GLOBAL ACCOUNTING CONVERGENCE

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GLOBAL ACCOUNTING CONVERGENCE

A Project

by

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Abstract

of

GLOBAL ACCOUNTING CONVERGENCE

by

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The International Accounting Standards Board (IASB) has developed the International Financial Reporting Standards (IFRS) as a single set of global accounting guidelines. As the world's economy has become increasingly connected, the need for a single set of global accounting guidelines has become necessary. The United States has stated interest in adopting IFRS, although, at this time the United States has not adopted IFRS. This project reviews prior articles on the topic of global accounting convergence. Also, this project examines the Stock and Exchange Commission's (SEC) research on the United States role on global accounting convergence. The conclusion reached is that the United States should adopt IFRS. A single set of accounting guidelines provides greater transparency and consistent information for users of financial statements.

__________________________, Committee Chair
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TABLE OF CONTENTS

LIST OF FIGURES

Page

Chapter 1

INTRODUCTION

In today's global economy, the rate of globalization and growth is ever-increasing. Advances in technology have increased the rate in which the world economy is inextricably linked together. Investors are now capable of instantly engaging in financial transactions that cross national borders, thus eliminating barriers that previously existed. The information gap and lag time has been virtually eliminated because of the internet. Investors can gain information on foreign firms and securities immediately. The advancements in technology have played a large part in increasing the activity of global markets. As investing becomes more global, investors' need for transparency as well as a full account of financial information that crosses national borders increases. The U.S. Stocks and Exchange Commission (SEC), has long supported a single set of globally accepted accounting standards. As SEC chairperson Mary L. Schapiro stated on February 24, 2010, "For nearly 30 years, the Commission has promoted a single set of high-quality globally accepted accounting standards, which would advance the dual goals of improving financial reporting within the U.S. and reducing country-by-country disparities in financial reporting," (SEC.gov).

The purpose of this project is to provide background information about global accounting convergence and to explore the United States' role in the move towards establishing one set of global accounting guidelines. The world has long discussed a single set of accounting guidelines to provide clarity and protection for investors in the global capital markets. While many countries throughout the world have adopted the

International Financial Reporting Standards (IFRS), the United States is still assessing the validity of IFRS to distinguish if adoption is an appropriate action to take. The SEC has been evaluating IFRS and the potential impact to American issues and investors, although, the SEC has continually supported the adoption of a single set of high quality accounting standards. This project provides background on the International Accounting Standards Board (IASB), IFRS and it explores the positive and negative aspects of accounting convergence. The conclusion of the project looks at the United States stance on global accounting convergence and assesses whether adoption of IFRS is an appropriate course of action.

Chapter 2

ACCOUNTING DIVERSITY

2.1 Accounting Differences

Throughout the world, many different accounting methods are used. This may cause confusion when comparing financial statements of multinational companies. If this is the case, why are there many different accounting systems? A survey of the relevant literature indicates that some of the commonly accepted factors influencing a country's financial reporting are the legal system of the country, taxation, providers of financing, inflation and political ties (Doupnik and Perera 31). These factors vary greatly from one nation to the next and are a significant reason why financial reporting varies. With so many public and private entities at play in hundreds of nations, it is extremely difficult to decide on a consensus on financial reporting. If the goal is to have one set of globally accepted accounting standards, compromise is needed. There are two major types of legal systems used around the world: code law and common law. Code law countries generally have corporation law, which establishes the legal parameters governing business enterprises. In a code law system, the government writes and enforces the accounting code. Code law accounting tends to give the managers a significant amount of discretion in making various accounting estimates (Ball). As Ray Ball indicates in his article, *Accounting Abroad – How to Keep Managers and Auditors in Line:*

> In good years managers can reduce reported income by overestimating expenses, by underreporting revenues, and even by transferring funds to hidden reserves. These techniques put income in the bank for the future. In bad years, they can increase reported income by reverting to normal accounting estimates, taking income out of the bank (Ball).

Thus, code law countries tend to have general accounting practices that do not provide much detail regarding some specific accounting practices. Common law countries take a vastly different approach. In common law countries, specific accounting rules are established by the profession, or bay and independent nongovernmental bodies (Doupnik and Perera 32). An example of this is the Financial Accounting Standards Board (FASB), in the United States. The FASB outlines specific and detailed rules on how to report financial statements. Also, the United States Generally Accepted Accounting Principles (U.S. GAAP) are set by an independent body. Common law systems typically place greater emphasis on public information than code law systems. Common law accounting systems generally have much more detailed guidelines as opposed to code law countries (Ball). Differences in a nation's legal system have great influence on their accounting system.

Taxation is another reason why it is difficult for global convergence of accounting standards. In some countries financial statements form the basis for taxation; whereas, in other countries the financial statements are adjusted for tax purposes and submitted to the government separately from the reports sent to stockholders (Doupnik and Perera 33). It is challenging for a country to change their taxation practices. The public will usually pressure the government to reduce taxes; therefore, if a policy is viewed as increasing taxes, there will likely be heavy backlash. An example of differences is taxation and its effect on accounting can be illustrated by observing the practices of Germany and the United States. In Germany, published financial statements serve as the basis for taxable income. In most cases, for an expense to be deductible for tax purposes it must also be used in the calculation for financial statement income. It is advantageous for German companies to attempt to minimize their income for tax purposes through the use of accelerated depreciation. Accelerated depreciation must also be taken in the calculation of accounting income. In the United States, conformity between the tax statement and the financial statements is required only in regards to the use of last in, first out (LIFO) inventory cost flow assumption. U.S. companies are allowed to use accelerated depreciation for tax purposes and straight line for deprecation in financial statements. All else being equal, a German company is likely to report lower income than a U.S. company (Doupnik and Perera 33). Taxation is a sensitive topic that raises much debate; as a result, a major change to a country's taxation system is a daunting task.

Political influences may also hinder the advancement of accounting convergence. It is difficult to change the status quo because, in large part, keeping the norm requires no adjustment. Nationalism is a political roadblock that hinders progress in the arena of global accounting convergence. Nationalism may cause a nation to focus on a set of homogenous policies that are separate from the policies and interests of other nations. This is evident in the attempt of global accounting standards. Different countries may be cautious of altering their accounting guidelines and giving a separate body any kind of authority over them. In Todd Hines article, *International Financial Reporting Standards: a Guide to Sources for International Accounting Standards,* he states:

> The United States has been so cautious about joining a binding global accounting scheme that it does not have unilateral power to influence or set its own accounting rules. Under the current U.S. GAAP system, all accounting standards are promulgated by U.S. organizations, with the ultimate authority residing in a U.S. government agency. A private U.S. organization, FASB, issues standards but the Securities and Exchange Commission retains ultimate authority. If the United States started following IFRSs, it would not retain this kind of control over the accounting standards to which its capital markets would adhere (Hines 6).

