption, but I expect it to be consistent with findings in the European Union. Unlike Hong Kong, Australia did not have difficulty enforcing IFRS once it was adopted because they already had a highly regulated market. Since Australia had been in preparation for the adoption of IFRS for many years by developing their *International Convergence and Harmonization Policy* and had already paralleled many of its domestic GAAP, there weren't many significant differences remaining after the implementation of IFRS.

Expected Results in the United States

As the United States prepares to tentatively adopt IFRS in 2015, the Financial Accounting Standards Board has been working with the International Accounting Standards Board to eliminate differences between the two standards to make initial adopting smoother. As discussed in my analysis of Hong Kong, the European Union,

and Australia this was a critical step in preparing companies for the impacts of the IFRS adoption. In a most recent convergence attempt, the FASB has issued a proposal to establish consistency with IFRS in offsetting financial assets and liabilities on the balance sheet (Financial Accounting Standards Board). This significant difference between U.S. GAAP and IFRS results in the single largest quantitative difference in reported numbers on the balance sheet (Financial Accounting Standards Board). While the United States has continuously delayed its plan for IFRS convergence and more importantly, full adoption of IFRS, the FASB has demonstrated a commitment to pursing a path towards international convergence. This recent proposal is yet another example of this commitment.

After examining how IFRS adoption impacted companies and the market within Hong Kong, the European Union, and Australia, it has become apparent how critical domestic convergence efforts towards IFRS during the pre-adoption phase were to the success experienced by these countries. If they had not concentrated their efforts in years prior to the adoption of IFRS, I suspect their outcomes may have been significantly different. Based on these observations, I believe it is crucial for the FASB to continue focusing its efforts on paralleling its standards with the International Accounting Standards Board.

Although the FASB has been making convergence efforts with the IASB, the following are remaining controversial differences that must be resolved before the U.S. adopts IFRS:

- *Treatment of Intangible Assets* - Under IAS 38, a principles-based approach is used when determining classifications for intangible assets as

there is a recognizable distinction between the research phase and the development phase. Expenses incurred during the research phase are expensed as incurred into net income, while developmental expenses are capitalized on the balance sheet if the project demonstrates positive projected cash flows. On the contrary, U.S. GAAP recognizes all expenses as incurred regardless of phase except for the capitalization of development software costs under certain circumstances (McGladrey "Comparing").

- *Income Statement - Extraordinary Items* - U.S. GAAP currently allows companies to disclose unusual and infrequent transactions as extraordinary items listed specifically below operating income to convey to financial statement users significant events that affected the company during the year that were considered outside the scope of its ordinary business. IFRS prohibits the recognition and disclosure of extraordinary items as a separate line item and require them to be disclosed within operating income (Ernst and Young 6). This difference between reporting standards may cause confusion among stakeholders if unusual events having a material impact on net income are not disclosed as such under IFRS.
- *Inventory* - Under current U.S. GAAP, companies are permitted to use the last-in first-out (LIFO) approach when valuing inventory, but IFRS does not allow this cost method. IFRS also allows previously recognized impairment losses to be reversed if circumstances for write down no longer exist, whereas reversal of write-downs is not permissible under

U.S. GAAP (Ernst and Young 14). Depending on the rising or declining of prices at the time of inventory purchase, this difference would cause significant differences in the calculation of cost of goods sold between the two reporting standards. This would also result in tax implications for companies as they will no longer be allowed to use the LIFO inventory method which usually increases cost of goods sold resulting in lower taxable income. For companies focusing their efforts on paying the least amount of taxes, the elimination of LIFO will affect their financial statement preparation.

- *Impairment of Goodwill* - Under U.S. GAAP determining impairment of goodwill currently entails a two-step approach involving a recoverability test and impairment testing if requirements are met from the previous test. On the contrary, IFRS uses a simpler one-step approach (Ernst and Young 19). This difference of calculation techniques would still produce the same result and would not affect the financial statements, but it is an additional accounting technique that will have to be addressed by the U.S.
- *Revenue Recognition* - IFRS does not permit the use of the completed contract method when accounting for construction costs whereas U.S. GAAP allows either the percentage-of-completion or completed contracts method (Ernst and Young 35).
- *Fair Value and Hedge Accounting* –Under IFRS, hedge accounting for financial instruments is only available to entities under certain requirements and does not allow the “shortcut” method for interest rate

swaps whereas the "shortcut" method is permissible under U.S. GAAP (Grant Thornton "Comparison").

