

2012

Report to the Trustees of the IFRS Foundation

**IFRS Foundation staff analysis of the SEC Final Staff Report—
Work Plan for the consideration of incorporating IFRS into the
financial reporting system for US issuers**

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Disclaimer: this paper, prepared by IFRS Foundation staff, provides an analysis of the SEC Staff Report from the perspective of the IFRS Foundation and the IASB as an international standard-setter. It does not purport to address every topic described by the SEC Staff Report. This paper is published as a convenience to interested parties and has been not been approved by either the IASB or the Trustees of the IFRS Foundation.

1. Introduction and Executive Summary

The publication of the SEC Staff Report represents an important milestone for the SEC on its multi-year evaluation of International Financial Reporting Standards (IFRS). As such, it should be read within the context of the historic leadership position the SEC has played in fostering a global transition to IFRS.

In 1973, the SEC supported the involvement of the American Institute of Certified Public Accountants (AICPA) in the creation of the International Accounting Standards Committee (IASC), which was the predecessor to the IASB.¹ In a 1997 report to Congress², the SEC encouraged the efforts of the IASC to develop a core set of accounting standards that could serve as a framework for financial reporting in cross-border offerings.

In 1999, the SEC took a leading role in the design of the reform of the IASC with regard to its organisation, governance and funding, resulting in the formation of the IASB and in a refocusing of its mission which was now defined as being to develop a single set of high quality global accounting standards. In 2000 the SEC played a leading role in the decision by the International Organization of Securities Commissions (IOSCO) to endorse the IASC core standards for use in cross-border listings.

In 2007, the SEC voted unanimously to remove the requirement for non-US companies reporting using IFRS as issued by the IASB to provide a detailed reconciliation of profit and equity back to US GAAP. At the same time, the SEC announced its intention to consider whether domestic US companies should also be required or permitted to use IFRS. As commissioner Casey made clear in a speech in 2011:

“The Commission has already made the determination that IFRS, as issued by the IASB, are of high quality. This determination was necessary to our decision in 2007 to permit foreign private issuers to make filings with the Commission using financial statements prepared in accordance with IFRS without reconciliation to US GAAP.”³

In November 2008, the SEC set out a proposed ‘Roadmap’, which foresaw that, subject to an assessment of various milestones and considerations, the SEC could be in a position in 2011 to decide whether to require US issuers to use IFRS beginning in 2014, potentially allowing earlier use for certain US issuers from 2009.⁴

¹ In September 1973, SEC Chairman Ray Garrett said that SEC Chief Accountant John Burton was “working with the AICPA and various international accounting groups to resolve the important differences in financial reporting around the world.” (Zeff, 2012)

² Report Pursuant to Section 509(5) of the National Securities Markets Improvement Act of 1996 on Promoting Global Pre-eminence of American Securities Markets (October 1997), <http://www.sec.gov/news/studies/acctgsp.htm>

³ Keynote Address at the Society of Corporate Secretaries and Governance Professionals 65th Annual Conference (29 June 2011) available at: <http://www.sec.gov/news/speech/2011/spch062411klc.htm>.

⁴ Available at: <http://www.sec.gov/rules/proposed/2008/33-8982.pdf>.

In February 2010, the SEC commissioners issued a statement reaffirming their strong commitment to a single set of global standards and to the recognition that IFRS is best positioned to be that set of standards, including for use in the US.⁵ The statement directed staff to develop and execute a work plan to support this process.

These decisions and actions were consistent with policy statements of the G20. In summit declarations from 2008 onwards, the leaders of the G20 countries, with the support of the Financial Stability Board (FSB)⁶, have called upon standard-setters to achieve a single set of high quality global accounting standards.

On 13 July 2012 the staff of the SEC published their final report on IFRS (the SEC Staff Report). The SEC Staff Report represented the culmination of almost two years' work by staff to analyse the issues related to the possible incorporation of IFRS into the US financial reporting regime.

The SEC Staff Report was designed to inform the SEC commissioners for when they would come to decide whether, and if so, how, IFRS should be applied in the US. It is understood that the SEC staff's next step would be to develop a recommendation to the commissioners on IFRS, but no timetable has been disclosed for completing this work.

Shortly after the SEC Staff Report was published, the IFRS Foundation Trustees issued a statement committing them to carefully consider the observations in the SEC Report. This document summarises the IFRS Foundation staff's assessment of those observations.

The Trustees asked that:

- (a) In order to maximise the benefit of the analysis to both the IASB and the international community, IFRS Foundation staff should evaluate the US research within an international context.
- (b) Staff should draw upon other credible sources of information. This should include academic research, as well as relevant documentation and experience from other jurisdictions that have already completed their own transitions to IFRS.
- (c) Staff should identify opportunities to further enhance the activities of the IFRS Foundation and the IASB on the basis of the findings of both the SEC staff report and the other studies.

⁵ February 2010 "Commission statement in support of Convergence and Global Accounting Standards, <http://www.sec.gov/rules/other/2010/33-9109.pdf>: "In addition to reaffirming the Commission's strong commitment to a single set of global standards, the recognition that IFRS is best-positioned to be able to serve the role as that set of standards for the U.S. market, and the convergence process ongoing between the Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB"), this statement outlines certain of these factors that are of particular importance to the Commission as it continues to evaluate IFRS through 2011."

⁶ The FSB was established in April 2009 as the successor body to the Financial Stability Forum.

Analysis of the conclusions of the SEC Staff report

The following provides an analysis of the main issues addressed in the SEC Staff Report. For convenience, we have grouped our analysis into five sections, with this Introduction and Executive Summary as Section 1. Section 2 contains the main observations made by the SEC staff about the functioning of the IFRS Foundation and the IASB. The third section analyses the SEC observations on IFRS as global standards. The fourth section deals with issues of adoption and endorsement in the transition to IFRS as identified by the SEC staff, and the fifth section highlights other challenges faced by jurisdictions that are considering making the transition to IFRS.

SEC analysis of the IFRS Foundation and the IASB

Governance

The SEC staff note that the overall design of the governance structure of the IFRS Foundation strikes a reasonable balance between providing oversight of the IASB and recognising and supporting its independence. In addition, while the IASB's objectivity could be threatened by outside political influence, such tension is not unique to the IASB.⁷

In terms of protecting the independence of the IFRS Foundation, we recognise that pleading by special interest groups is a fact of life for accounting standard-setters. Indeed, there is a fine line between being responsive to feedback and being subject to undue political influence. Sometimes, there are external attempts to cross this line. During the financial crisis, both the IASB and FASB have been subjected to political pressure.

The ongoing strengthening of our governance structures should further protect the independence of the IASB. In the 11 years since the IFRS Foundation was established, the governance arrangements of the organisation have been subject to two public Constitution Reviews, a Trustees' Strategy Review and a Governance Review by the IFRS Foundation Monitoring Board (the Monitoring Board). The Chairman of the SEC serves as a member of the Monitoring Board. Indeed, the Monitoring Board itself was created in 2009 "to further enhance the public accountability" of the organisation.⁸ Each successive review has led to further enhancements to the governance and public accountability of the IFRS Foundation. The recommendations of the latest Strategy and Governance Reviews are in the process of being implemented.

Furthermore, we believe that the heterogeneous nature of the IFRS community, the internationally and professionally diverse composition of the IASB and the creation of the Monitoring Board all help to dilute undue pressure from any one jurisdiction or special

⁷ SEC Staff report, p. 68

⁸ MOU to strengthen the Institutional Framework of the International Accounting Standards Committee Foundation, preamble, April 2009

interest group. Nevertheless, the IFRS Foundation and the IASB will always have to be vigilant in protecting the independence of accounting standard-setting.

