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A COMPARISON OF IFRS AND US GAAP WITH POTENTIAL EFFECTS ON INVESTMENT ANALYSIS

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Abstract:

Drawing on the academic literature in accounting, finance and economics, we analyze economic and policy factors related to the potential adoption of International Financial Reporting Standards (IFRS) in the U.S. We highlight the unique institutional features of U.S. markets to assess the potential impact of IFRS adoption on the quality and comparability of U.S. reporting practices, the ensuing capital market effects, and the potential costs of switching from U.S. GAAP to IFRS. We also consider how a switch to IFRS may affect worldwide competition among accounting standards and standard setters, and discuss the political ramifications of such a decision on the standard setting process and on the governance structure of the International Accounting Standards Board. Our analysis shows that the decision to adopt IFRS mainly involves a cost-benefit tradeoff between (1) recurring, albeit modest, comparability benefits for investors, (2) recurring future cost savings that will largely accrue to multinational companies, and (3) one-time transition costs borne by all firms and the U.S. economy as a whole, including those from adjustments to U.S. institutions. We conclude by outlining several possible scenarios for the future of U.S. accounting standards, ranging from maintaining U.S. GAAP, letting firms decide whether and when to adopt IFRS, to the creation of a competing U.S. GAAPbasedset of global accounting standards that could serve as an alternative to IFRS.

1- Introduction and Overview;

The AICPA AAG-Investment provides assistance for preparing financial statements in conformity with US GAAP and provides specific guidance on industry accounting standards and practices for both SEC registered and nonregistered investment companies.

In June 2009, the FASB issued The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, which was codified in ASC 105-10. It establishes the FASB Accounting Standards Codification as the single source of authoritative accounting principles to be applied in the preparation of financial statements in conformity with US GAAP. The industry-specific guidance noted in AAG-Investment was codified primarily into ASC 946 Financial Services—Investment Companies.This publication will focus primarily on nonregistered investment companies.In June 2009, the FASB issued The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, which was codified in ASC 105-10. It establishes the FASB Accounting Standards Codification as the single source of authoritative accounting principles to be applied in the preparation of financial statements in conformity with US GAAP. The industry-specific guidance noted in AAG-Investment was codified primarily into ASC 946 Financial Services—Investment Companies.

The FASB and the IASB are working on approximately a dozen projects under the Memorandum of Understanding (MoU). The FASB and IASB originally targeted completion of the convergence projects by June 2011. In mid-2010, the FASB and IASB announced a modified strategy for completion of the convergence agenda that extended some projects into the second half of 2011 and beyond. The boards also committed to perform additional stakeholder outreach to allow for more participation in the standard-setting process. More recently, in their November updated progress report, the boards retained the target completion date of June 2011 or earlier for the convergence projects they consider most urgent (i.e., financial instruments, revenue recognition, leases, statement of comprehensive income and fair value measurement) and made changes to the timeline on certain lower-priority projects.
No matter the outcome of the SEC's decision and direction, the ongoing convergence and development of standards will result in significant changes in the United States. This, together with new regulations driven by the financial crisis and continued global adoption of IFRS, will result in an extended period of substantial change.Some areas where IFRS may significantly affect an investment company's financial statements include valuation, classification of capital, and consolidation. It is important to remember that IFRS is not only an accounting and reporting matter, but also affects operations including fund design, marketing, and investor relations. Conversions involve not only internal accounting functions but also investor communication, management, vendor contracts, information systems, financing agreements including debt covenants, and tax reporting and compliance. Therefore, it is important to train people working in these functions for investment companies in IFRS.

2. Why would investment companies want to think about IFRS now?

- **Focus on the challenge.** The next several years will bring major changes to US financial reporting. Whether changes arrive through convergence, an SEC-mandated move to IFRS, regulation, or continued voluntary IFRS adoption by private investment companies, the effect on US asset managers will be considerable.
- **Maintain corporate oversight.** IFRS adoption for statutory reporting continues in many territories. Influence transition timing, strategies, and policy decisions of non-US affiliates that are increasingly likely to be on some form of IFRS in the foreseeable future. Closely follow international acceptance of IFRS for statutory purposes.