The U.S. is not alone in this type of national thinking. Because of the different sources of influence and pressure, it is difficult for a country to essentially give up any authority. Even though it may be for the "greater good" to forsake some authority and come to an understanding, this is going to be a major hurdle to overcome in many countries.

2.2 Problems Arising From Accounting Diversity

Accounting diversity across different nations can cause several problems. For example, multinational corporations prepare consolidated financial statements. Due to different accounting policies in different countries, these multinational corporations will typically have to prepare two sets of financial statements: one set that meets local standards, and another set that meet the guidelines of the parent country. Take General Motors (GM) as an example, GM has subsidiaries in more than 50 countries. Each subsidiary is required to prepare financial statements in accordance with local regulations (Doupnik and Perera 35). Thus, all of these subsidiaries will produce two sets of financial statements. This is inefficient and costly. Labor and resource costs increase because staff has to spend more time and resources creating two different sets of financial documents. Also, staff will need to obtain expertise in more than one country's accounting guidelines. In contrast, GM and other multinational companies would save resources if there was one set of global guidelines.

As business and investing take place on a global stage, accounting diversity causes confusion and uncertainty. Financial statements prepared under different guidelines, depending on what country they are from, may not be comparable. From an investor's point of view, analyzing financial statements from a foreign county with different accounting guidelines may cause uncertainty. This uncertainty can hinder an investor's decision, thus distorting the market. Accurate and consistent public information is vital in regards to investing, not only domestically, but globally. With so many different accounting standards, it would not be surprising for a company to show a profit using one country's accounting standards, and then show a loss using another country's standards (Hines 5). The solution to this dilemma is one set of global accounting standards.

In 2003, U.S. investors bought and sold nearly $3 trillion worth of foreign stocks while investors traded over $6 trillion in U.S. equity securities. Also, in recent years there has been a great increase in the number of mutual funds invested in the stock of foreign companies (Doupnik and Perera 36). With one set of clear and consistent accounting standards, investors' risk would decrease tremendously.

Not only does the lack of consistent accounting guidelines affect individual investors, it also affects the decisions made by corporations when deciding on foreign acquisitions. The same concept applies to these corporations. When reviewing financial statements of foreign companies, the information may be considerably different, causing the company to spend more resources in making adjustments. Financial statements prepared at the national level may have limited value when making comparisons with companies in other countries.

Another problem caused by accounting diversity is the issue of companies gaining access to foreign capital markets. If a company desires to obtain capital by selling stock or borrowing money in a foreign county, it might be required to present a set of financial statements prepared in accordance with the accounting standards of the county in which the capital is being obtained. To have stock traded in the United States, foreign companies must either prepare financial statements using U.S. accounting standards, or provide a reconciliation of local GAAP net income and stockholders' equity to U.S. GAAP (Doupnik and Perera 35). This is costly and inefficient for these foreign companies.

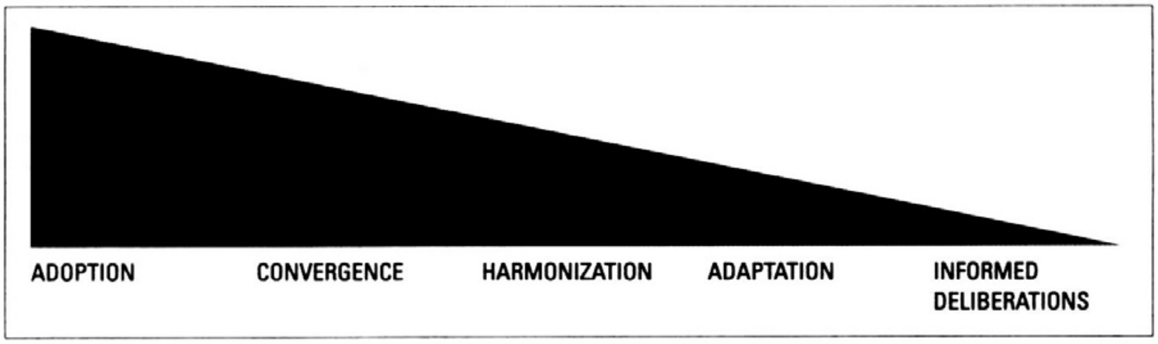
Chapter 3

ACCOUNTING CONVERGENCE

3.1 What is Accounting Convergence

There is no single solution to the issues at hand when discussing global accounting. To decrease the information gaps from one country to the next, changes must be made. The process of "harmonization" or "convergence" have been heavily discussed and debated. Harmonization refers to countries having different accounting standards, although, the standards don't conflict. Convergence refers to the adoption of one set of standards globally. Although these ideas are similar, there is a clear distinction between them. The Australian Accounting Standards Board (AASB) released a policy statement, *International Convergence and Harmonization Policy*, in which it defines the differences of each. According to the policy statement, "international convergence" means working with other standard-setting bodies to develop new or revised standards that will contribute to the development of a single set of accounting standards for worldwide use. "International harmonization," of Australian accounting standards, refers to a process that leads to these standards being made compatible with the standards of international standard-setting bodies, which would result in high-quality standards (qtd. in Payne and Ranagan 16-17). In order for the global economy to be fully realized, a level of harmonization or convergence must be attained.

Figure 1: Degrees of Convergence



Source: Payne and Ranagan, "To Converge or Not to Converge?"

3.2 Benefits of Convergence

Convergence of accounting standards would eliminate the issue of the comparability of financial statements worldwide. Investors will have consistent information when evaluating foreign securities. Also, investors would have the potential to reduce risk through international diversification. Not only would the financial statement comparability aid individual investors, it would simplify the evaluation by multinational companies of possible foreign takeover targets. Financial reporting costs would also be reduced by companies who would like to list their shares on foreign stock exchanges. Cross-listing of securities would allow companies to gain access to less expensive capital in other countries and would make it easier for foreign investors to acquire the company's stock (Doupnik and Perera 71). These same companies would see cost reduction in the preparation of worldwide consolidated financial statements. Multinational companies would not have to prepare two sets of financial statements and have personnel that have an extensive knowledge to two different sets of accounting guidelines.

Differences in reporting, based on country, causes investor confidence to decrease. As it becomes impossible to make an "apples to apples" comparison, investors develop a sense of uncertainty, thus, investor confidence declines. This uncertainty and lack of investor confidence may increase the cost of capital. Investors often incorporate a premium to their required rate of return on an investment if there is any uncertainty or lack of comparability about the figures, such premiums can be as large at 40 percent (Doupnik and Perera 71).