Funding

The SEC Staff Report notes that the IFRS Foundation has made progress in developing a funding mechanism that is broad-based, compelling, open-ended and country-specific. However, the SEC Staff Report:

- (a) raises concerns about the continued reliance by the IFRS Foundation on funding from the large public accounting firms⁹;
- (b) notes that fewer than 30 countries contribute to the financing of the IFRS Foundation;
- (c) notes that the Trustees have been unsuccessful in obtaining the funding for the portion of the IFRS Foundation budget allocated to the US; and
- (d) notes the ‘in-kind’ funding contributions to the IFRS Foundation by US sources, such as the FASB staff efforts on US GAAP–IFRS convergence projects.

We agree that the Trustees have continued to make progress in developing a funding mechanism that meets the four characteristics described above. Indeed, the majority of the IFRS Foundation funding now comes from publicly-sponsored arrangements. However, we make the following points in response to the observations set out in the SEC Staff Report:

- (a) The analysis of the funding arrangements as set out in the SEC Staff Report overlooks the fact that the European Commission, which is the biggest contributor to our budget, represents 27 member states of the European Union (EU). Furthermore, the analysis does not recognise that royalty payments are received from an additional 19 countries. It also does not take into account that some voluntary funding arrangements by some countries have been withdrawn in anticipation of the introduction of publicly-sponsored schemes that have already been agreed. When considering these factors, 69 countries provide, directly or indirectly, financial support for the work of the IFRS Foundation, instead of the fewer than 30 as identified by the SEC staff. We do, however, agree with the SEC’s suggestion that the IFRS Foundation should continue to expand the number of countries contributing to its budget.
- (b) We acknowledge that the FASB has contributed significant resources to support the joint standard-setting efforts related to the convergence programme. However, we believe that this is a joint process and, where efforts and resources are shared equally by both boards, so too are the benefits. Consequently, the staff perspective is that the sharing of such resources, while indeed helpful to the work of both the IASB and the FASB, should not be factored in when considering the US contribution to the operational budget of the IFRS Foundation.

⁹ SEC Staff report, p. 6

- (c) A publicly sponsored arrangement has yet to be implemented in the US. As a result, the reliance on voluntary contributions is most acute in the US. We believe that US funding should have public sponsorship (either direct or implicit governmental or regulatory support) because such an arrangement would be consistent with the principles of the Trustees' Strategy Review. If such an arrangement was in place in the US, then the total voluntary proportion of contributions as a percentage of overall contributions would fall significantly. The Trustees have been discussing the possibility of instigating a long-term public funding arrangement with the SEC since 2009 but a solution has yet to be identified.
- (d) Another result of the lack of a publicly sponsored funding arrangement is that the US has to date not contributed a proportionate amount to the IFRS Foundation's budget. Currently, a proportionate US contribution based on GDP (the primary indicator used by the IFRS Foundation to assess the funding expectations of a country) would amount to just over £4 million, however, only £1.3 million is currently expected to be collected from US sources in 2012. We note that, while around 20-25% of the total seats in the Foundation's different bodies are currently held by the US, the US contributions amount to less than 10% of the total country contributions to the Foundation's budget. Ultimately the lack of public funding in the US can only be resolved by the US authorities themselves, directly or indirectly.

Due process

On the subject of the comprehensive nature of the IASB's due process, the SEC staff:

- (a) observes that the IASB's due process is heavily based on consultation and gathering of facts and views, open deliberations, analysis, and the explanation of its decisions to the public;
- (b) notes that IASB members' deliberations involve extensive debate and analysis; and
- (c) believes that IASB members decide on the resolution of issues on projects on the basis of their technical merits and overall usefulness for investors and other users of financial statements.

We welcome the SEC staff's comments. Furthermore, during 2012 the IASB has been working with the Trustees to further enhance its reporting, accountability and due process requirements. As a result of these enhancements, the IASB is required to report throughout the life of each technical project on the steps that it has taken to protect the integrity of its technical decisions. The reporting of the IASB's consideration of due process and the Trustees' review of those actions has also been enhanced, to ensure that interested parties can monitor these activities. Through the Due Process Oversight Committee (DPOC), the Trustees have;

- (a) undertaken activities that highlight the importance of the independence of the standard-setting process;

- (b) enhanced the role of the DPOC to periodically check that the IASB's due process is operating against an agreed framework;
- (c) intensified the DPOC's interactions with the IFRS Advisory Council (the Advisory Council) and the IFRS Interpretations Committee (the Interpretations Committee) so that more meaningful and better-informed feedback on the functioning of the IASB is received; and
- (d) appointed dedicated staff to support the management of their due process responsibilities.

IFRS as global accounting standards

The SEC Staff Report comments on various aspects of IFRS as global accounting standards. We make the following observations on these comments.

Comprehensiveness

To assess the comprehensiveness of IFRS, the SEC staff compared IFRS with US GAAP.

Remaining differences between US GAAP and IFRS

The SEC Staff Report notes that even after a decade-long convergence programme, some differences remain between IFRS and US GAAP. The SEC Staff Report does not imply that either US GAAP or IFRS has the better solution, only that they are different. Nevertheless, the importance to the US of these differences should not be downplayed. At the same time we note that, as a result of more than ten years of joint work with the FASB to improve IFRS and US GAAP and bring about their convergence, the differences that the US will have to bridge are significantly smaller in scope than the differences faced by other major countries that have already adopted IFRS.

Furthermore, when considering these remaining differences, it is important to consider whether the existing level of alignment between IFRS and US GAAP can be maintained. Both the IASB and the FASB are independently considering their respective post-MoU work programmes. There is a risk that, in the absence of a US decision on adoption, a decade of convergence may be followed by a new period of divergence.

Industry-specific guidance

The SEC Staff Report notes comments by some respondents about the lack of industry-specific guidance contained within IFRS, which is due to the IASB's preference for industry-neutral principles. The SEC staff believes that industry guidance should not be removed from US GAAP until the IASB has had the ability to evaluate fully such guidance and to address any voids in IFRS.

The IASB has always advocated financial reporting requirements that account for transactions and activities across industries, rather than developing industry-specific guidance. Many specialised activities, such as insurance contracts or property investment, are undertaken by a wide range of entities that are not in specialised industries. We believe

that such an approach avoids the proliferation of potentially conflicting industry-specific requirements. Furthermore, we note that, in 2008, the SEC published the findings of the Pozen Report,¹⁰ which recommended that industry-guidance should be eliminated from US GAAP to reduce avoidable complexity. The Pozen Report went on to recommend that the SEC should encourage the IASB to limit future industry-specific guidance.

The issue of industry-specific guidance would need to be addressed as part of any transition arrangements to IFRS.

Areas where IFRS could be improved

The SEC Staff Report states that the SEC and commentators have noted that IFRS guidance is limited in a number of areas, such as accounting for common control transactions, and lacking altogether for certain industries, such as insurance and extractive activities. Although IFRS covers a broad range of activities, there are clearly some gaps that over time will be addressed. The IASB has recently identified such areas as a result of its consultation on its future agenda, and priorities have been established. In the meantime, in cases when IFRS does not cover a particular topic, the Standards will often permit the use of existing domestic requirements. For example, Australian companies are able to apply the existing Australian accounting standard on insurance contracts without negating their ability to attest compliance with IFRS.