With these significant differences between U.S. GAAP and IFRS still outstanding, there is concern that if left unchanged before the adoption of IFRS the U.S. could experience considerable impacts on the financial statements once IFRS is fully adopted. There is also concern within the U.S. surrounding costs associated with changes in computerized accounting systems as well as internal controls related to the adoption of IFRS. With more information needed to comply with certain IFRS, accounting systems may not have the ability to capture all this information in their current operating state. Many of the major accounting systems used by large corporations such as SAP will need to be reconfigured to accommodate the changing accounting standards and need for more detailed information. According to a recent Deloitte publication, if companies are "viewing the adoption of IFRS as simply a reporting change it can lead to costly rework at a later date and/or cumbersome and inefficient processes" (Deloitte 1).

There is also great speculation regarding the increased cost in audit fees as a result of U.S. companies adopting IFRS. While there is no research pertaining to the differences in audit fees in pre-adoption versus post-adoption of IFRS in other countries, it is my belief that audit fees will initially increase in the year of adoption, but overall will not be materially different from current audit costs. This assumption is based on the fact that in the first year of adoption, auditors will be required to examine a broader range of financial transactions and data that are required to comply with IFRS. Also, audit work pertaining to the testing of internal control will have to be

revised to fit the specific reporting requirements of IFRS. While there may be an initial increase in audit costs, auditors will become accustomed to the different reporting requirements and the learning curve will increase causing auditors to become more efficient. As the learning curve increases audit fees will decrease to a level similar to that of fees before the IFRS adoption.

After analyzing the impacts of IFRS adoption in other countries and steps they had taken prior to the adoption, the U.S. can expect to have similar results especially to those of the European Union. Like the European Union, since U.S. GAAP already is considered having high-quality reporting standards and continued early efforts are being placed on convergence with IFRS, there will not be many material differences once the U.S. adopts IFRS. The EU had been preparing for years for the adoption of IFRS as has the U.S., and once adoption was finally achieved, they encountered few significant problems and differences.

While Hong Kong initially had trouble enforcing the new IFRS among management and auditors due to lack of incentives and ramifications, I do not see this paralleling within the U.S. The SEC along with the AICPA already have effective measures of control over financial reporting by management and corresponding work performed by auditors. Non-compliance with the mandated IFRS would result in companies being unable to register with the SEC and thus, an inability to remain a publicly listed company. This deterrent alone will most likely be enough motivation for U.S. corporations to comply with the mandated IFRS.

Consistent with the EU, Hong Kong, and Australia, the U.S will also experience less managing of earnings by management due to the decrease in accounting

alternatives. The higher level of transparency within financial statements will not allow for management to manipulate earnings as much which will likely result in a reduction of capital costs consistent with experiences in the European Union. Investors and stakeholders will be able to place a greater reliance on the financial statements because their preparation and reporting requirements are not left to the discretion of management.

Conclusion

In conclusion, after evaluating the effects of IFRS adoption, I believe the U.S. will recognize a slight beneficial result in its quality of financial reporting. With more disclosure requirements and less opportunities for managerial discretion in accounting applications, U.S. financial statements will gain a more reputable standing when compared to global financial statements. This is imperative as the global market is becoming increasingly more competitive and foreign economies are thriving. If the U.S. chooses to abandon its efforts in IFRS adoption, it could hinder its ability to compete within the global market.

Throughout my research within the topic of IFRS there were areas that hindered my ability to explore directions that I feel could have contributed to my thesis. In some of the countries I examined, there was not enough information on key topics I wanted to address within my research such as direct evidence relating to the impact on earnings per share and examples of specific International Accounting Standards that had a direct effect on financial statements. In regards to future research, I feel there are ample opportunities to explore specific International Accounting Standards that

affect different areas of the financial statements. Another area I would have like to expand on given more time and available prior research involves the impact on audit fees in other countries after the adoption of IFRS and anticipated effects within the U.S. Through my experience in the auditing field within the last year, I feel this research could be greatly expanded through a more in depth examination into how audit fees and processes would be affected after the adoption of IFRS.

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