- **Use scenario planning.** Incorporate likely convergence and IFRS adoption expectations into your strategic thinking and business planning. Consider the effects various alternative paths could have. Identify and consider the implications of business, accounting, tax structure, financing, long-term contractual commitment, investor, control systems and work-force related issues.
- **Identify what you can do now.** Be mindful of aspects of convergence and conversion that will take the longest. If highly probable changes can be made efficiently and without waste, get started addressing those challenges. Consider smaller controlled one-off projects where desirable.

The many distinctions between IFRS and US GAAP may affect an investment company's financial results. The biggest impact to investment companies is that IFRS is not industry-specific. Unlike US GAAP, there is no IFRS investment guide with an accounting framework designed specifically for the industry. As a result, investment companies reporting on IFRS will have to follow the same set of accounting principles applicable to all IFRS reporters in all industries around the globe. As such, investment companies will need to be aware of the effects that a potential move to IFRS could have on fund design, contracts, agreements, the calculation of net asset value (NAV), tax implications, etc., and to consider how these changes should be communicated to investors, regulators, and other users of financial data.Retrospective application of all IFRS effective at the reporting date is required for an entity's first IFRS financial statements, with some optional exemptions and limited mandatory exceptions.

An entity shall explain how the transition from previous GAAP to IFRS affected its reported financial position, financial performance, and cash flows. To comply with this transition requirement, reconciliations from previous GAAP to IFRS are required for reported equity at the date of transition to IFRS (i.e., the beginning of the earliest period presented in the first IFRS financial statements) and equity and profit and loss at the end of the latest period presented under the previous GAAP. The reconciliation should provide sufficient detail to enable users to understand the material adjustments to equity and the impact on profit or loss.

If the entity also presented a statement of cash flows under its previous GAAP, it shall explain any material adjustments to the statement of cash flows. For annual periods beginning on or after January 1, 2009, a first-time adopter is also required to present its opening balance sheet at the date of transition to IFRS.

3. First-time adoption of IFRS:

	US GAAP does not provide specific guidance for first-time adoption of its accounting framework, similar to that of IFRS 1, described below. However, first-time adoption of US GAAP does require full retrospective application unless some standards specify a different transitional treatment for first-time application). US GAAP has no requirement to present reconciliations of equity or income statement upon first-time adoption; however, the first-time adopter also needs to consider the requirements of the exchange where the company is listed and the legal or state jurisdiction where the company is based.
IFRS	IFRS 1, First-time Adoption of International Financial Reporting *Standards*, provides specific guidance on applying IFRS for the first time. First-time adoption of IFRS as a primary accounting basis generally requires full retrospective application of the standards, effective at the reporting date for the entity's first IFRS financial statements. However, IFRS 1 establishes optional exceptions (e.g., business combinations, employee benefits) and mandatory exceptions (e.g., hedge accounting, estimates) from retrospective application. An entity's first IFRS financial statements must present reconciliations of profit or loss in respect of the last period reported under previous GAAP, of equity at the end of the last period reported under previous GAAP and of equity at the start of the earliest period presented in the financial statements. These reconciliations should be presented in sufficient detail to enable users to understand the material adjustments made in the conversion to IFRS.

4. Conceptual Underpinnings:

This section provides the conceptual underpinnings for our report. As the case for IFRS adoption in the U.S. and in other countries is generally made on the basis of improvements inreporting quality and comparability across firms and countries, we focus on these two concepts and their economic consequences. First, we describe how financial reporting and disclosure quality are linked to important economic outcomes, i.e., market liquidity, firms' costs of capital and corporate decision-making. Second, we discuss how better comparability of reporting across firms and countries can affect these economic outcomes. Third, we emphasize that there are direct and indirect costs to improving corporate reporting and that these costs need to be traded off against the benefits of reporting improvements. It is important to note that, in this section, we use the terms "reporting" and "disclosure" in a very broad sense, encompassing the wealth of corporate information that firms provide to investors and other outside parties through various channels. Moreover, the terms "reporting" and "disclosure" refer to firms' *practices*, rather than the standards that govern them.