We agree that, like any established set of accounting standards, there are areas where IFRS can be improved. There are various mechanisms for such improvements to be made over time. For major projects, the IASB seeks public input through the IASB's three-yearly public consultation on its future agenda, in order to provide a clear demonstration of how priorities on its agenda are set. The IASB's Annual Improvements process provides a mechanism for more targeted improvements, while the Interpretations Committee is able to address areas where diversity in practice is identified, or to prevent it developing.

Principle-based standards

The SEC Staff Report noted that there is a perception that IFRS is more principle-based than US GAAP. We believe that both sets of standards are principle-based—US GAAP requirements, like IFRS, are drawn, largely, from a conceptual framework.

US GAAP tends to be more detailed and to use more quantitative 'bright-line' tests than IFRS. IFRS places more reliance on establishing clear objectives and expressing the requirements as principles. The SEC Staff Report does not question the benefits of having more objective-based standards, and therefore fewer detailed rules.

The SEC Staff Report notes that the early experiences with new principle-based requirements in US GAAP illustrates that "objectives-based standards are not necessarily

¹⁰ Report of the Advisory Committee on Improvements to Financial Reporting to the SEC (2008) <http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf>

problematic in their auditability or enforceability.”¹¹ However, the SEC Staff notes commentators concerns that the Interpretations Committee should become more active to reduce diversity in the application of IFRS.

Maintenance

Interpretations

The SEC Staff Report notes observations from outreach conducted by SEC staff that the Interpretations Committee should do more to address issues on a timely basis.

We agree that the Interpretations Committee should be more active in providing Interpretations. This was one of the main recommendations of the 2011 Trustees’ Strategy Review *IFRSs as the Global Standards: Setting a Strategy for the Foundation’s Second Decade* (the Strategy Review)¹². Responding to this recommendation, in May 2012 the Trustees published the recommendations of a further review of the efficiency and effectiveness of the Interpretations Committee. This review recommended that the Interpretations Committee should:

- (a) develop a broader range of ‘tools’ to be deployed by the Interpretations Committee, enabling it to be more responsive to requests for assistance;
- (b) revise the criteria used to determine which issues the Interpretations Committee should take action on;
- (c) improve the Interpretations Committee’s communications regarding issues that it decides not to address; and
- (d) expand the Interpretations Committee’s outreach and the transparency surrounding its decisions..

The recommendations of the review have been now been implemented in full.

Post-implementation Reviews

In the SEC Staff Report, the SEC staff recommended that the IASB move to a model whereby the staff working on Post-implementation Reviews would report directly to the Trustees, as is the case with the Post-implementation Reviews of FASB Standards.¹³

We believe that there are merits to each approach. Post-implementation reviews conducted by the oversight body provide some comfort that the assessor will not have a bias towards his or her own work. However, the Trustees and the IASB have concluded that the IASB will be able to conduct a more effective review by having the IASB consider and assess directly

¹¹ SEC Staff Report, p.27.

¹² <http://www.ifrs.org/The-organisation/Governance-and-accountability/Strategy-Review/Documents/TrusteesStrategyReviewFeb2012.pdf>

¹³ SEC Staff Report, pp.49–50.

the views of respondents rather than receiving a summary report from the trustees. The Trustees and IASB understand the risk that this could be perceived as not being an independent assessment. However, they are confident that the transparent way in which the reviews are being conducted will protect the integrity of the process. The DPOC receives regular updates on the steps being taken. This approach ensures a combination of effective self-review, with the highest levels of transparency through the publication of all views received and the evaluation of those views by staff, combined with effective scrutiny by the Trustees and the public at large.

National standard-setters

The SEC Staff Report:

- (a) recognises the procedures that the IASB has in place for working with national standard-setters, as well as the high levels of interaction with national standard-setters on a bilateral basis; and
- (b) recommends that the IASB should extend its involvement with national standard-setters in several processes, such as during the development of a new Standard, outreach activities and Post-implementation Reviews.

The IASB already has strong and effective relationships with national and regional accounting standard-setting bodies through a combination of bilateral, multi-lateral and informal arrangements. However, we agree that these relationships could be strengthened further by formalising such networks and organising them on a regional and global basis. This was an important recommendation of the Trustees' Strategy Review.

In response to this recommendation, the IASB has begun preparatory work to establish an Accounting Standards Forum (the Forum) comprising national standard-setters and other regional bodies. The Forum will provide advice and feedback to the IASB on major technical issues related to its standard-setting activities and input to the IASB on national and regional issues. This group will become an important sounding board for the IASB throughout the life cycle of its standard-setting activities.

Enforceability

The SEC Staff Report notes the importance of achieving greater consistency in the enforcement of IFRS if the benefits of a single set of global accounting standards are to be fully realised. We agree with this conclusion. The main responsibility of the IASB in this respect is to create Standards that are enforceable. To be enforceable, Standards must be clear and use language that allows unambiguous translation into various languages, as well as for the purpose of electronic filing using eXtensible Business Reporting Language (XBRL), without undue difficulties.

However, having enforceable standards is a necessary, but not sufficient, condition for global comparability. Research commissioned by the IFRS Foundation¹⁴ notes that the benefits of IFRS depend on the level of enforcement in a country. Such enforcement is the responsibility of both the regulatory authorities the financial markets and of auditors. Consistent enforcement of IFRS will require action by the international community, such as securities regulators and the audit oversight bodies.

The auditing of financial statements is an important oversight function to also ensure the consistent application of IFRS. The auditors' role is subject to independent oversight by public sector agencies who are accountable to governments. The IASB can support this work, but has no authority or ability to enforce consistent application.

Notwithstanding this clear division of responsibilities, the IASB stands ready to co-operate closely with the regulatory authorities to mutually benefit from our experiences. This was a recommendation of the Trustees' Strategy Review and multi-level discussions with organisations such as IOSCO are already under way.

We welcome the commitment expressed in the SEC Staff Report to work with the IASB, other securities regulators and the accounting profession to improve consistency in the application and enforcement of IFRS on a global basis. Because the SEC staff currently, and in recent history, serves as Chair of the IOSCO policy committee 1 on Multinational Disclosure and Accounting, and with a large number of foreign SEC registrants now reporting using IFRS, we believe that the SEC has both an important role to play and a vested interest in a successful outcome.

If the SEC decides to adopt IFRS, enforcement in the US will always remain the sole responsibility of the SEC, so there is no danger of US standards of enforcement being affected by outside influences. Furthermore, if and when the US completes its transition to IFRS, the SEC could extend its existing leadership in worldwide enforcement to the IFRS domain, while sharing with the rest of the world its experience and practices in accounting standards enforcement.

It is however clear that, without a single set of global standards, consistent application of accounting standards across the world will by definition not be achievable.

Issues related to adoption, endorsement and transition

The SEC Staff Report discusses various issues related to incorporating IFRS into US GAAP. Many of these issues are specific to the US and can only be addressed by US authorities in the environment in which they operate. The IFRS Foundation staff is not in a position to give definitive answers or suggestions to the observations made by the SEC staff. Instead, in this chapter we refer extensively to the way in which many IFRS jurisdictions have dealt with different issues while adopting IFRS. While it is true that every jurisdiction has its unique

¹⁴ "The case for global accounting standards: arguments and evidence", Tarca et al, 2012 (see appendix).

challenges, and this will certainly be the case in the biggest national capital market in the world, we believe this international experience provides a useful backdrop for analysis.

