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The Need, Challenges, and Prospects of IFRS Adoption in the United States

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The sole author designed, analyzed, interpreted and prepared the manuscript.

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ABSTRACT

Academic research shows that IFRS-based financial statements enhance transparency and comparability of financial statements. However, Securities and Exchange Commission, the regulatory body in the United States, continues to refuse to require or permit domestic companies to use IFRS. There exists a robust demand for IFRS in the United States. Though there are some obstacles in the path of IFRS adoption, these are not considered insurmountable and adoption of IFRS will provide US companies with much needed flexibility.

Keywords: IFRS; US GAAP; convergence; small and micro-sized entities.

ABBREVIATIONS

IFRS : International Financial Reporting Standards
GAAP : Generally Accepted Accounting Standards
GDP : Gross Domestic Product
SME : Small and micro-sized entities

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FASB : Financial Accounting Standards Board
IASB : International Accounting Standards Board
SEC : Securities and Exchange Commission
PPE : Properties, Plant, and Equipment
LIFO : Last-in First-out
FIFO : First-in First-out
EPS : Earnings Per Share

1. INTRODUCTION

IFRS has been endorsed, among others, by the G20 leaders, International Monetary Fund (IMF), and International Organization of Securities Commissions (IOSCO). As of 2023,147 out of 168 jurisdictions require IFRS for all or most of domestic public companies [1]. Considering the fact that before 2005, no major jurisdiction required IFRS, this expansion of IFRS has indeed been remarkable.

Although major economies, such as China, India, and Japan have not required use of IFRS, they have made substantial progress in aligning their domestic standards with IFRS. China has already completed two major updates to its domestic accounting standards. As a result of these updates, Chinese Accounting Standards (CAS) are very similar to the IFRS though some critical differences remain. For example, IFRS allows both historical cost and fair value method for valuation of property, plant and equipment and intangible assets whereas CAS only allows them to be valued at cost. Reversal of impairment of long-term assets is prohibited under CAS whereas IFRS only prohibits the reversal of impairment loss for goodwill. CAS requires pooling of interest accounting on the combination of commonly controlled enterprises while IFRS does not mandate a specific method for such entities. Finally, Chinese accounts are usually classified by function and accounting period always begins on January 1 of every year [2]. It should be noted that Chinese companies representing more than 30 per cent of total market capitalization already use IFRS for the purpose of dual listing in Hong Kong and China [3,3a,3b,3c].

In India, IFRS adoption received a big impetus in 2015 when the Ministry of Corporate Affairs (MCA) announced a phased adoption of IndAS [4], the Indian Accounting Standards, which are largely converged with IFRS. In phase I, beginning April 1, 2016, companies with a net worth of 500 crore INR or more ($75 million) were required to adopt IndAS. In phase II, beginning April 1, 2017, companies with a net worth between 250 and 500 crore INR (between $37.5 and $75 million) were required to adopt IndAS. As in the case of China, there are differences in some areas such as leasing, revenue recognition, foreign currency, and convertible bonds.

Japan has allowed domestic companies the option to use IFRS since 2009 and the number of companies making use of that option is growing rapidly. As of 2023, 274 domestic Japanese companies with a combined market capitalization of JPY 400 trillion representing 29% of market capitalization have adopted or plan to adopt IFRS [5].

2. ECONOMIC BENEFITS OF IFRS

A key reason for rapid expansion of IFRS across the globe is that it is viewed as a single set of high-quality accounting standards. An extensive body of academic research has documented economic benefits of IFRS.

IFRS enhances the transparency of financial statements to allow readers to better understand the operating performance and financial condition of the firm. There are several indicators of enhanced transparency. Analysts' forecast became more accurate [6] and forecast errors and dispersion are significantly lower in the post-IFRS adoption period [7,8]. The value relevance of earnings, as measured by the correlation between stock market reaction (changes in stock prices) and earnings, also increased after adoption of IFRS [9,10,11]. Enhanced transparency reduces information asymmetry and leads to lower cost of equity for adopting firms [12]. The comparability of financial statements of firms increases in countries adopting IFRS [13]. This is expected and is the main rationale for the development of IFRS. Increased comparability and transparency together reduce the "home-bias" of investors because they make it easier to understand financial statements of foreign companies as they are based on a common set of accounting standards. As a result, adopting countries experience increased flow of foreign direct investment [14] and portfolio investment [15].

