

# Convergence or Adoption of IFRS in the United States?

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Subject Area: Accounting

## Introduction

Today, two global leaders, the United States (U.S.) and Japan, are working on separate projects with the International Accounting Standards Board (IASB) in pursuit of high quality global accounting standards. The Accounting Standards Board of Japan (ASBJ) and the Financial Accounting Standards Board (FASB) in the U.S. are attempting to converge their respective Generally Accepted Accounting Principles (GAAPs) with International Financial Reporting Standards (IFRS). The two standards-setting bodies, ASBJ and FASB, are meeting biannually in Tokyo and Norwalk sharing their respective progress towards convergence with IFRS.

Two additional members of the G-20, India and Indonesia, are converging with IFRS and China has substantially converged its national standards. The trend is clearly towards convergence and eventual full adoption of IFRS by all major economic powers, including the United States.

## The Challenges of Convergence

The growth in multinational corporations, often through multinational mergers and consolidations, the growth in international markets for goods and services facilitated by advances in information technology, and the interconnection of growing international financial markets argue for the development of high quality common standards for financial reporting that will provide consistency in financial reporting across borders. Movement toward convergence of U.S. GAAP with IFRS has had its fits and starts, its advances and delays, but convergence now appears to be inevitable. The question remains whether the latest date targeted for convergence (2015) will be achieved or not due to significant differences between U.S. GAAP and IFRS that remain.

The “rules based” nature of U. S. GAAP versus the “principles based” nature of IFRS characterizes the fundamental difference between GAAP and IFRS. GAAP is more prescriptive and detailed in its reporting and disclosure requirements than IFRS. The “rules based” approach of GAAP is often criticized as a contributing factor to a lack of quality in GAAP reporting because companies become focused more on bending and twisting the rules to their advantage rather than simply reporting what has happened. The more detailed the guidance, the greater the opportunity to find the loopholes in the guidance. Earnings management through the artful use of the rules is considered by some a requisite for growth in shareholder wealth. As a result, an added advantage of convergence with IFRS and its “principles based” approach to some is that the increased latitude will result in more transparent disclosure because some distinctions

without a difference will be eliminated and reasons for reporting choices will require a more complete explanation.

In addition to this fundamental difference between U. S. GAAP and IFRS the increased use of fair value reporting for financial instruments, tangible assets and intangible assets required under IFRS will inject more subjectivity into the reported numbers. The ultimate goal of reporting for U.S. GAAP is to enable investors and creditors to predict the amount, timing and probability of future cash flows from the historical events and transactions reported in the financial statements. Many argue that fair value numbers are more relevant for this purpose because they are more faithful to the economic essence of the events reported. However, this also increases the need for verification. The responsibility of audit committees and external auditors to provide reasonable assurance will only increase in a principles-based and fair-value world. Human nature is what it is, and fraud is not unknown in the IFRS world.

## Challenges Beyond Convergence

### Conceptual Framework

The FASB and IASB have separate conceptual frameworks, similar in structure, but different in how they are used. The FASB Financial Accounting Standards Codification<sup>TM</sup> is the authoritative source of U.S. GAAP; FASB's conceptual framework is a non-authoritative source. In IFRS, its conceptual framework is authoritative, used by standards setters to refine standards and by users when IFRS lacks definitive guidance related to a specific recording and reporting of an economic event. The FASB and IASB have a project in process to converge their respective conceptual frameworks; it is partially, but not fully, complete.

### LIFO

A major difference in IFRS and U.S. GAAP is in the acceptable methods of accounting for inventories and cost of goods sold. U.S. GAAP allows the use of Last-In-First-Out (LIFO) for tax purposes, if the organization uses LIFO for its financial reporting. IFRS does not allow the use of LIFO. This difference is a major obstacle for convergence and/or adoption of IFRS. A "carve out," a difference between local or industry-specific standards and IFRS (example IAS 39 in the European Union), is a possible alternative to address the gap. However, President Obama's 2013 budget, if approved, would remove this obstacle from full adoption of IFRS. It proposes the repeal of LIFO accounting for inventories, increasing federal tax revenues by \$73+ billion 2013-2022<sup>1</sup>. Political pressures, especially from *The LIFO Coalition*, will make this part of the budget a difficult one to sell.

### Long-Term Assets

IFRS and U. S. GAAP continue to record property, plant, and equipment at historical cost. However, IFRS differs in that it allows revaluation of whole classes of property, plant, and equipment. When revaluation is chosen, IFRS then requires regular valuations of those whole classes of assets. U. S. GAAP does not allow revaluation of property, plant, and equipment. With intangible long-term assets, IFRS requires capitalization and amortization over the useful life in a similar manner to U. S. GAAP. With this class of assets, IFRS also allows for revaluation.

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<sup>1</sup> Office of Management and Budget (2012). *Fiscal Year 2013 Budget of the U.S. Government*. Summary Tables, page 222. <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/budget.pdf> accessed April 16, 2012.

## **XBRL**

Accompanying each Accounting Standards Update (ASU) to the FASB Financial Accounting Standards Codification™ is a section detailing how the revision affects the U.S. XBRL taxonomy. There is a corresponding IFRS XBRL taxonomy, one that differs from the more robust one in the United States. Until a single taxonomy is developed and maintained, this is a significant hurdle to the full adoption of IFRS by the United States.<sup>2</sup>

## **Financial Statement Presentation**

The FASB and IASB joint project on financial statement presentation may result in significant changes to the financial statements. Adoption of the initial proposal would result in the following:

- The balance sheet would be renamed the statement of financial position. It would consist of five sections: (1) business, including operating assets and liabilities along with investing assets and liabilities; (2) financing assets and liabilities; (3) income taxes; (4) discontinued operations; and (5) equity. The Boards have tried to distinguish between how a company finances its business and how it uses that capital to create value.
- The cash flow statement would have the same five sections as the statement of financial position. The big change is that companies would be required to use the direct method instead of the indirect method used by most companies today.
- The income statement would be renamed the statement of comprehensive income and would also consist of five sections (all of the sections from the statement of financial position except equity would be replaced by other comprehensive income). In addition to the basic financial statements, the Boards are proposing that companies provide a new schedule in the footnotes that would reconcile the cash flow statement to the statement of comprehensive income. The reconciliation would lay out how much of each income and expense line item is the result of cash flows, accruals and re-measurements.

## **Summary**

Convergence of IFRS and U.S. GAAP continues and appears to be a future *fait accompli*. However, full adoption of IFRS by the United States depends on political pressures and implementation problems related to full adoption. Every aspect of financial reporting is touched to a lesser or greater degree by differences between the rules-based GAAP and the principles-based IFRS. Convergence has been achieved in a number of areas to date and others are being actively pursued. If history teaches us anything, the current date for convergence may yet be optimistic.

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<sup>2</sup> Selling, Tom (2012). "Can a Lack of XBRL Tags Stop the IFRS Express?" *The Accounting Onion*. <http://accountingonion.typepad.com/theaccountingonion/2011/04/can-a-lack-of-xbrl-tags-stop-the-ifrs-express.html> accessed April 17, 2012.