Methods of incorporation

The SEC Staff Report notes that:

- (a) pursuing the designation of IFRS as directly authoritative was not supported by the vast majority of participants in the US capital markets;
- (b) an endorsement mechanism is needed, to ensure that sovereignty is maintained and proper influence can be exerted in the standard-setting process of the IASB;
- (c) the SEC staff would find it most logical to incorporate IFRS into US GAAP for legal and administrative reasons; and
- (d) the vast majority of commenters envision a strong role for the FASB in the endorsement of IFRS and that they expect the FASB to be able to exert influence on the standard-setting process of the IASB through this endorsement role.

None of these considerations is unique to the US. As stated by the SEC Staff Report, few jurisdictions designate IFRS as authoritative, with most following some form of endorsement process through which the Standards become authoritative. Such a mechanism can serve as an important 'sovereignty circuit-breaker' to ensure that international rules do not automatically form a part of national law. Such arrangements are used by the majority of IFRS jurisdictions and are respected by the IASB.

We also understand that US respondents wish to see a strong role for the FASB. From the IASB perspective, it is clear that the US's contributions to the future Accounting Standards Forum and to the standard-setting process of the IASB would have greater weight if the US were to employ an endorsement approach to the use of IFRS.

However, the SEC Staff Report¹⁵ acknowledges the risks to IFRS as a single set of high quality globally accepted Standards if the process of incorporating IFRS into US GAAP resulted in material changes to IFRSs being introduced. Such an outcome might be viewed by other jurisdictions as legitimising their own customisation of IFRS to meet local requirements. We note the importance of a high threshold for non-endorsement: any exception is unhelpful because it reduces the international comparability of financial reports and undermines the benefits of global standards. Consequently, it should be activated as rarely as possible.

Transition arrangements

The SEC Staff Report notes that:

- (a) some commentators were opposed to a 'big bang' method of transition, favouring instead a more gradual transition to IFRS; and

¹⁵ SEC Staff Report, p.88.

- (b) indirect methods of incorporation could lessen the total costs required while extending any timeframe for incorporation.

We note that it is for individual jurisdictions to determine the most appropriate method to adopt IFRS.

The SEC Staff Report does not contain a systematic analysis of possible methods of gradual transition to IFRS, but experiences of previous IFRS adopters suggest a range of adoption methods.

Giving adopting entities sufficient time for preparation is essential to keep the burden of conversion as low as possible. Adequate preparation time allows for proper training and education, and may enable companies to reduce the costs of system changes.

A gradual approach through convergence might be an appropriate short-term strategy for a particular jurisdiction and may facilitate bringing closer together two or more sets of standards, but it cannot be a substitute for adoption.

However, the viability of a gradual introduction of IFRS on a Standard-by-Standard basis is in the view of staff, questionable. We have found no evidence of a jurisdiction that has successfully adopted IFRS using a Standard-by-Standard approach. Those jurisdictions that had initially considered such an approach decided, after further investigation, to follow the so-called 'big bang' approach instead. A gradual introduction of IFRS at a Standard-by-Standard level would present many technical challenges because of the significant cross-referencing that would be needed between the individual Standards that make up the full set of IFRS. Moreover, it would probably be very costly for preparers to go through a protracted period of gradually applying new Standards. It has also the potential of creating disruption to financial markets that would be due to a protracted period of changes to financial reporting, by creating uncertainty and lack of comparability for single companies' financial statements over the entire transition period. Finally, a Standard-by-Standard approach would also entail the risk of a multitude of smaller or bigger exceptions to IFRS, which would defeat the purpose of adopting a single set of global standards.

Some jurisdictions seeking a more gradual transition to IFRS have chosen to permit optional use of IFRS for certain types of companies. This is the method currently deployed in Japan. If such an approach were used in the US, it could provide the SEC with important data regarding the practical application of IFRS by domestic US companies. A drawback of optional use of IFRS is that while it increases comparability with a company's international peers, it may impede comparability with domestic peers. Consequently, in the view of staff such an option should only be regarded as a short-term strategy. The challenge of reduced comparability could be further reduced by confining the optional use of IFRS to a subset of US companies with major international activities. The loss in domestic comparability would be compensated for by a gain in international comparability of these entities.

Another possible alternative would be to make IFRS mandatory for a limited subset of US companies that are internationally active, while companies that are mainly active in the domestic US market would retain US GAAP for a longer period. This option would result in

fewer issues of comparability, because all internationally active companies would report under IFRS. Again, their loss in domestic comparability would be compensated for by a gain in international comparability.

Once again, we note that determining transitional arrangements is a matter for the US alone. However, with more than 100 countries having already completed this transition, including many major developed economies, we believe that the experience of the international community of making the transition to IFRS provides SEC staff with an important resource to draw upon.

Investors' understanding of IFRS in the US

The SEC Staff Report notes that investors generally support the idea of the US moving to a single set of global accounting standards, but that support for IFRS as that set of standards is conditional.¹⁶ Investors' primary concerns are similar to those of other US stakeholders. However, one of the main concerns, as noted in the SEC Staff Report, relates to how well-prepared US investors are for a transition from IFRS to US GAAP. The SEC Staff Report notes that:

- (a) most institutional and professional investors who are already familiar with IFRS do not see investor preparedness being a major hurdle to incorporating IFRS; but
- (b) investors who are focused exclusively on US domestic companies, as well as smaller companies and private investors who are less familiar with IFRS, are reluctant to commit to develop a competence in IFRS until it becomes clear how the SEC will proceed with IFRS.

Experience from other jurisdictions has shown that once a decision is made about IFRS, even domestic investors have sufficient time and resources to support the transition.

We believe that once the SEC has decided how it will proceed with IFRS, a combination of sufficient time, alongside investor education programmes, will help to alleviate the burden of a transition to IFRS among this important group of investors. Furthermore, we recognise the role we have to play in this endeavour.

Regulatory environment

The SEC Staff Report notes that adopting IFRS can present challenges to the regulatory environment.

We agree with the SEC that these challenges should not be underestimated. Our analysis of other major jurisdictions that have already adopted IFRS suggest that adaptations in the regulatory environment can indeed be challenging, but they can be overcome. For example, many jurisdictions have decided to preserve references to existing national GAAP within authoritative literature such as financial regulation. In such cases, the body charged with

¹⁶ SEC Staff Report, p.72.

approving financial reporting requirements has specified that IFRS are equivalent to national GAAP.

Furthermore, we recognise the concerns expressed by US industry regulators about their ability to be heard and to have their views given due consideration by the IASB in the standard-setting process. The IASB is aware that prudential supervisors, for example, rely on financial reports for some of their functions. To assist prudential supervisors, the IASB engages in an enhanced dialogue with such authorities, particularly through the Financial Stability Board and the Bank of International Settlements.¹⁷ It is not unusual for other relevant regulatory agencies around the world to engage in dialogue with the IASB, both directly through the IASB's standard-setting process as well as indirectly through national standard-setters or other regulators who represent their region or jurisdiction.

We agree that addressing the link between financial reporting and tax accounting can be challenging. Different countries have dealt with this in different ways: in some, tax requirements are linked to the same financial statements, while in others the introduction of IFRS has resulted in a separation of tax rules from accounting standards.