Accounting harmonization and convergence has gained momentum recently because of these issues. While this may not be the solution that fixes everything, it is a major step in the right direction. Auditors, investors and policy makers will all receive the same information. This in turn will have many beneficial impacts such as less risk, greater availability and allocation of resources and better decision making by individuals and enterprises.

Chapter 4

IFRS

4.1 Creation of the IASB

The International Financial Reporting Standards (IFRSs) was created with the goal of providing a single internationally recognized set of accounting standards. IFRS are set by the International Accounting Standards Board (IASB). The goal of the IASB is to develop IFRS into a high quality set of standards. Select members of the IASB, with the best available combination of technical skills and background experience of relevant international business and market conditions, contribute to the development of high-quality, global accounting standards (SEC 2007, 14).

The International Accounting Standards Board (IASB) was preceded by the Board of the International Accounting Standards Committee (IASC), which operated from 1973 until 2001. IASC was founded in June 1973 as a result of an agreement by accountancy bodies in Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom, Ireland and the United States; these countries also constituted the Board of IASC at that time (ifrs.org). The broad objective of the IASC was to develop "international accounting standards". The IASC was funded by contributions from member bodies, multinational companies, financial institutions, accounting firms and the sale of IASC publications.

The IASC's harmonization efforts came in three phases. The first phase, which lasted fifteen years, saw the IASC issue 26 generic International Accounting Standards (IASs). The IASC's approach to standard setting during this phase was to accommodate many existing practices in many different nations (Doupnik and Perera 77). This proved to be a daunting task. With so many different nations and rules, accommodating existing guidelines was ineffective.

Two significant events took place during the second phase of IASC's harmonization effort. The first was the 1989 publication of the *Framework for the Preparation and Presentation of Financial Statements*. This publication set out the objectives of financial statements, the qualitative characteristics of financial information, definitions of the elements of financial statements, and the criteria for recognition of financial statement elements (Doupnik and Perera 77). *The Framework* publication was very important because it provided detailed information about financial statements. It was the beginning of an effort towards the comparability of financial statements. *The Framework* served as a guide to address the standards, although, *The Framework* itself was not a standard and could not override any issued standard (Hines 9). The second event was the "Comparability of Financial Statements Project." The main objective of this project was to "eliminate most of the choices of accounting treatment currently permitted under International Accounting Standards" (Doupnik and Perera 77).

The final phase began with the IOSCO (International Organization of Securities Commission) agreement in 1993 and ended with the creation of the IASB in 2001. A core set of international standards were developed that were endorsed by the IOSCO for cross-listing purposes. The most significant development during this phase was the proposal to restructure the IASC; consequently, the IASB was created.

During the existence of IASC, 41 IASs were issued. Also, a Standing Interpretations Committee (SIC) was established to provide guidance on implementing standards. The SIC did not have authority to provide guidance on financial reporting issues not specifically addressed by existing IASs. After the IASC issued a draft and received feedback, a final SIC interpretation was considered and approved by the committee. It was then submitted to the IASC, if approved, the draft would be issued in final form. The SIC passed 33 interpretations during its existence (Hines 12).

In November of 1999 the IASC Strategy Working Party voted to disband itself and form the IASB. The IASC faced problems of legitimacy with regard to constituent support, independence and technical expertise. Some of the perceived shortcomings were that there was a full time workload, but only a part time board. Also, there was a need for a wider group of countries, constituencies and organizations with decision input. People questioned the IASC's lack of commitment in developing the highest quality standards possible (Doupnik and Perera 80). Responding to these concerns, the IASC formed the Strategy Working Party in 1996. The Strategy Working Party issued a document in December of 1998 entitled *Shaping IASC for the Future*. The recommendations of the Strategy Working Party were designed to deal with the issue of legitimacy. They attempted to balance calls for a structure based on geographic representativeness, and those based on technical competence and independence (Doupnik and Perera 80). The establishment of the IASB addressed and improved all these issues. Membership was expanded, the budget was increased, more full-time staff members were added and an effort was made to establish better relationships with different national standard setters

(Hines 9). Also, representativeness would be provided by the geographic distribution of the trustees, who would be essential to ensuring the effectiveness and independence of the board. However, board members would be selected based on their expertise.

The IASB officially took over from the IASC on April 1, 2001. This newly created body was in charge of creating international accounting standards, which were to be called International Financial Reporting Standards (IFRS). The formation of the IASB in 2001, with a change in focus from harmonization to global standard setting, marked the beginning of a new era in international financial reporting (Doupnik and Perera 80).

4.2 Structure of the IASB

The IASB is a stand-alone, privately funded accounting standard-setting body established to develop global standards for financial reporting. The IASB is overseen by the IASC Foundation, a stand-alone organization responsible for, among other things, the activities of IASB. There are 22 trustees that make up the IASC Foundation and they appoint IASB board members, oversee their activities and raise necessary funding for the IASB, the IASC Foundation, the International Financial Reporting Committee (IFRIC) and the Standards Advisory Board (SEC 2007, 13). The constitution of the IASC Foundation states the following objectives:

> (a) To develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other

> financial reporting to help investors, other participants in the world's capital markets, as well as other users of financial information make economic decisions.
>
> (b) To promote the use and rigorous application of those standards.
>
> (c) In fulfilling the objectives associated with (a) and (b), to take account of, as appropriate, the needs of a range of sizes and types of entities in diverse economic settings.
>
> (d) To promote and facilitate adoption of International Financial Reporting Standards (IFRSs), being the standards are interpretations issued by the IASB, through the convergence of national accounting standards and IFRSs (IASC constitution).

The IASB board is made up by 12 full-time and two part-time members who serve a five- year term subject to one reappointment. A minimum of five IASB members must have a background as practicing auditors, three must have a background as preparers of financial statements, three must be users of financial statements, and at least one must come from academia (Doupnik and Perera 81). Paragraph 24 of the IASC Foundation constitution states that:

> The main qualifications for membership of the IASB shall be professional competence and practical experience. The Trustees shall select members of the IASB, consistently with the Criteria for IASB members set out in the Annex to the Constitution, so that it will comprise a group of people representing, within that group, the best available combination of technical expertise and diversity of international business and market experience in order to contribute to the

> development of high quality, global financial reporting standards. The members of the IASB shall be required to commit themselves formally to acting in the public interest in all matters. No individual shall be both a Trustee and an IASB member at the same time (IASC Constitution).