It should be kept in mind that the extent to which these and other benefits are realized depends on preparer's incentives and regulatory enforcement. For example, if a firm is

controlled by a small group of owners (insiders or family members) or if they rely on financing from banks, they may have less need for high quality financial reporting compared to publicly owned firms who need regular access to capital markets.

Lack of compliance with standards and disclosure requirements [16] severely limit the benefits of IFRS. For example, IFRS adoption did not have any significant effect on earnings management in India [17]. Auditors play an important role in ensuring the accounting quality under IFRS [18]. Strong enforcement is often the determining factor in realizing the benefits of adoption. As an example, although IFRS was adopted by the entire European Union, positive outcomes of IFRS adoption occurred primarily in five EU countries (Finland, Netherlands, Norway, UK, and Germany) who had carried out strong enforcement concurrent with IFRS adoption [19].

3. CONVERGENCE BETWEEN US GAAP AND IFRS

In 2002, the IASB and FASB signed a memorandum of understanding (MOU) that later came to be known as the "Norwalk Agreement." Under this agreement, the two boards pledged to use their best efforts to (a) make their existing financial reporting standards "fully compatible as soon as is practicable" and (b) "to coordinate their future work programs to ensure that once achieved, compatibility is maintained [20]." In 2006, FASB and IASB updated the MOU [21] and in 2009 they set the goal to complete major convergence projects by 2011.

After signing the memorandum of understanding (MOU), the two boards held numerous joint meetings and their interpretive bodies, Emerging Issue Task Force (FASB) and International Financial Reporting Interpretation Committee (IASB), also worked closely. The understanding was that in areas where either IFRS or US GAAP had the clearly preferable standard, the other board would adopt that standard and in areas where both standards needed improvement, the boards would work jointly on a converged improved standard. As a result, significant progress was made in narrowing the difference between US GAAP and IFRS. The boards issued broadly convergent standards on major topics such as fair value measurement, business combination, share-based payments, and revenue recognition. They also aligned guidance on minor topics such as error corrections, discontinued operations, extraordinary items, and voluntary accounting changes.

After this initial success, the convergence process suffered serious setback as projects on many important topics such as income taxes, impairments, post-employment benefits, financial statement presentation, and conceptual framework were abandoned because of disagreements between the two boards. Even more worrisome trend is the divergent paths taken by them. Two notable examples of this are recently issued standards on leasing and insurance. The FASB issued leasing standard (Leases-Topic 842) recognized both operating and financing leases [22]. The IASB issued leasing standard (IFRS 16 Leases) treats all leases as finance type [23]. On the lessor side, US GAAP continues to recognize sales type lease whereas IFRS doesn't. For sales and leaseback transactions, the US GAAP permits seller-lessee to recognize the entire gain if it is deemed a sale under revenue recognition standard whereas IFRS allows only partial recognition of the gain. For insurance contracts, the final standard issued by the FASB (ASU 2015-09- Disclosures about Short Duration Contracts) was restricted in scope, applying only to short duration insurance contracts [24]. It sought only "targeted improvements" to existing measurement and disclosure requirements. For long duration contracts, the ASU 2018-12, issued in 2018, revised objectives that differed significantly from the joint insurance project [25]. The IASB, on the other hand, issued a comprehensive standard (IFRS 17 Insurance Contracts) to ensure consistent treatment of all insurance contracts [26].

Although both FASB and IASB continue down divergent paths, one sliver of hope is that the FASB continues to consult with the IASB on issues of mutual interest and participates in the development of IFRS through its membership in the IASB's Accounting Standards Advisory Forum. In addition, US stakeholders continue to write comment letters to the IASB proposal, albeit this activity has decreased significantly in recent years coinciding with the loss of interest in the IFRS by the SEC [27].