The SEC Staff Report notes the difficulties caused by IFRS not permitting the use of the Last In First Out (LIFO) method for inventory valuation. The LIFO coalition in the US acknowledges that the use of LIFO is fundamentally a taxation matter and avoids any justification of the method for financial reporting purposes. They assert that changes to financial reporting requirements should not influence a decision about LIFO and note that the US Treasury has broad discretion to permit the continued use of the LIFO inventory method.

Human capital readiness

The SEC Staff Report notes that the large US international public accounting firms and multinational companies have an extensive understanding of IFRS. We believe that this substantial human capital capability puts the US at a distinct advantage when compared to other jurisdictions setting out to make the transition to IFRS.

However, in the same way as for other jurisdictions, we accept the argument that US preparers with limited international operations, and smaller and mid-sized US audit firms, will need to further develop their IFRS competencies in advance of any transition to IFRS.

The experience from other developed jurisdictions that have already completed their transitions to IFRS has shown that, with appropriate planning, the human capacity can be successfully developed at an appropriate cost.

Several factors provide reassurance that the US accounting profession would deliver the human capital needed for the adoption of IFRS, including:

¹⁷ Excerpted from the IASB and IFRS Interpretations Committee draft *Due Process Handbook*.

- (a) the convergence programme, which has substantially reduced the differences between IFRS and US GAAP;
- (b) the existing exposure and use of IFRS by foreign private issuers in the US;
- (c) the likelihood that a relatively long transition period to IFRS would be provided, particularly for smaller, publicly traded companies; and
- (d) the inclusion of IFRS in CFA Institute and the AICPA exams.

Furthermore, the IFRS Foundation Education Initiative already works with the relevant US institutions to support increased IFRS knowledge and skills. We envisage that the intensity of this co-operation will develop further once a decision is made by the SEC.

Costs of transition

The SEC Staff Report notes the difficulties associated with developing implementation plans and assessing transition costs until the SEC decides if and how to proceed with IFRS.

The experience of other jurisdictions is helpful when assessing the range of possible costs. In Canada, a study of 146 companies involved in the recent transition to IFRS showed that 66 per cent of respondents had budgeted less than \$500,000 in Canadian dollars for the transition, while 32 per cent planned to spend less than \$100,000 in Canadian dollars.

In Korea, the costs for non-financial companies making the transition to IFRS were estimated to be \$250,000 in US dollars while the total cost for financial companies was \$2,400,000 in US dollars.

In Brazil, a survey revealed that transition costs were less than \$1 million US dollars for 77 per cent of respondents.

For smaller companies in Europe, the cost of making the transition to IFRS and the subsequent recurrent application costs were estimated to be respectively 0.31 per cent and 0.06 per cent of turnover. While these cost estimates are not insignificant, overall they have not been prohibitive.

With regard to the US, there are some specific points that should be taken into consideration. First, the decade-long convergence programme has resulted in the differences between IFRS and US GAAP being less than those between most other jurisdictions. This reduction in differences should mean a reduction in the costs associated with transition. Second, the costs of implementing the new converged Standards (such as Fair Value Measurement Revenue Recognition and Leases) will be borne by US preparers, regardless of whether the US moves to IFRS or retains US GAAP. Consequently, these costs should not be accounted for as transition costs. Moreover, it can be argued that combining the work to adopt the convergence projects with the move to adopt IFRS would reduce total transition costs.

The SEC Staff Report does not provide an analysis of the benefits of the use of IFRS in the US. The IFRS Foundation has recently commissioned a study¹⁸ to review academic research on the benefits of IFRS adoption. The study—which is included as an appendix to this analysis—finds these benefits to be considerable.

These results, however, cannot be simply projected onto the US. The US already has high quality accounting standards with a solid reputation. In the short term, the benefits for the US may be smaller than those for countries that started out with standards that were only understood domestically. Having said that, the US incorporation of IFRS is still likely to have important benefits: US investors increasingly rely on foreign growth economies to optimise the return on their investments—increased transparency and comparability in international capital markets is in their interest. Furthermore, the global application of IFRS means that US companies have an interest in being able to use the Standards on a consistent basis across all of their activities. Finally the US stands to gain by the beneficial effect of a single set of global standards on the world economy as a whole.

As IFRS becomes the global standard, the US has an interest in participating in its development and application as expressed by the SEC Staff Report.¹⁹ Such influence can be expected to be concomitant with US commitment to IFRS as a single set of global standards.

Final comments

In conducting this analysis, the IFRS Foundation staff have concluded that the SEC Staff Report provides a valuable contribution to the already extensive body of research and information on IFRS. It not only informs the discussion in the US on whether, and if so, how IFRS could be incorporated into the US financial reporting system, but it makes an important contribution to the IFRS Foundation’s evaluation of its own strategy, governance and activities.

In conducting the analysis of the SEC Staff Report, staff have complemented the SEC’s analysis of considerations related to IFRS adoption with experience and academic research from other jurisdictions that have already completed their own transitions to IFRS.

While the size of the US economy relative to other jurisdictions presents significant challenges in transition that are unique to the US, the experience of other countries suggests that many of the challenges can be overcome with the appropriate political will to make a commitment to the mission of a single set of global standards. Moreover, in many areas the US is better prepared than other jurisdictions to consider the adoption of IFRS.

¹⁸ “The case for global accounting standards: arguments and evidence”, Tarca et al, 2012 (see appendix).

¹⁹ SEC Staff Report, p. 1

2. The IASB as a global accounting standard-setter

The SEC Staff Report notes the importance to the SEC of assessing whether the accounting standard-setter, ie the IFRS Foundation and the IASB as its standard-setting board, has the required funding and governance structures to support the independent development of accounting standards for the ultimate benefit of investors.²⁰

The SEC staff focus on four areas:

- (a) oversight of the IFRS Foundation;
- (b) the composition of the IFRS Foundation and the IASB;
- (c) funding of the IFRS Foundation; and
- (d) the IASB standard-setting process.

The SEC Staff Report is helpful in identifying concerns that existing and potential users may have. Many of the recommendations in the SEC Staff Report describe matters that the IFRS Foundation has already identified through its own reviews. Their report provides comfort that that the steps we are already taking are the right ones. It also includes helpful and constructive recommendations for further consideration by the IFRS Foundation.

Oversight

The SEC staff review found that the overall design of the governance structure of the IFRS Foundation strikes a “reasonable balance of providing oversight of the IASB while at the same time recognizing and supporting its independence.”²¹

However, the SEC Staff Report notes concerns expressed during their consultations that that the IASB’s objectivity could be undermined because of outside political influence.²² One commentator stated that the IASB’s independence “needs to be protected from political interference, and pressure from regulators, at all costs”.²³

The IFRS Foundation’s governance structure seeks to strike a balance between public accountability and its independence from undue influence by external or political forces. This tension is not unique to the IASB: standard-setters in other jurisdictions have faced, and continue to face, political pressures. A recent example is the debates about financial reporting and whether accounting standard-setters should set standards in a way that is helpful to prudential regulators.

²⁰ SEC Staff Report, p.34.

²¹ SEC Staff Report, p.35.

²² SEC Staff Report, p.68.

²³ SEC Staff Report, p.68, footnote 361.

A primary role for the Trustees is to advocate, and preserve the independence of, the IASB's standard-setting processes. Indeed, the IFRS Foundation's *Constitution* establishes an independent standard-setting process, subject to extensive due process requirements, but protected from special and parochial interests. As noted in the Trustees' Strategy Review, this independence has been a fundamental strength of the IFRS Foundation and the IASB, and gives credibility to the Standards.