4.1. Effects of Improved Reporting and Disclosure Quality:

Corporate reporting can have many economic consequences and it is impossible to enumerate all of them. Moreover, not all effects are well understood and supported by evidence. The one that is probably best supported by theory and evidence is the effect of reporting quality on market liquidity.2 The idea is that information asymmetries among investors introduce adverse selection

into securities markets, i.e., less-informed investors are concerned about trading with better-informed investors. As a result, less-informed investors lower (increase) the price at which they are willing to buy (sell) asecurity to protect against the losses from trading with better-informed counterparties. Similarly, information asymmetry and adverse selection reduce the willingness of uninformed investors to trade. Both effects reduce the liquidity of securities markets, i.e., the ability of investors to quickly buy or sell shares at low cost and with little price impact. Corporate disclosure can mitigate the adverse selection problem and increase market liquidity by leveling the playing field among investors (Verrecchia, 2001). Empirical studies support this argument and provide evidence that better disclosures reduce information asymmetry and increase market liquidity (e.g., Welker, 1995; Healy et al., 1999; Leuz and Verrecchia, 2000; Bushee and Leuz, 2005).

In addition, better reporting and disclosure can affect the cost of capital. First, there is the notion that investors require a higher return from less liquid securities, which is in essence a liquidity premium (e.g., Amihud and Mendelson, 1986; Chordia et al., 2000; Easley et al., 2002). Second, better disclosure can lower investors' estimation risks, i.e., make it easier for investors to estimate firms' future cash flows. This effect can directly reduce the required rate of return of an individual security as well as the market risk premium of the entire economy (e.g., Easley and O'Hara, 2004; Lambert et al., 2007 and 2008). Third, better disclosure can improve risk sharing in the economy, either by making investors aware of certain securities or by making them more willing to hold them, which again reduces the cost of capital (e.g., Merton, 1987; Diamond and Verrecchia, 1991).

Empirical studies generally support a link between reporting or disclosure quality and firms' costs ofcapital (e.g., Botosan, 1997; Botosan and Plumlee, 2002; Hail, 2002; Francis et al., 2004 and 2005;Hail and Leuz, 2006; Leuz and Schrand, 2008), although some of the evidence is still debated (e.g., Leuz and Wysocki, 2008 Liu and Wysocki, 2007; Core et al., 2008).

Finally, it is important to note that the effects of reporting and disclosure often extend beyond thefirm providing the information (e.g., Dye, 1990; Admati and Pfleiderer, 2000; Leuz and Wysocki,2008). The disclosure of one firm can be useful to other firms for decision-making purposes but itcan also help reduce agency problems in other firms. For instance, the disclosure of operatingperformance and governance arrangements provides useful benchmarks that help outside investors toevaluate other firms' managerial efficiency or potential agency conflicts and, in doing so, lower thecosts of monitoring. While the incremental contribution of each firm and its disclosures is likely tobe small, these information transfers could carry substantial benefits for the market or the economy asa whole. Empirically, the aggregate effects of such information transfers and governance spilloversare still largely unexplored, but this does not imply that they are less real or irrelevant.

4.2. Effects of More Comparable Reporting Practices:

Another important dimension of corporate reporting is its comparability across firms. Making iteasier and less costly for investors and other stakeholders to compare across firms can makecorporate reporting more useful, even if the quality of reporting is held constant. For instance, morecomparable reporting makes it easier to differentiate between less and more profitable firms or low riskand high-risk firms, which in turn reduces information asymmetries among investors and lowersestimation risk. These improvements resulting from greater comparability can also increase marketliquidity and reduce firms' costs of capital (aside from the cost savings for investors). Similarly,more comparable reporting across firms from different countries facilitates cross-border investmentand the integration of capital markets. Recent evidence supports this notion (e.g., Aggarwal et al.,2005; Leuz et al., 2008a). Making it easier for foreigners to invest in a country's firms could againimprove the liquidity of the capital

markets and enlarge firms' investor bases, which in turn improvesrisk-sharing and lowers cost of capital (Stulz, 1981; Cooper and Kaplanis, 1986).