4. THE ROLE OF THE SEC

As the SEC has sole regulatory authority over financial reporting of publicly traded companies, it comes as little surprise that changes in the SEC leadership over years have seriously

impacted the U.S. journey towards IFRS [28]. Christopher Cox, the SEC Chair from 2005 to 2009, was strongly in favor of adoption of IFRS. The most significant step towards IFRS adoption came during his tenure in 2007 when the SEC issued a rule to allow foreign companies to submit to the Commission financial statements using IFRS as adopted by the IASB (no jurisdictional adaptations) without reconciling them with US GAAP [29]. In 2008, the SEC proposed a "Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by US Issuers". The proposed 'roadmap' set certain milestones that, if achieved, would have required use of IFRS by U.S. companies in 2014 [30].

Subsequent chairperson Mary Schapiro (2009-2012) took a more deliberative stance as the SEC started to have second thoughts. She directed the SEC staff to carry out a Work Plan to address key areas of concern including independence and comprehensiveness of IFRS, impact of its adoption on regulation, tax code, and audit, and readiness of preparers and investors. In addition, the SEC signaled its intention to reassess the IASB-FASB convergence project before taking a final decision in 2011. The decision was subsequently delayed. In 2011, the SEC issued a staff paper, "Exploring a Possible Method of Incorporation," that presented a framework combining endorsement and convergence ("condorsement") to incorporate IFRS into domestic financial reporting [31]. Under this approach, the FASB would endorse and incorporate newly issued IFRS standards into US GAAP after following the due process. The SEC and FASB would retain their ability to modify or supplement IFRS when doing so would be in public interest. During the transition period, the FASB would converge US GAAP to IFRSs by addressing and evaluating differences between the two sets of standards. The ultimate goal was that a "U.S. issuer compliant with US GAAP should also be able to represent that it is compliant with IFRS as issued by the IASB." However, the final Work Plan, issued in 2012, skirted the question whether adoption of IFRS was in the best interests of US investors. In fact, it categorically stated, "(the report) does not imply — and should not be construed to imply — that the Commission has made any policy decision as to whether International Financial Reporting Standards should be incorporated into the financial reporting system for U.S. issuers [32]."

The first significant setback to the goal of IFRS adoption came in 2014 when Mary Jo White, the SEC Chair, speaking at the dinner hosted by Financial Accounting Foundation, said that as the Commission considers IFRS, three things are important: "first, the interests of U.S. investors would remain front and center as the Commission considers IFRS; second, the FASB would remain front and center as the ultimate standard setter of accounting standards for U.S. companies; and third, the role the United States plays in the development of global standards must be an important consideration" [33]. This effectively scuttled the move towards adoption of IFRS as it made clear that the FASB was not going to cede the standard setting authority to IASB.

However, if past pronouncements of the SEC are any guide, prospects of even a voluntary adoption of IFRS by the United States are bleak. In 2015, the SEC Commissioner Kara Stein categorically stated, "I am not convinced of a need to abandon U.S. GAAP in favor of IFRS… I'm also not convinced that providing financial statements in two different sets of accounting standards would be beneficial for either investors or issuers" [34]. Later in the same year, James Schnurr, then SEC Chief Accountant, reaffirmed these views. Citing lack of support and real impediments, he said that he probably would not recommend that the SEC should mandate IFRS or that U.S. companies should have the choice of preparing their financial statements under those standards. Instead, he advanced a proposal to allow U.S. companies to provide IFRS-based information as a supplement to US GAAP financial statements [35].

5. DEMAND FOR IFRS

There is a robust demand for IFRS in the United States. As of 2021, 64% of the largest 100 companies in Fortune Global 500 companies submit their financial statements to the SEC using only IFRS [36]. This creates a demand for financial analysts to devote time and resources to familiarize themselves with IFRS in order to understand the financial statements of these foreign entities and to make investment recommendations. The investors also need to familiarize themselves with IFRS to make informed investment decisions. Apart from the demand from financial analysts and investors, there are at least four scenarios where U.S. entities use IFRS [37].