Each IASB member, whether full-time or part-time, must commit himself or herself formally, and indeed agree contractually, to act in the public interest. All members of the IASB and senior staff are required to disclose financial interests that are relevant to the work of the IASB. The very high level of transparency with which the IASB operates also helps to ensure that those observing its standard-setting process can also observe the decision-making processes. It would be very difficult for any IASB member to act other than in the public interest without their behaviour being challenged. The SEC Staff Report noted that allowing part-time IASB members with other employment arrangements "may give rise to economic incentives that might call into question a member's independence of judgement in setting financial reporting standards."²⁴ During its consultation on the *Final Report on the Review of the IFRS Foundation's Governance*²⁵ (Governance Review), the Monitoring Board noted that among other factors to consider as part of efforts to diversify the IASB membership, considering part-time members as a means to potentially enhance the involvement of those with practical experience with IFRS should not be ruled out. The Monitoring Board reiterated that the Trustees and IASB Chair had the power to consider part-time IASB members where appropriate. However, the IASB currently does not have any part-time members and there are no current plans to bring part-time members onto the IASB.

Independence is a prized asset for the IFRS Foundation, but independence comes with the requirement of public accountability. To meet that requirement, the IFRS Foundation has a three-tier system of governance: a Monitoring Board that acts on behalf of public authorities, the Trustees who oversee all activity, and the IASB as the standard-setting body. The Trustees believe that this three-tier structure is serving the organisation well and balances the needs for public accountability and the independence of the standard-setting process. That view was shared by many stakeholders who responded to the Trustees' consultation on their Strategy Review and to the Monitoring Board on its Governance Review.

Composition of the IFRS Foundation and the IASB

The IFRS Foundation is a global organisation and tries to ensure that it has truly international representation in all aspects of its work. The IFRS Foundation's *Constitution* sets out requirements that the membership of the Trustees and the IASB are representative both geographically and by industry background.

²⁴ SEC Staff Report, p.50.

²⁵ <http://www.ifrs.org/Alerts/PressRelease/Documents/GovernanceReviewFinalReportFeb2012.pdf>

Trustees

The Board of Trustees is required to reflect the world's capital markets via geographical diversity and an appropriate balance of professional backgrounds. All Trustees are required to show a firm commitment to the IFRS Foundation and to the IASB as a high quality global standard-setter, to be financially knowledgeable, and to have the ability to meet the time commitment that is required from them.

In terms of the geographical spread, the *Constitution* provides that there shall be six Trustees appointed from each of the Asia–Oceania region, Europe and North America, one from each of Africa and South America, and two from any area, subject to maintaining an overall geographical balance.

The Trustees are responsible for establishing procedures for filling Trustee positions and the Monitoring Board is responsible for the approval of all Trustee appointments and reappointments. In line with a recommendation in the Monitoring Board's Governance Review, the documentation of the criteria and processes for Trustee nominations and appointments is being improved and made publicly available.

IASB

The IASB currently has 15 full-time members. The *Constitution* provides for a membership of 16, of which up to 3 members may be part-time (and would not be required to sever their existing employment arrangements). Members of the IASB are selected by the Trustees on the basis of the criteria in the *Constitution*, with the main qualifications being professional competence and practical experience. The Trustees select members so that the IASB will be composed of a group representing the best available combination of technical expertise and diversity of international business and market experience. This should enable IASB members to effectively contribute to the development of high quality, global accounting standards, while providing an appropriate mix of recent practical experience among auditors, preparers, users and academics.

The *Constitution* requires that the geographic balance of the IASB is as follows: Four members from each of the Asia-Oceania region, Europe and North America. One member from each of Africa and South America, and two members from any area, subject to maintaining overall geographic balance.

The IASB currently has members from the following countries: Australia (1), Brazil (1), China (1), France (1), Germany (1), India (1), Japan (1), Korea (1), the Netherlands (1), South Africa (1), Sweden (1), the United Kingdom (1) and the United States (3).

Technical staff

The technical staff that supports the IASB is also drawn from an international community. At the end of 2011 the 68 technical staff came from 21 countries, including seven staff members seconded from national standard-setters.

In summary, we believe that the heterogeneous nature of the IFRS community, the internationally and professionally diverse composition of the IASB and the creation of the Monitoring Board in 2009 all help to dilute undue pressure from any one jurisdiction or special interest group. Nevertheless, the IFRS Foundation and the IASB will continually have to be vigilant in protecting the independence of standard-setting.

Funding

The SEC Staff Report raises a number of issues about the funding of the IFRS Foundation, and whether it affects the IFRS Foundation's independence, either in appearance or in fact.²⁶

The funding of the IFRS Foundation has proved to be an ongoing challenge, because of the lack of any mandatory legal instrument that forces countries to support it. However, over time, significant progress has been achieved: discussions with countries that have yet to contribute to the IFRS Foundation's budget have been initiated at staff level with the Trustees' support. A financing plan was developed for countries who do not meet their funding target, and further discussions with the Monitoring Board about encouraging countries to start or to continue their contributions are ongoing.

An important achievement in the efforts made towards stable independent funding is demonstrated by the fact that, from 2007 to 2011, the level of voluntary funding has dropped from 43 per cent to 33 per cent of total income. A number of countries are in the process of implementing long-term funding arrangements. Active examples include Russia and Brazil who have Memorandums of Understanding in place to support their funding.

In addition, the number of countries who support the IFRS Foundation continues to increase: the SEC staff finds that fewer than 25 per cent of the countries that allow or adopt IFRS contribute to the financing of the IFRS Foundation and that the number of jurisdictions from which organisations made a contribution dropped from 31 to 25²⁷.

However, the following facts, when considered, result in a different conclusion:

Of the absolute drop reported from 31 to 25, three of the countries that did not contribute in 2011 were putting into place long-term non-voluntary funding regimes, which are expected to come into force in 2012.

In addition, as already noted in the SEC Staff Report in 2011, the EU now provides central funding and, as a result, three specific countries ceased individual funding and are replaced by the EU funding. The EU is listed as one contributor in the IFRS Foundation 2011 Annual Report, but is made up of 27 countries. Ten of these EU countries also make individual contributions and were therefore already listed as contributors, so in effect, there is an overall increase in the total number of EU countries of 17, when splitting out individual countries from the EU central fund, as it appears in the SEC Staff Report.

²⁶ SEC Staff Report, pp.34, 38, 52–53, 58 and 68.

²⁷ SEC Staff Report, pp.57

Further, while the IFRS Foundation lists contributions by countries in its Annual Report, there is no individual listing of payments that were made by way of royalties. In 2012, 49 countries are expected to contribute by way of royalty payments and, of these, 27 represent additional countries who are not shown as contributing directly.

Consequently, a total of 69 countries make a contribution of some form towards the IFRS Foundation, which is 58 per cent of the total countries requiring or permitting the use of IFRS.

It is important to note that the EU grant is given to the IFRS Foundation on a 3-year commitment basis. The IFRS Foundation is currently discussing the renewal of the grant for another 3 years, and is confident that the grant will be renewed.

The SEC staff states that the continued reliance by the IFRS Foundation on funding from the largest accounting firms will continue to cause concerns about the adequacy and independence of the IASB's funding model.²⁸ We believe that the governance structure of the Foundation ensures that the IASB's independence is not compromised by any such contributions. Furthermore, while the Foundation does not believe that the dependence on the accounting firms for funding compromises the independence of the IASB, the IFRS Foundation is working to secure stable funding in order to reduce or eliminate this perceived dependency. An important component in removing this dependence is to address the ongoing funding challenges in the US, described in the following pages.