In addition, better comparability can also have effects on corporate decisions and, in particular,gains from trade. More comparable reports allow firms to make better-informed investment choicesdue to a better understanding of competing firms, both within a country and across countries.Moreover, firms that have comparable financial reports can more efficiently contract with suppliersand customers in other countries. It may also enable them to bid more easily on governmentcontracts in another country.

4.3. Cost-Benefit Tradeoff Related to Firms' Reporting Quality and Comparability Choices:

It is important to note that, despite the tangible benefits of better and more comparable reportingand disclosure, there are also direct and indirect costs to improving corporate reporting. The directreporting and disclosure costs come in many forms and include the preparation, certification anddissemination of accounting reports. These costs can be substantial, especially considering theopportunity costs of those involved in the process. Moreover, these costs are likely to have fixedcomponents, making certain reports or disclosures particularly burdensome for smaller firms.

Disclosures can also have indirect costs because other parties can use information provided to capitalmarket participants (e.g., competitors, labor unions, regulators, tax authorities, etc.). For example,detailed information about line-of-business profitability can reveal proprietary information tocompetitors (e.g., Verrecchia, 1983; Feltham et al., 1992; Hayes and Lundholm, 1996; Leuz, 2004;Berger and Hann, 2007).

5. Role of Accounting Standards for High-Quality and Comparable Reporting:

As discussed in Section 2, higher quality and more comparable reporting and disclosure can haveeconomy-wide benefits and positive externalities. Thus, it makes economic sense for standard settersand policymakers to assess the current reporting environment within a market or country (includingprivate incentives and other institutional and regulatory forces) to determine if changes to thereporting environment could move reporting quality and comparability closer to their socially optimallevels (net of costs). However, it is important to ask how standard setters and policymakers canachieve these goals and, in particular, what role the accounting standards play in achieving highqualityand comparable reporting *practices*. The evidence discussed in the previous section indicatesthat capital markets and investors reward higher transparency and high-quality reporting. However,this evidence does not pinpoint the quality of the accounting *standards* as the primary source of thesebenefits. To the contrary, the evidence from academic studies suggests a limited role of standards inshaping reporting practices.

To substantiate this important point, we first draw on relevant empirical work from theinternational accounting literature, which highlights the role of reporting incentives and countries'institutional frameworks in shaping firms' reporting practices. Second, we draw on the notion ofcomplementarities to illustrate that changing solely the accounting standards is likely to have limitedeffects and, in some cases, can even have undesirable effects. The concept of reporting incentivesand the notion of complementarities form an important basis for our subsequent analyses. Finally,we review arguments on the suggested effects of IFRS reporting and discuss whether the evidencefrom voluntary and mandatory IFRS adoption around the world supports these arguments.

5.1. Incentives as Key Determinant of Reporting Quality and Comparability:

There are a number of recent studies that challenge the premise that changing the accountingstandards alone can make corporate reporting more informative or more comparable.

This literaturehighlights the importance of firms' reporting incentives, rather than accounting standards, as keydrivers of observed reporting quality (e.g., Ball et al., 2000 and 2003; Leuz et al., 2003; Ball andShivakumar, 2005; Burgstahler et al., 2006). These studies recognize that accounting standards givefirms substantial reporting discretion because the application of the standards involves considerablejudgment. For example, accounting measurements rely on management's private information andinvolve an assessment of the future, making them subjective representations of management'sinformation set. Firms are given reporting discretion for a good reason (e.g., Watts and Zimmerman, 1986). Onone hand, reporting discretion allows managers to use their private information to produce reportsthat more accurately reflect firm performance and are more informative to outside parties. On theother hand, whether managers use their reporting discretion in this way depends on their reportingincentives. Managers may also have incentives to obfuscate economic performance, achieve certainearnings targets, avoid covenant violations, underreport liabilities, or smooth earnings – to name justa few. Given managers' information advantage, even vis-à-vis the auditors and enforcementagencies, it is difficult to constrain such behavior. But the issue is not just a matter of properenforcement of the accounting standards.