The IASB board members are required to sever all employment relationships that may compromise a member's independent judgment in setting accounting standards, or that may give rise to perceived economic incentives (IASC constitution.). The current IASB members are from nine different countries and have a variety of backgrounds. The IASB has the sole responsibility of establishing IFRS. Like the IASC, the IASB is located in London. The IASB has stated that it is committed to "developing, in the public interest, a single set of high-quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements" (SEC 2007, 15).

The IASC board first approved a *"Framework"* in 1989, and this was reaffirmed by the IASB in 2001. The objective of *the Framework* is to establish the concepts underlying the preparation and presentation of IFRS based financial statements. Also, the IFRS *Framework* serves as a guide to the Board in developing future IFRSs and as a guide to resolving accounting issues that are not addressed directly in an International Accounting Standard or International Financial Reporting Standard or Interpretation. *The Framework* addresses:

1. The objective of financial reporting
2. The qualitative characteristics of useful financial information

3. The reporting entity

4. The definition, recognition and measurement of the elements from which financial statements are constructed

5. Concepts of capital and capital maintenance (International Financial Reporting Standards, http://www.iasplus.com/standard/framewk.htm)

The Framework also states that the primary users of the financial reporting are potential investors, lenders and other creditors, who use the information to make decisions about buying, selling or holding equity or debt instruments, as well as providing or settling loans or other forms of credit. A major dilemma that results from the differentiation of accounting guidelines from nation to nation is that decision making becomes difficult. One must obtain extensive knowledge of several different nations' guidelines in order to make informed decisions. *The Framework* is designed to assist decision makers. Thus, investors, creditors, lenders, multinational companies, among others will make more informed and better, decisions (International Financial Reporting Standards http://www.iasplus.com/standard/framewk.htm).

The IASB and the implementation of IFRS have received international support. In a 2002 survey the six largest public accounting firms surveyed 54 countries in regards to their promotion of accounting convergence with IFRS. Almost all the countries surveyed intended to converge with IFRS, and they indicated that the IASB is the appropriate body to develop global accounting guidelines (Doupnik and Perera 96). Approximately 100 countries require or allow the use of IFRS, and many other countries are replacing their national standards with IFRS (SEC 2007, 16).

4.3 International Acceptance of IFRS

The European Union (EU) issued a directive in 2002 that required all listed companies of member states to prepare consolidated financial statements based on IFRS beginning January 1, 2005 (Doupnik and Perera 100). Approximately 7,000 companies in the EU are impacted by this regulation. The change to IFRS involved major modifications to accounting policies for these listed companies. In order to make the switch to IFRS as efficient as possible, the U.K. Institute of Chartered Accountants urged British companies to provide investors and analysts with clear explanations of their preparations for adopting IFRS, and changes to accounting policies ahead of publication of their 2005 accounts (Doupnik and Perera 100). This was a significant step in the process, as it is important to educate investors beforehand. If investors are uneducated, there will be uncertainty, which will decrease investor confidence. In order to secure investor confidence, the U.K. Institute of Chartered Accountants wanted to inform investors before implementing IFRS.

Many other countries have implemented IFRS for their listed domestic companies. Other countries, such as Canada and Israel, have plans to adopt IFRS as their accounting standard in the future. As these countries and others adopt IFRS, their success will have a major impact on the decision of other countries to adopt IFRS. As the sample size increases, and more data is gathered, the world will have a greater understanding on the effectiveness of IFRS. Figure 2 provides information on the plans for convergence with IFRS in some regions throughout the world.

Figure 2: Worldwide Adoption of IFRS

Country	**Status for listed companies as of April 2010**
Argentina	Required for fiscal years beginning on or after 1 January 2011
Australia	Required for all private sector reporting entities and as the basis for public sector reporting since 2005
Brazil	Required for consolidated financial statements of banks and listed companies from 31 December 2010 and for individual company accounts progressively since January 2008
Canada	Required from 1 January 2011 for all listed entities and permitted for private sector entities including not-for-profit organizations
China	Substantially converged national standards
European Union	All member states of the EU are required to use IFRSs as adopted by the EU for listed companies since 2005
France	Required via EU adoption and implementation process since 2005
Germany	Required via EU adoption and implementation

	process since 2005
India	India is converging with IFRSs over a period beginning 1 April 2011
Indonesia	Convergence process ongoing; a decision about a target date for full compliance with IFRSs is expected to be made in 2012
Italy	Required via EU adoption and implementation process since 2005
Japan	Permitted from 2010 for a number of international companies; decision about mandatory adoption by 2016 expected around 2012
Mexico	Required from 2012
Republic of Korea	Required from 2011
Russia	Required for banking institutions and some other securities issuers; permitted for other companies
Saudi Arabia	Not permitted for listed companies
South	Required for listed entities since 2005

Africa	
Turkey	Required for listed entities since 2008
United Kingdom	Required via EU adoption and implementation process since 2005
United States	Allowed for foreign issuers in the US since 2007; target date for substantial convergence with IFRSs is 2011 and decision about possible adoption for US companies expected in 2011.

NOTE: The list refers to listed companies only. The table is not an authoritative assessment of the use of IFRS in those countries. In the majority of cases, the information has been provided by the relevant national authorities or is based on information that is publicly available. For definitive information on the use of IFRSs in any particular country or countries contact the relevant national authority or authorities directly.

Source: (http://www.ifrs.org/Use+around+the+world/Use+around+the+world.htm)

4.4 Differences Between U.S GAAP and IFRS

A major difference between U.S GAAP and IASB is that the IASB uses a principles-based approach rather than a rules-based approach. Principals-based standards focus on establishing general principles derived form the IASB Framework, providing recognition measurement, and reporting requirements for the transactions covered by the standard. By following this approach, IFRS tends to limit guidance for applying the general principles to typical transactions and encourages professional judgment in applying general principles to transactions specific to an entity or industry (Doupnik and Perera 102). The IASB takes the stance that a rule-based approach is counterproductive and aids those who are intent on circumventing the rules. With the detailed guidelines under the rule-based approach, "loopholes" may be created. As Sir David Tweedie, IASB chairman, articulated about the rule based approach, "The emphasis tends to be on compliance with the letter of the rule rather than on the spirit of the accounting standard" (IFRS.org). On the other hand, the principles-based approach enables those that are applying the standards to use their professional judgment and not be bound by strict guidelines. In theory, this should reduce the loopholes that are created with financial engineering.