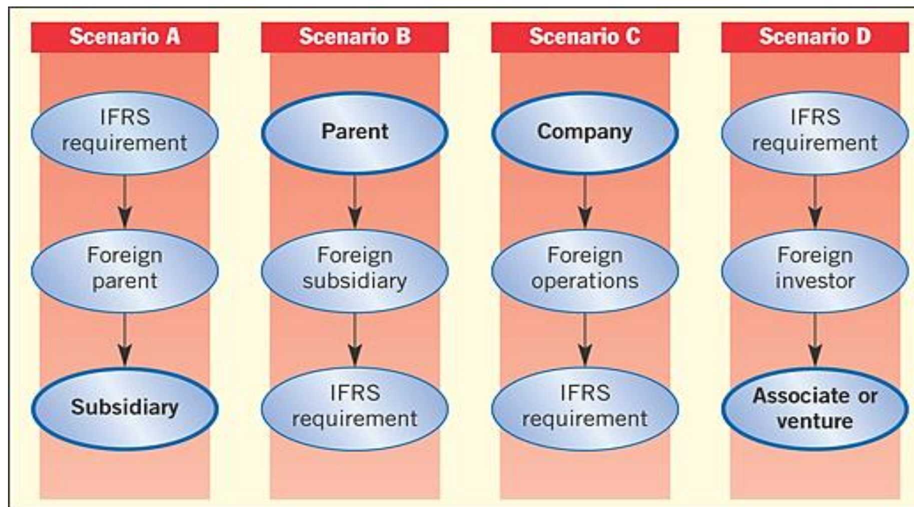

Exhibit 1. Potential IFRS Use by U.S. Companies
Source- Gannon DJ, Ashwal A. Financial reporting goes global. Journal of Accountancy. 2004; 198(3), p. 45.

Scenario A- A foreign parent company that uses IFRS has a **U.S. Subsidiary**. In such case, the subsidiary has to prepare IFRS statements for consolidation purposes.

Scenario B- A **U.S. parent** company has subsidiaries in foreign countries that require IFRS. In this case subsidiaries will submit IFRS statements to the parent company. The **U.S. Parent** will convert them to US GAAP to prepare consolidated financial statements.

Scenario C- A **U.S. company** has operations in foreign countries where regulators, tax authorities, or banks require IFRS statements.

Scenario D- A foreign investor that uses IFRS has invested between 20% -50% in a **U.S. Associate or Joint Venture** company. The foreign investor will require that the latter supply IFRS-based information for accounting purposes.

Apart from above cases, some U.S. multinationals require their subsidiaries to use IFRS whether or not local jurisdictions of subsidiaries require it. They find that converting from one set of IFRS statements to US GAAP is far more efficient and cost effective than to ask them to use US GAAP and then convert it into the GAAP of their country of domicile.

The IASB has also issued a highly simplified and streamlined version of IFRS (IFRS for SMEs) tailored for small and medium sized entities [38]. These companies need to prepare general-purpose financial statements for use by owners, lenders, creditors, rating agencies, and tax authorities but often lack staff and technical expertise needed to comply with the complexities of IFRS or US GAAP. IFRS for SMEs was initially released in 2009 and comprehensively reviewed and revised in 2015. A second comprehensive review is underway since 2022. It accomplishes the goal of simplification in numerous ways by- (a) omitting some topics not relevant to a typical SME such as EPS or segment reporting, (b) eliminating some options such as revaluation of PPE, and (c) greatly streamlining measurement and recognition of other items. For instance, goodwill is amortized, and interest is not capitalized. The result is a compact set of self-contained standards compared to the voluminous US GAAP.

The IASB also has a guide for micro-sized entities that extracts from IFRS for SMEs only the requirements that are likely to be relevant for a typical micro-sized entity [39]. It doesn't modify any of the principles of IFRS for SMEs for recognizing and measuring assets, liabilities, income, and expenses and contains cross-references to IFRS for SMEs for matters not covered by the Guide. Compliance with the Guide automatically results in compliance with IFRS for SMEs.

The IASB has also set up an SME Implementation Group (SMEIG) that publishes implementation guidance featuring a complete set of illustrative financial statements and required notes and disclosures and is accompanied by an optional question-and-answer guidance. The IASB also provides free training material and conducts regional "train the

trainer' workshops to build the capacity for implementation in developing and emerging economies. As a result of these significant support and outreach efforts, IFRS for SMEs has experienced tremendous growth worldwide. It has been translated in 24 languages and currently 83 countries (including UK, Switzerland, Ireland, and Israel) either require or permit the use of IFRS for SMEs.