5.2. Complementarities among the Elements of Countries' Institutional Frameworks:

Accounting standards are one of many important institutional elements affecting financialreporting practices in a country. In well-functioning economies, these elements are likely to becomplementary to each other. For instance, accounting information plays an important role infinancial contracting (e.g., Watts and Zimmerman 1986). Financial claims and control rights areoften defined in accounting terms: e.g., financial ratios specify when a corporate borrower is in(technical) default or how much the borrower can pay in dividends. Investors in public equitymarkets also use financial statements to monitor their claims, make investment decisions or exercisetheir rights at shareholder meetings. Thus, it is reasonable to expect that corporate reporting evolvesin concert with other institutional factors to facilitate, among other things, financial transactions andcontracting. Moreover, standardizing reporting, either by regulation or private standard setting, canreduce transaction costs compared to negotiating what is to be reported on a contract-by-contractbasis (e.g., Ross, 1979; Ball 2001). Crafting accounting standards for the informational andcontracting needs of key parties in an economy increases these transaction costs savings. The keyparties in the economy are also active participants in the political process which affects mandatedreporting policies and other economic regulations (see also, Section 6). Moreover, accountingstandards likely reflect ownership and financing patterns in a country. Conversely, accountingstandards can influence financial contracting (e.g., leases, performance-based compensation, off balancesheet financing). Due to these interdependencies, a well-designed set of accountingstandards and other elements of the institutional infrastructure should be complementary, i.e., fit andreinforce each other. The notion of complementarities implies that countries with different sets of institutional endowments are likely to select different accounting standards and that diversity inaccounting standards is an expected outcome of diversity in countries' institutional infrastructures.

5.3. Effects of IFRS Adoption on Reporting Quality and Comparability:

In this section, we discuss several hypotheses about the effects of IFRS reporting. We thenreview the empirical evidence on voluntary and mandatory IFRS adoption in various countriesaround the world and discuss the extent to which it supports the hypothesized IFRS effects. In muchof the IFRS debate, the arguments are presented in general terms and not tailored to a particularcountry. We therefore revisit these arguments and the evidence in Section 4 and apply them to theissue of IFRS adoption in the U.S.

5.3.1. General Arguments on the Effects of IFRS Adoption:

Most of the arguments in favor of IFRS adoption focus on the effects on capital markets andinvestors. One argument is that the adoption of IFRS improves financial reporting to outsideinvestors. To support this argument, proponents point out that IFRS are more capital-market orientedand, hence, more relevant to investors as well as more comprehensive, especially with respect todisclosure, than most local GAAP.7 If the switch to IFRS does in fact improve corporate reportingand disclosure, prior analytical and empirical studies suggest that mandatory IFRS reporting shouldbe associated with an increase in market liquidity as well as a decline in firms' costs of capital.

5.3.2. Evidence from Voluntary IFRS Adoptions around the World:

Empirical studies on the effects of IFRS reporting can be divided into two categories, dependingon whether they analyze voluntary or mandatory adoptions. At present, there are only a few studiesthat analyze the effects around the introduction of mandatory IFRS reporting; most studies examinefirms' voluntary decisions. This and the following section review the evidence in both categories. Empirical studies on the economic consequences of *voluntary* IFRS adoptions generally analyzedirect capital-market effects, such as liquidity or cost of capital, or the effects on various marketparticipants, such as the impact on analyst forecast properties or on the holdings of institutionalinvestors.

Leuz and Verrecchia (2000) examine German firms that adopt IAS or U.S. GAAP andfind that those firms exhibit lower bid-ask spreads and higher turnover compared with GermanGAAP firms. Using implied cost of capital estimates, Cuijpers and Buijink (2005) do not findsignificant differences across local GAAP and IFRS firms in the European Union (EU). Daske(2006) examines voluntary IAS adoption by German firms and finds that they exhibit a higher cost ofequity capital than local GAAP firms. Daske et al. (2007) show that firms with a "serious"commitment to adopting IFRS experience larger cost of capital and market liquidity benefitscompared to firms that simply adopt IFRS as a "label." Finally, Karamanou and Nishiotis (2005)show positive short-window abnormal returns around the announcement of IAS adoption.