Funding from the US

The SEC Staff Report repeats the fact that the US has a significant interest in providing stable funding to the IFRS Foundation and is committed to exploring strategies to address this issue. However, the SEC or its staff cannot act as a fundraiser for a "private organization."²⁹

The SEC staff describes the current situation as an "interesting dynamic":³⁰ one of the proposed membership criteria in the Monitoring Board is based on "financial contributions by the jurisdiction." The result is that the SEC membership in the Monitoring Board depends on the efforts of others (the Trustees) in the US. However, the SEC Staff Report states that "the Trustees have not been successful in raising funding in the US to meet the US funding objectives."³¹

The IFRS Foundation allocates contributions to different countries according to their relative GDP. In 2012, the proportionate US contribution, determined on this basis, accounts for 20 per cent (£4,256,043) of the total IFRS Foundation contributions. However, the US to date

²⁸ SEC Staff Report, pp.57-58.

²⁹ SEC Staff Report, p.56.

³⁰ SEC Staff Report, p.56.

³¹ SEC Staff Report, p.58.

has not contributed a proportionate amount, with only £1.3 million expected to be collected from US sources in 2012. In terms of the estimated 2012 contribution in the US, this accounts for 8 per cent of total country contributions.

The ongoing funding challenges in the US result in that the continued reliance on voluntary contributions in the US adversely affects the total split between voluntary and publicly sponsored contributions.

If a publicly sponsored arrangement were to be implemented in the US, the voluntary proportion of total contributions would fall to 27 per cent making the public country contributions add up to 73 per cent of the total country contributions.

The SEC Staff Report states that the US has contributed significant resources to support the joint standard-setting efforts of the IASB and the FASB. While we acknowledge these efforts and resources, we believe that this is a joint process that contributes equally to both sides of the project. Any efforts and resources are shared by both boards, and so are the benefits. Consequently, the view of staff is that the sharing of technical staff to support convergence activities should not be included in an assessment of the US's financial contribution to the operational budget of the IFRS Foundation.

The SEC Staff Report also states that there are impediments to introducing in the US a publicly sponsored funding arrangement in support of a private-sector organisation such as the IFRS Foundation (the US Financial Accounting Foundation/FASB has been designated as an official standard-setter and is therefore outside the scope of this restriction).

In some other parts of the world, for funding purposes the IFRS Foundation is regarded as a public sector organisation—because of its role and function in the international regulatory environment, as well as its governance structure. Of particular relevance in the US is the role that the IASB has in developing IFRS used by foreign private issuers. Accordingly, the IFRS Foundation already has a formal role within the US market. Furthermore, the US Federal Reserve already contributes to the funding of the IFRS Foundation as an expression of its support for the public mission of the IFRS Foundation.

We note that, while around 20-25 per cent of the total seats in the Foundation's different bodies are currently held by the US, the US contributions amount to less than 10 per cent of the total country-based contributions to the Foundation's budget. Ultimately the lack of public funding in the US can only be resolved by the US authorities themselves directly or indirectly. Indeed, the efforts to raise private funding in the US are not only difficult to realise, because of the criticism expressed in the SEC Staff Report about the dependence of the IFRS Foundation on private sources, but are also contrary to the IFRS Foundation's objectives of eliminating the dependence on private funding.

The standard-setting process

The SEC Staff Report commented favourably on the IASB's due process requirements:

“The Staff observes that the IASB's due process is heavily based on consultation and gathering of facts and views, open deliberation, analysis, and the

*explanation of its decisions to the public. The Staff has noted that IASB member deliberations and re-deliberations on technical projects involve extensive debate and analysis regarding possibilities to recognize, measure, present, and disclose financial information. The Staff believes, based on its monitoring, that IASB members decide on the resolution of issues in projects based on the technical merits and overall usefulness for investors and other users of financial statements, and the Staff is not aware of instances in which IASB members have not acted in the public interest or have failed to exercise independence of judgment in setting IFRS.*³²

Those comments were made in relation to the due process requirements under which the IASB and Interpretations Committee operated before reforms were instituted by the Trustees in 2012, which are discussed in further detail below.

Enhanced due process

During 2012 the IASB has worked with the DPOC to develop even more robust reporting and accountability requirements. The enhanced due process requirements have been exposed for public comment and are expected to be finalised by the end of 2012. The new due process requirements formalise the enhanced oversight that the DPOC has been providing and will result in better information regarding the IASB's adherence to due process being publicly available from the IFRS website. Consequently, the enhancements will further protect the integrity of the standard-setting process.

In its standard-setting activities, the IASB seeks to strike an appropriate balance between sufficient due processes and consideration of the timeliness and of often complex technical matters. There have been some concerns expressed about the timeliness in which the IASB addresses emerging issues. This is discussed below.

The Strategy Review also proposed a number of enhancements to the Trustees' oversight role that have been put in place. The enhancements of the due process mean that the Trustees have:

- (a) undertaken activities that highlight the importance of the independence of the standard-setting process;
- (b) enhanced the role of the their Due Process Oversight Committee (DPOC) to periodically review that the IASB's due process is operating against an agreed framework;
- (c) intensified the DPOC's interactions with the IFRS Advisory Council (the Advisory Council) and the IFRS Interpretations Committee (the Interpretations Committee) so that more meaningful and better-informed comments on the functioning of the IASB is received; and
- (d) appointed dedicated staff to support the management of their due process responsibilities.

³² SEC Staff report, p.36.

The IFRS Interpretations Committee

The SEC Staff Report noted that they “heard from commenters that the United States has a more active interpretive mechanism, including through the FASB’s EITF, and that a robust interpretive mechanism is necessary to ensure that users can undertake and have access to comparable financial analysis.”³³ Those respondents said that the Interpretations Committee “should do more to address issues on a timely basis.”³⁴

The Interpretations Committee has 14 voting members drawn from a variety of countries and professional backgrounds. They are appointed by the Trustees of the IFRS Foundation and are selected for their ability to maintain an awareness of current issues as they arise and the technical ability to resolve them. There are two observers: IOSCO and the European Commission.

The recently completed review of the Interpretations Committee by the Trustees of the IFRS Foundation received similar views. Respondents indicated that the Interpretations Committee has not been sufficiently responsive to requests for implementation assistance.³⁵ As a result of its review the Trustees recommended that the Interpretations Committee should be given a broader range of ‘tools’, enabling it to be more responsive to requests for assistance. As a result of the review, the Interpretations Committee is operating under revised criteria, which are designed to make it more responsive to requests. These changes have already been implemented.

The Trustees also recognised the importance of improving the way in which the Interpretations Committee gathers information to support its work and how it communicates information about the issues it is considering, with the aim of making its decisions about which issues to address even more transparent. The Interpretations Committee now uses the IASB’s network of national standard-setters and regional bodies when it assesses the extent of emerging diversity in practice.

The review of the Interpretations Committee also highlighted the importance of working with securities regulators. These regulators see potential divergence emerging in practice and are well positioned to help the IASB identify areas where improvements to Standards should be made. To help with this, the IASB has taken steps to improve how it interacts with securities regulators, both directly with individual securities regulators as well as a deepening of co-operation with IOSCO. In addition, the Interpretations Committee has the right to invite members of securities regulatory bodies to act as official observers to its meetings.