Chapter 5

U.S. HISTORY ON ACCOUNTING CONVERGENCE

5.1 Background on U.S. View of Convergence

The United States support of harmonization and convergence is not a recent occurrence. The Stock and Exchange Commission (SEC) has long advocated reducing the disparity between accounting practices between the United States and other countries as a means to facilitate cross-border capital formation while ensuring adequate disclosure for the protection of investors and the promotion of fair, orderly and efficient markets (SEC, 2007 19). In a 1981 release proposing revisions to Form 20-F, the Commission expressed its support for the work of the IASC in formulating guidelines and international disclosure standards. In a 1988 Policy Statement, the SEC supported the establishment of mutually acceptable international accounting standards as a critical goal to reduce regulatory obstacles that result from different national accounting standards without compromising investor protection. The Policy Statement also stated, "Securities regulators and members of the accounting profession throughout the world to continue efforts to revise and adjust international accounting standards with the aim of increasing comparability and reducing cost" (SEC 2007, 19). The SEC reaffirmed their commitment to working with securities regulator throughout the world to achieve an efficient international securities market system.

In 1997 the SEC, at the direction of Congress, compiled a report on developing high quality global accounting standards. The report stated that for an issuer wishing to raise capital in more than one country, compliance with different accounting standards to be used in preparation of financial statements increased compliance costs and created inefficiencies. The SEC encouraged IASC's efforts to develop a high quality set of international accounting standards. The SEC believed this would decrease the concerns stated above, also, it would increase the access of U.S. investors to foreign investments in the U.S. public capital market. In the report, the SEC also stated that their evaluation of the IASC core standards would involve an assessment of whether it constituted a comprehensive body of transparent, high quality standards that could be rigorously interpreted and applied (SEC 2007, 21).

The SEC issued a *Concept Release on International Accounting Standards* in February of 2000. The release was aimed at seeking public feedback on what elements were necessary to promote convergence and uphold the quality of financial reporting at the national level. In this release, the SEC described high quality standards as a "comprehensive set of neutral principles that require consistent, comparable, relevant and reliable information that is useful for investors, lenders and creditors, and others who make capital allocation decisions (SEC 2007, 21)." The SEC also stated that high quality standards "must be supported by an infrastructure that ensures that the standards are rigorously interpreted and applied (SEC 2007, 22)."

In 2003 the Congress mandated that the SEC prepare a study on the adoption of a principal-based accounting system as part of the Sarbanes-Oxley Act. The Commission concluded that "the optimal approach to accounting standard setting would be based on a consistently applied conceptual framework and clearly stated objectives rather than solely on either rules or principles, one benefit of which would be the facilitation of greater convergence between U.S. GAAP and international standards" (SEC 2007, 22). Once again, they showed their support for international convergence of accounting standards. This was on the heels of several accounting scandals which prompted the Sarbanes-Oxley Act. The SEC's report to Congress interpreted convergence as a "process of continuing to discover and opportunity to learn by both U.S. and international standard setters. The benefits of which include greater comparability and improved capital formation globally," (SEC 2007, 23).

5.2 FASB

The Financial Accounting Standards Board (FASB) is an independent, non profit, body who has been establishing U.S. accounting principles since 1973. The FASB is overseen by the Financial Accounting Foundation (FAF). The FAF is responsible for selecting the seven full-time FASB members; also, the FAF is responsible for funding the FASB. The FASB is committed to international harmonization, and eventually, international accounting convergence. The FASB works with IASB and with other national accounting standard setters in their pursuit of international harmonization (SEC 2007, 17).

5.3 Norwalk Agreement

In October of 2002, the FASB and IASB came together and established a "memorandum of understanding," known as the Norwalk Agreement. Both parties "acknowledged their commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting" (FASB and IASB Memorandum of Understanding). The FASB and the IASB pledged to use their best efforts:

(a) To make their existing financial reporting standards fully compatible as soon as is practicable and

(b) To co-ordinate their future work programs to ensure that once compatibility is achieved, it is maintained (FASB and IASB Memorandum of Understanding).

At their April and October 2005 meetings, the FASB and IASB reconfirmed their commitment to the convergence of U.S. GAAP and IFRS. Furthermore, in the 2006 memorandum of understanding, both bodies acknowledged that a single set of global standards remains as a primary goal, and a work plan that included long and short term projects for the following two years was set forth. As stated in the 2006 memorandum of understanding, the following points about convergence were agreed upon:

- Convergence of accounting standards can best be achieved through the development of high quality, common standards over time.
- Trying to eliminate differences between two standards that are in need of significant improvement is not the best use of the FASB's and the IASB's resources—instead, a new common standard should be developed that improves the financial information reported to investors.
- Serving the needs of investors means that the boards should seek to converge by replacing weaker standards with stronger standards (FASB and IASB Memorandum of Understanding).

5.4 U.S. Roadmap

On November 14, 2008 the SEC proposed a "Roadmap" for the potential use of financial statements prepared in accordance with IFRS guidelines. The purpose of this Roadmap was to take a major step towards the realization of the U.S. joining the efforts of securing one set of high quality globally accepted accounting standards. Also, the Roadmap was intended to encourage investors and U.S. issuers of financial statements to analyze the impact of IFRS in U.S. capital markets, and on the preparation of financial statements. The SEC asked for input from investors and issuers as part of the discussion on whether IFRS was appropriate for the U.S.

The SEC stated that the potential accounting standards should be neutral and independent principles that included consideration of alternative approaches. The Commission also emphasized that the guidelines needed to stay current as accounting issues and business practices change. The Roadmap indicated that the SEC would advocate independence and continuous evaluation of the IASB. The SEC Roadmap made it apparent that certain philosophies and principles had to be met in order for the U.S. to consider IFRS.

The Roadmap also stated that the Commission may target 2011 as a potential date to make a decision with regards to mandating IFRS in the U.S. This was dependent on many factors, one being the realization of the Norwalk Agreement by the IASB and FASB by 2011. Also, the implementation relied on the approach of the accounting guidelines. The Roadmap stressed the importance of independence, diversity of input and constant innovation to keep standards current. The Commission expected that the accounting standards would not only improve the accuracy and effectiveness of financial reporting, but also the protection of investors. The SEC would consider all of these factors in the assessment of IFRS in the U.S. As stated in the Roadmap, "in considering future action as set out in this Roadmap, the Commission would also assess whether it believes that the IASB continues to develop its standards, including converged standards, through a process that reflects these elements" (SEC 2008, 23).

The SEC also expressed their desire for the IASC to have a monitoring group that oversees their activities. The Roadmap used the example of the Financial Accounting Foundation which oversees the FASB. Oversight of the IASC would enhance accountability of the IASC. A key factor in the Roadmap is that "the Commission believes … effective oversight is critical to mandating that U.S. issuers prepare financial statements in accordance with IFRS," (SEC 2008, 26). The SEC stated that the mandate of IFRS in the U.S. would not be in place until an effective monitoring group was established.