6. Summary of applicable standards under US GAAP and IFRS:

Subject	US GAAP	IFRS
Accounting standards/industry practice	ASC 946 Financial Services—Investment Companies	Framework for the Preparation and Presentation of Financial Statements; IFRS 1, First-time Adoption of International Financial Reporting Standards; IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors
First-time adoption	Not Applicable	IFRS 1R, First-time Adoption of International Financial Reporting Standards
Components of financial statements	ASC 946 Financial Services—Investment Companies	IAS 1, Presentation of Financial Statements; IAS 10, Events after the Reporting Period

Statement of assets and liabilities	ASC 946 Financial Services—Investment Companies	IAS 1, Presentation of Financial Statements; IAS 32R, Financial Instruments: Presentation
Equity—classification	ASC 480 Distinguishing Liabilities from Equity	IAS 32R, Financial Instruments: Presentation
Net assets—measurement	ASC 946 Financial Services—Investment Companies;	IAS 39, Financial Instruments: Recognition and Measurement
Net assets—measurement	ASC 946 Financial Services—Investment Companies; ASC 825 Financial Instruments; ASC 820 Fair Value Measurements and Disclosures; ASC 470 Debt with Conversion and Other Options	IAS 39, Financial Instruments: Recognition and Measurement
Schedule of investments	ASC 946 Financial Services—Investment Companies	IFRS 7 Financial Instruments: Disclosures
Overview of the consolidation model	ASC 946 Financial Services—Investment Companies; ASC 810 Consolidation	IAS 27R, Consolidated and Separate Financial Statements(a); SIC 12, Consolidation-Special-Purpose Entities; IFRS 5, Non-Current Assets Held for Sale and Discontinued Operations
Equity method of accounting for investments in common stock/investment in associates	ASC 323 Investments—Equity Method and Joint Ventures	IAS 28, Investment in Associates; IAS 31, Interests in Joint Ventures
Financial instruments	ASC 946 Financial Services—Investment Companies; ASC 825 Financial Instruments; ASC 820 Fair Value Measurements and Disclosures; ASC 815 Derivatives and Hedging; ASC 325 Financial Instruments; ASC 275 Risks and Uncertainties ASC 210-20 Offsetting	IAS 32R, Financial Instruments: Disclosure and Presentation; IAS 39, Financial Instruments: Recognition and Measurement; IFRS 7, Financial Instruments: Disclosures IFRS 9, Financial Instruments (c)
Segment reporting	ASC 280 Segments Reporting	IFRS 8, Operating Segments (b)

a) Applicable for business combinations for which the acquisition date is on or after the) beginning of the first annual reporting period beginning on or after July 1, 2009 (early adoption .is permitted). Note: IFRS 3R and IAS 27R should be applied at the same time

b) Applicable for annual periods beginning on or after January 1, 2009 (early adoption is) .(permitted

(c) Applicable for annual periods beginning on or after January 1, 2013(early adoption is permitted; however, the standard has not yet been endorsed by the European Union).

Conclusion:

In this paper we reviewed many international companies voluntarily prepared their financial statementsin accordance with U.S. GAAP. Thus, these companies viewed U.S. GAAP as a viable alternative toIFRS. However, foreign governments and regulators were reluctant to officially adopt U.S. GAAP asthey have little direct influence and there is no formal representation on the FASB. In contrast, the
IASB allows national regulators and constituencies to have a say in the formulation of IFRS.A critique of IFRS is that any country can adopt this set of high-quality standards regardless of their ability to properly implement and enforce them. As a consequence, the standardslose their ability to signal a country's quality of financial reporting (Ball, 2006).Finally, we note that the initial set of firms that are given a choice of IFRS adoption should bechosen sufficiently large because the possible network benefits of a single set of standards arise onlywhen a large fraction of firms adopt the new set of standards. Thus, the currentSEC proposal that only makes a small number of firms eligible for early IFRS adoption could be selfdefeatingbecause the economies of scales and network effects will not be evident for such a smallgroup.

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