Although small and private companies in the U.S. have been slow to adopt IFRS for SMEs, as the domestic awareness grows, these companies will find this simplified compact set an attractive alternative that is less costly and more relevant to their needs than the modified GAAP set out by the Private Company Council (PCC).

6. CONCLUSION

Academic research shows that IFRS is a high-quality global set of accounting standards [40,41]. It enhances transparency and comparability of financial statements; decreases cost of capital and promotes cross-border investments and capital flows. Despite near worldwide acceptance of IFRS, the United States, the country with the largest capital market in the world, has been reluctant to fully incorporate IFRS into domestic GAAP or to give U.S. companies the option to use it.

There are a few stumbling blocks in the path of IFRS adoption. First, U.S. auditors face high legal and professional liability. If anything goes wrong and stock price experiences serious decline, the company and its auditors are sued by investors for misleading them even though the cause of stock price decline may have little to do with accounting. To shield themselves against such potential liability, accounting professionals demand and the FASB obliges, an elaborate set of accounting rules and guidance. IFRS, on the other hand, is 'principle-based' and requires considerable professional judgment. Although professional judgment is critical for quality of financial reporting, it also makes an easy target in litigation. Second, IFRS doesn't allow LIFO. That means LIFO companies will face a onetime tax penalty on LIFO reserve when they switch to FIFO. Without changes in tax code to provide relief to companies, IFRS adoption will continue to face opposition. Third, massive investments in educational and outreach efforts will need to be made to enable preparers and auditors switch to a new accounting regime. The transition to IFRS will also necessitate one-time investments in information technology and accounting software. Finally, bankers and lenders also need to be onboard both to accept IFRS-based financial statements and to renegotiate any accounting-based covenants impacted by the switch.

While these stumbling blocks have some merit, they are not unique or insurmountable. More than 100 countries have successfully overcome such transition hurdles to adopt IFRS. In many ways, the United States will have an easier transition time. The convergence project has reduced many differences between IFRS and US GAAP and investors are already exposed to IFRS-based financial statements from foreign SEC registrants. IFRS is part of curriculum in many universities and large public accounting firms have developed tremendous expertise in both assisting their clients in implementation of IFRS and auditing IFRS-based financial statements.

Ultimately, the decision to adopt IFRS lies with the SEC. Although the SEC has criticized IFRS by saying that it allows too much judgment and is not enforced rigorously across jurisdictions, it has implicitly acknowledged that U.S. investors are not harmed by IFRS by allowing foreign companies listed in the United States to issue IFRS-based statements. There exists a robust demand for IFRS from U.S. multinationals and subsidiaries of foreign companies who have to bear the costs of preparing financial statements using two sets of accounting standards.

While this study argues for adoption of IFRS by the United States, it must be acknowledged that there is lack of consensus on this issue. The US GAAP is viewed as a set of high-quality accounting standards that is accompanied by a robust enforcement institutional framework including SEC, securities laws, investor legal protections, auditors, and financial analysts. Therefore, US investors would gain little additional benefit from adoption of IFRS [42]. Accounting standards like any other standard are shaped by social, economic, and political forces which exert strong influence at the country level. Adoption of IFRS will crimp the ability of FASB and SEC to respond to the needs of US preparers and investors [43].

To conclude, this study contributes to the accounting literature by tracing the history of convergence of US GAAP-IFRS convergence, the role of SEC, and the demand for IFRS in the United States. It is highly relevant to various

stakeholders such as policymakers, regulators, preparers, and investors. One limitation of the study is that it relies on secondary sources. Future research in this area may focus on eliciting direct input from stakeholders via surveys and interviews.

DISCLAIMER (ARTIFICIAL INTELLIGENCE)

Author(s) hereby declare that NO generative AI technologies such as Large Language Models (ChatGPT, COPILOT, etc.) and text-to-image generators have been used during writing or editing of manuscripts.

COMPETING INTERESTS

Author has declared that no competing interests exist.

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