One major goal of the Roadmap was to assess and evaluate from the time of issuance until 2011. At that time, the SEC would determine whether to mandate that public companies use IFRS guidelines to prepare financial statements by 2014. Certainly, this would depend upon whether or not it is in the best interest of the public. The Roadmap was aimed at assessing the impact of mandating the use of IFRS in order to promote a single set of high quality globally accepted accounting standards. The Roadmap states, "Because IFRS has the greatest potential to become the global standard of accounting, we believe it is in the interest of U.S. investors, U.S. issuers and U.S.

markets to consider mandating reporting using IFRS in the United States as well (SEC 2008, 33)."

Chapter 6

RECENT DEVELOPMENTS OF U.S. CONVERGENCE

6.1 2010 SEC Work Plan

On February 24, 2010 the SEC released the *Commission Statement in Support of Convergence and Global Accounting Standards*. This statement was a follow up to the 2008 report. In this report, the SEC reaffirms their stance that a single set of high quality accounting standards will benefit U.S. investors, and that this goal is consistent with their mission of protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation (SEC 2010, 3). Also, the Commission reiterated their goal of convergence of U.S. GAAP and IFRS.

The Commission directed their staff to develop and execute a work plan to increase understanding of the Commission's purpose and public transparency in the potential convergence of U.S. GAAP and IFRS. After execution of this work plan and completion of the FASB and IASB convergence projects, the Commission believes they will be in a better position to make a determination regarding integration of IFRS into the U.S. financial reporting system.

After receiving input for affected parties, the SEC believed that a more comprehensive work plan of greater detail would increase transparency and understanding to the public. The work plan highlights several areas for SEC staff to consider. Specifically, the work plan addresses areas of concern that were highlighted by critics, including:

- Sufficient development and application of IFRS for the U.S. domestic reporting system.
- The independence of standard setting for the benefit of investors;
- Investor understanding and education regarding IFRS;
- Examination of the U.S. regulatory environment that would be affected by a change in accounting setting;
- The impact on issuers, both large and small, including changes to accounting systems, changes to contractual arrangements, corporate governance considerations, and litigation contingencies; and
- Human capital readiness (SEC 2010, 1).

6.2 U.S. Concerns on Convergence

As the SEC states in several of their publications, global accounting guidelines must be a "comprehensive set of neutral principles that require consistent, comparable, relevant and reliable information that is useful for investors, lenders and creditors, and others who make capital allocation decisions," (SEC 2010, 4). The potential guidelines must be developed and applied correctly and consistently. While the Commission and others analyze IFRS, the IASB must make modifications if necessary. The application of global accounting standards is a relatively new experience. Adjustments and further development may improve the protection of investors and the efficiency of the capital markets.

The SEC stresses the importance of comprehensive accounting guidelines. As stated in the 2008 proposed Roadmap, "IFRS is not as developed as U.S. GAAP in certain areas, (SEC 2008, 42)." The example used to illustrate this lack of development is the lack of guidance for certain areas, such as accounting for certain common control transactions, recapitalization transactions, reorganizations, and acquisitions of minority shares not resulting in a change of control and similar transactions (SEC 2010, 5). Part of the work plan, and overall assessment of IFRS, is the development of the guidelines in these areas. If IFRS develops into a robust, inclusive set of accounting guidelines, the U.S. and other nations have a greater likelihood to adopt these principles.

Another concern raised by the proposed Roadmap deals with auditing IFRS and the enforcement of these guidelines. Some of the concerns raised by critics were regarding the risk of opportunistic accounting; diminished comparability; and the potential for accounting conclusions of preparers to be unfairly criticized by auditors, regulators, and investors (SEC 2010, 8). These concerns are critical and must be addressed before the adoption of IFRS becomes a reality.

The consistent application of IFRS is also a primary concern. In order for global comparability of financial statements to be realized, reliable application of the guidelines must be demonstrated. If consistent application of guidelines is absent, confusion and uncertainty may be prevalent.

In order to fully realize the true benefits of global accounting guidelines, any conflicts of interest must subside. The Work Plan developed by the SEC includes an ongoing review of the functioning of the IASB's governance structure, and developments to secure a stable, broad-based source of funding (SEC 2010, 21). The Work Plan also states that full, fair and reliable disclosure is essential to facilitate the meaningful comparison of financial information across national borders (SEC 2010, 29). In order to ensure a full, fair and reliable disclosure is present, the IASB must display complete independence from influences that may affect their ability to remain impartial

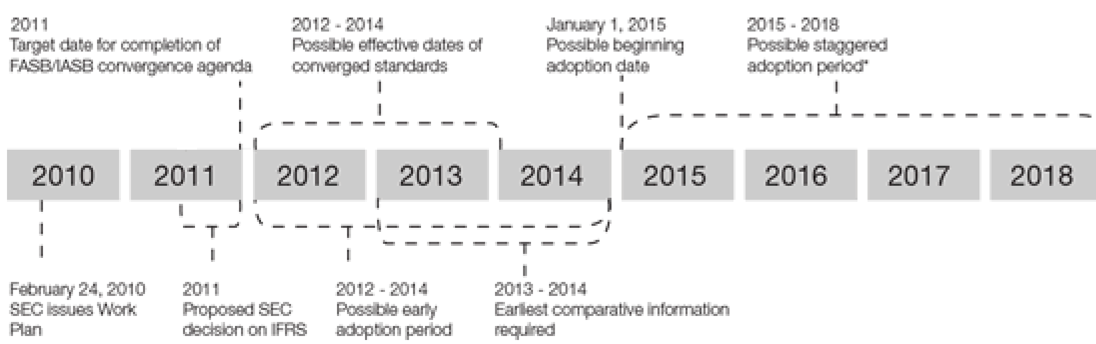
The benefits of a single set of high quality standards would be fully realized only when investors have a comprehensive understanding of IFRS. At this time, the SEC believes that further education is needed in this regard. Undoubtedly, there will be a period of transition, in which investors have questions and uncertainties; although, proper education of investors will shorten this period and ease the transition. After investors have a strong understanding of IFRS, their confidence will increase which will greatly benefit the comparability of financial statements.

Issuers of U.S. financial statements provide information to many parties for various purposes. Adoption of IFRS may lead to changes of the information conveyed to these parties. As stated in the Work Plan, changes to the Commission's accounting standards could affect issuers and the information they provide to regulatory authorities, and others that rely on U.S. GAAP as a basis for their reporting regimes (SEC 2010, 31). This will be another area of analysis for the Commission as part of the current Work Plan.

Such a major change in the financial reporting of U.S. issuers has far reaching effects. The Work Plan acknowledges that incorporation of IFRS will require consideration of the vigilance of all parties involved in the financial reporting process, including: investors, preparers, auditors, regulators and educators. As a result, any change involving the incorporation of IFRS into the financial reporting system for U.S. issuers would require greater familiarity of IFRS for investors, preparers, auditors, regulators, academics, and many others (SEC 2010, 39). The human capital readiness in the U.S. in regards to the potential adoption of IFRS is greatly correlated to the education of investors and others. As the amount of education and understanding increases, the human capital readiness will increase.

After the Roadmap was unveiled in 2008, a level of uncertainty was raised. The Work Plan reduces this uncertainty and increases transparency of IFRS. Illustrating the concerns that the SEC has in regards to adopting IFRS displays their commitment to seeking the benefits of a global set of accounting guidelines. As the economy is recovering from the impacts of a recession, the SEC faces many other issues. As the Work Plan is executed, the SEC should provide a more definitive answer as to their position of adopting IFRS.

Figure 3: Possible Timeline of U.S. Adoption of IFRS



Assuming that the SEC determines in 2011 to incorporate IFRS into the US domestic reporting system, a possible timeline may unfold as follows:

Key dates

February 24, 2010:	SEC issues statement in support of convergence and global accounting standards, inclusive of work plan
2011:	Target date for completion of ASB / IASB convergence agenda
2011:	Proposed SEC decision on IFRS
2012 - 2014:	Possible effective dates of converged standards
2012 - 2014:	Possible early adoption period
2013 - 2014:	Earliest comparative information required, assuming 2015 beginning adoption date
January 1, 2015:	Possible beginning adoption date
2015 - 2018:	Possible staggered adoption period

Source: PricewaterhouseCoopers LLP

http://www.pwc.com/us/en/issues/ifrs-reporting/transition-to-ifrs-status.jhtml

6.3 Work Plan Update

On June 2, 2010 the FASB and IASB announced modifications to their timetable, and prioritization of standards being developed under the Board's joint agenda in response to stakeholders concerns regarding, “their ability to provide high-quality input on the large number of major exposure drafts planned for publication in the second quarter of this year (SEC 2010, 2)." In particular, the Boards committed to publishing exposure drafts in phases, in order to enable more effective stakeholder participation in the standard-setting process and to improve the Boards’ re-deliberation process. Consequently, the Boards have prioritized completion of certain joint projects by June 2011, while delaying completion of other projects until after the original June 2011 target date (SEC 2010, 2).

SEC Chairman Schapiro stated the following in regards to the modification of FASB and IASB timetables:

> I foresee no reason that the adjustment to the targeted timeline for certain joint projects should impact the staff’s analyses under the Work Plan issued in February 2010, particularly when that adjustment is designed to enhance the quality of the standards. Indeed, focused efforts on those standards the boards consider highest priority for the improvement of U.S. [generally accepted accounting principles (“GAAP”)] and IFRS will facilitate the staff’s analysis (SEC 2010, 2).

On October 29, 2010 the SEC released their first update in regards to the Work Plan. In regards to the comprehensiveness of IFRS, the evaluation of IFRS is based on a comparison of U.S. GAAP and IFRS (SEC 2010, 4). The purpose of this comparison is to evaluate if the incorporation of IFRS would result in greater guidance and comparability, or, if financial reporting would benefit. Also, the SEC is obtaining stakeholder perspectives regarding whether less prescriptive standards result in improved disclosures that facilitate enhanced financial analysis; the areas in which additional guidance would result in the most significant improvements to financial statements prepared under IFRS; the consequences of the absence of specific guidance in these areas; how investors, preparers, and auditors currently address these consequences in practice; and potential recommendations for improvements and standard setting (SEC 2010, 6).

The SEC's assessment of audit ability and enforcement involves analysis of: (1) audit and regulatory challenges in the audit of financial statements prepared under IFRS and the enforcement of IFRS, (2) trends in error corrections and accounting-related enforcement actions, and (3) how auditors, private securities litigators and regulators manage these challenges in practice (SEC 2010, 6). Currently, the SEC is evaluating why auditors feel constrained in certain areas of IFRS guidelines. In addition, the Staff is analyzing trends in error corrections and accounting-related enforcement actions in the United States and abroad, to determine whether use of IFRS may impair auditor and regulator efforts (SEC 2010, 7). The Commission will obtain feedback from auditors as to their modifications in practice due to IFRS.

The SEC is analyzing four components to gauge IASB independence in regards to IFRS. These components are:

- Oversight of the IFRS Foundation;
- Composition of the IFRS Foundation and the IASB;
- Funding of the IFRS Foundation; and

- IASB standard setting process (SEC 2010, 15)

The SEC will review the IFRS Monitoring Boards governance materials to determine if any changes are necessary. The Commission's primary goal in this area is to assess the Monitoring Board's oversight role and if they continue to support the independent setting of standards (SEC 2010, 16).

A key element to the independence of the accounting guidelines is the funding of the IASB. To ensure that independence does exist, the SEC must have knowledge of where the funding of the IASB comes from. In principle, the IFRS Foundation believes that it is appropriate to determine the amount of funding to seek from each country based on each country's GDP (SEC 2010, 19). IFRS works closely with public entities in different jurisdictions in order to generate the desired level of funding. The Commission has concluded that despite these efforts, the effort to achieve long term mandatory funding commitments for the IFRS Foundation is not complete (SEC 2010, 19). In addition to this revelation, the IFRS Foundation indicated it could expect a $4 million funding gap with respect to its self determined contribution target for the United States (SEC 2010, 19). The source of IFRS funding is perplexing. The October 2010 update provided by the SEC found that a third of the IFRS funding came from international accounting firms. The IFRS Foundation cited that 31 jurisdictions contributed in 2009; although, not all regions that have incorporated IFRS into their accounting system contribute to the Foundation. Based on SEC research, less than 25% of countries that use IFRS as their guidelines contribute monetary funding to the Foundation (SEC 2010, 19). The two biggest contributors to the IFRS Foundation in 2009 were the Unites States and

Japan; however, neither nation has formally adopted IFRS. Going forward, the IFRS Foundation will need to evaluate their long term funding mechanism as a primary issue. The Foundation is at a liability, as their two biggest contributors have yet to adopt IFRS. If the United States or Japan decides not to implement IFRS; The Foundation will be at great risk. A necessary step will be developing better mechanisms to generate funding from jurisdictions that do not already provide funding.

A change from U.S. GAAP to IFRS would present uncertainty and anxiety from investors and producers of financial statements. In order to ease the transition, IFRS will need to be slightly modified for use in the U.S. The SEC is wisely evaluating feedback from foreign nations who have incorporated IFRS into their accounting system. Other nations have modified IFRS in order for integration into their own systems; thus, the U.S. can assess the impact the transition had on these other systems prior to adoption. In order to be successfully incorporated into the U.S. system, the extent of modification is challenging, The SEC realizes that an abrupt, drastic change is not an effective way to complete this transition. Therefore, an essential component of the transition will be in the modification and the staggered implementation of IFRS.

Issuers of financial statement will face challenges with the potential transition to IFRS. It will be costly for firms to train their staff on new methods of reporting and the impact of not being able to use LIFO can potentially be very expensive. Many of the firms impacted have used LIFO for years. Also, the process to develop their financial statements has been the same for years. These firms face immense and expensive challenges with the transition to IFRS. The policy makers must consider a fair and adequate amount of time to give to these firms and the benefits of the transition must be worth the costs. The costs and challenges may impact smaller regional firms more so than bigger, multinational firms. The SEC's work plans is going to focus on the following areas in regards to the impact on issuers:

- Accounting systems, controls and procedures;
- Contractual arrangements;
- Corporate governance
- Accounting for litigation contingencies; and
- Smaller issuers versus larger issuers (SEC 2010, 35).

As policy makers determine the method of transition to IFRS, the impact on issuers and the appropriate amount of time given to them is essential to its success.

Chapter 7

ANALYSIS OF POTENTIAL U.S. CONVERGENCE

7.1 Issues Regarding Convergence

The U.S. is faced with a dilemma. Pressure is mounting from many parts of the world for the U.S. to make a greater commitment to IFRS. As many nations have adopted IFRS, the world is waiting anxiously on the U.S. The SEC is taking a methodical approach to their evaluation and potential adoption of IFRS. Many issues are relevant as the SEC makes a decision. In today's economic world, a move towards a single set of accounting standards must be completed. It has been discussed for years, although, a concrete conclusion has not been made in the U.S. As the U.S. is at the center of the world's capital markets, the adoption of a single set of accounting standards by the U.S. will have global impacts.

IFRS provides the greatest opportunity for a set of high quality accounting standards. While this is the case, the IASB has issues that need to be resolved. The long term funding of IASB is not established. Also, the IASB does not receive monetary funding from most of the countries who have adopted IFRS. The United States and Japan provide substantial monetary contributions to the IASB, even though neither country has adopted IFRS. The IASB needs to develop an approach to ensure they receive proper funding for the long term; also, every country that has adopted IFRS should be assessed by their ability to contribute monetarily. The issue of independence is a continuing one as well. Can the IASB gain the proper funding and remain completely independent?

Although challenging, the IASB must remain independent in order to establish fair and proper guidelines. IFRS is the preeminent system to establish a single set of high quality accounting standards; therefore, the IASB must remain a stable, independent organization in the long term.

IFRS does not permit the use of LIFO as U.S. GAAP does. Many companies have used LIFO for decades. Forcing these firms to change their inventory reporting system is a monumental task. It will be a very costly task for these companies to transition away from LIFO. Staff will have to be trained under the FIFO method or the weighted average cost method. Firms that have used LIFO for years may find it costly to get an accurate understanding of their inventory. Under LIFO, typically, a company's taxable income will be less. Firms that use LIFO might have to pay more in taxes under the average cost or FIFO methods. The prohibition of LIFO under IFRS is a major change for U.S. companies. In order for an efficient transition to IFRS to take place, firms that currently use LIFO will need to be properly educated on the change.

Many regional firms and auditors have concerns about a transition to IFRS. These concerns are primarily derived from the potential costs of the switch and the lack of knowledge of IFRS. For decades the U.S. educational system has taught the U.S. GAAP method. Auditors and other personnel have used their knowledge of U.S. GAAP to do their job. A switch to IFRS will require a major overhaul of education. Many of these regional auditors and other personnel will need to be retrained and educated on IFRS. The bigger, multinational firms are supporters of a change to IFRS because many of their clients are in different regions of the world. These bigger firms already have adequate staff with the proper training in IFRS. The uncertainties faced by the smaller, regional firms are not the same concerns that the bigger firms face. The concerns expressed by local firms, auditors and educators are the many potential hurdles a change to IFRS will bring. Changing the educational system will be vital to the long term success of IFRS in the U.S. This will be an immense task.

7.2 Recommendation that U.S. should Converge

A change from the status quo is usually met with a plethora of challenges; although, the benefits from that change may outweigh the costs. The benefits of the U.S. adoption of IFRS cannot be forgone. A change to IFRS is necessary and in the long run the benefits will increase exponentially. The economy has become increasingly connected globally and all indications show that the economy will only become more inclusive in the future. The U.S. is at the center of the global economy; therefore, the U.S. has to be involved in a global adoption of accounting standards in order for all of the benefits to come to fruition.

As the world's capital markets become extremely easier to access, a shared universal investor "language" would be of enormous benefit. An American investor would be able to evaluate information provided by a European company and have confidence in her understanding. An investor would also be able to compare a domestic company to a foreign company and easily make the best decision for that business. Investor’s confidence in financial reporting would increase greatly, thus increasing the efficiency of the world's capital markets. Because of the benefits that investors gain with a single set of high quality accounting standards, the worldwide acceptance of IFRS has been growing. Nearly 100 countries have adopted IFRS. Although, the U.S. has not adopted IFRS at this time, U.S. ownership of foreign securities is increasing. With the increasing worldwide acceptance of IFRS and U.S. ownership of foreign securities, it is clear that the U.S. must act on the worldwide desire for a single set of accounting standards. U.S. acceptance of a set of high quality standards will improve comparability and transparency for U.S. investors, protecting them and increasing their ability to make better decisions.

Currently, if a foreign firm would like to offer their securities in the U.S. market they will have to create two sets of financial statements. If a U.S. firm would like to offer their securities in a foreign market they may need to generate a duplicate set of disclosures. This is costly for the firm and may discourage them from entering into a foreign market. If a foreign firm does not offer their securities in the U.S. because of the duplicate reporting, this deprives the U.S. investor from investment opportunities and potential gains. Also, if a U.S. firm is discouraged from entering a foreign market because of dual reporting, they may be losing an opportunity to gain capital. These firms would also discover a lower cost of capital because the costs of preparing duplicative sets of financial statements would be eliminated.

In order for the global market to reach its full potential, a common set of accounting guidelines must be present. A high quality set of accounting standards would improve transparency, comparability and investor protection. Though there are some challenges for the U.S. to adopt IFRS, the future benefits greatly outweigh the costs. As the global economy evolves in the future, the need for a single set of high quality accounting standards may be forced upon the U.S.

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