As a result of these enhancements, we expect the Interpretations Committee to deal with a wider range of requests. For example, the Interpretations Committee may make proposals

³³ SEC Staff Report p.65.

³⁴ SEC Staff Report p.4.

³⁵ Review of the Efficiency and Effectiveness of the IFRS Interpretations Committee, May 2012.

to the IASB for targeted, narrow-scope amendments or proposals for additional illustrative examples in Standards. The combination of the Interpretations Committee's revised agenda criteria and its ability to deal with a wider range of requests, including annual improvements, is designed to ensure that the IASB has a more responsive interpretations function.³⁶

Post-implementation Reviews

An additional safety mechanism that the IASB has introduced is the Post-implementation Review of new Standards or major amendments 2–3 years after the new requirements have become mandatory.

These reviews provide the opportunity for those using IFRS to comment on how a Standard is working in practice. The first such review began in early 2012. These reviews will be comprehensive, using a public Request for Information, a review of academic research, investor surveys and interviews, and broad consultation with the network of standard-setters and securities regulators.

In the SEC Staff Report, the SEC staff recommended that the IASB move to a model whereby the staff working on Post-implementation Reviews should report directly to the Trustees, as is the case with the Post-implementation Reviews of FASB Standards.³⁷

We believe that there are merits to each approach. Post-implementation reviews conducted by the oversight body provide some comfort that the assessor will not have a bias towards his or her own work. However, the Trustees and the IASB have concluded that the IASB will be able to conduct a more effective review by having the IASB consider and assess directly the views of respondents rather than receiving a summary report from the trustees. The Trustees and IASB understand the risk that this could be perceived as not being an independent assessment. However, they are confident that the transparent way in which the reviews are being conducted will protect the integrity of the process. The DPOC receives regular updates on the steps being taken. This approach ensures a combination of effective self-review, with the highest levels of transparency through the publication of all views received and the evaluation of those views by staff, combined with effective scrutiny by the Trustees and the public at large.

³⁶ The Annual Improvements process provides a mechanism for narrow-scope maintenance, by amendment to, rather than interpretation of, Standards. The IASB has an annual cycle of such improvements, grouping them into one package for the convenience of potential respondents rather than as a series of separate consultations. The amendments typically clarify guidance and wording, or make relatively minor amendments to the Standards to address unintended consequences of previous amendments, conflicts or oversights.

³⁷ SEC Staff Report, pp.49–50.

International engagement by the IASB

The SEC Staff Report refers to the importance expressed by US commentators of the FASB retaining some role in the standard-setting process if IFRS are incorporated into the US financial reporting system.³⁸

The IASB has processes in place to ensure that issues that affect a particular region or jurisdiction are carefully considered when the IASB or its Interpretations Committee are developing a new Standard or Interpretation. The IASB uses consultative groups extensively. At the beginning of 2012 the IASB had 14 advisory groups, including the IFRS Advisory Council. The groups had over 250 members and 29 observers from 44 different countries. Over 17 per cent of the members were from the US.

National standard-setter involvement

Members of the IASB and its staff also meet regularly with national standard-setters, including the FASB and the Accounting Standards Board of Japan (ASBJ), regional bodies such as the European Financial Reporting Advisory Group (and its associated standard-setters from the UK, France, Germany, Italy and the UK), the Asian-Oceanian Standard-Setters Group (AOSSG) and Group of Latin American Accounting Standard Setters (GLASS) as well as many other government bodies. The SEC Staff Report acknowledges this international engagement but also suggests that the IASB “should consider greater reliance on national standard-setters.”³⁹

The Trustees concluded their latest Strategy Review (which was co-ordinated with the review undertaken by the IFRS Foundation Monitoring Board) that the IASB should further improve and enhance its engagement with various key regulators to encourage better implementation of IFRS. As a result, the Trustees have asked the IASB to formalise relationships with national and regional standard-setting bodies, audit and securities regulators, the accountancy profession and others, including those from emerging market economies, to co-operate more closely and in a more proactive way. This would:

- (a) provide a mechanism for the network of participants in the IFRS community to work together, encouraging greater consistency in the implementation of IFRS;
- (b) provide a forum for securities and audit regulators, the accounting profession and the IASB to discuss ways to improve consistency and address areas of divergence;
- (c) deepen the pool of expertise available to the IASB and ensure that local issues are brought to the attention of the IASB;
- (d) assist the IASB’s global standard-setting activities by involving national and regional standard-setting bodies more closely and earlier on in the standard-setting process; and

³⁸ See, for example, SEC Staff Report, p.80 reporting the general view of investors. .

³⁹ SEC Staff Report, p.5.

- (e) allow the IASB to benefit from a deeper and broader range of resources and share the work involved in research, field testing and outreach activities.

This network has the potential to improve the quality of the Standards and reduce both the duplication of effort between the IASB and other standard-setting bodies and the risk of non-endorsement of a particular Standard.

The IASB has appointed a Technical Manager to improve the dialogue with national and regional standard-setting authorities, including the establishment of online resources for sharing information and collaborating between the IASB and the standard-setting community.

As the convergence programme with FASB is coming to an end and the global use of IFRS is growing, there is a pressing need for the IASB to rationalise its relationships with national standard-setters and regional bodies, moving away from a series of bilateral arrangements and developing more cohesive and collective arrangements. The proposal seeks to formalise and streamline the IASB's collective engagement with the global community of national standard-setters and regional bodies in its standard-setting process. The IASB will form an **Accounting Standards Forum** (the Forum) in 2013. The purpose of the Forum is to enable the IASB to better engage with national standard-setters and regional bodies as a collective body. The role of the Forum will be to advise and provide feedback to the IASB on major technical issues related to its standard-setting activities and to provide input on national and regional issues. The aim is to have representation at a high level of professional capability and a good knowledge of their jurisdictions/regions, so that views can be expressed clearly and discussed thoroughly with the IASB.

US involvement

While acknowledging that the IASB is a global standard-setter, many respondents to the SEC commented on the importance of a strong US voice in standard setting. The SEC Staff Report notes:

“In order to fulfil the SEC’s mission of protecting investors, maintaining fair, orderly, and efficient capital markets, and facilitating capital formation in the United States, the Staff believes it will be important for the United States to continue to have an active role in the international accounting arena to assist in the development and promotion of high-quality, globally accepted accounting standards; to be proactive in identifying new and emerging financial reporting issues; and to ensure that U.S. interests are suitably addressed in the development of those standards.”⁴⁰

The SEC Staff Report also states:

“... the IASB may be incentivized to take U.S. perspectives into greater consideration during the standard-drafting process—resulting in standards that

⁴⁰ SEC Staff Report, pp. 84-85.

meet the needs of U.S. constituents without the need for modification during an endorsement process, thus decreasing the likelihood of differences.”⁴¹

The FASB has been actively working with the IASB on joint projects. This longstanding relationship, and the more formal structures being put in place for working with standard-setters, will ensure that the US will have the opportunity to be actively involved in IASB projects and have a strong voice in the standard-setting process. From the IASB perspective, it is clear that the US’s contributions to the future Accounting Standards Forum would weigh significantly if the US were to employ an endorsement approach to the use of IFRS.

⁴¹ Ibid

3. IFRS as global accounting standards

The SEC Staff Report emphasises two factors that were identified in the 2008 proposed Work Plan for the potential incorporation of IFRS into the US financial reporting system as being particularly important when assessing IFRS as a set of financial reporting requirements. The Work Plan stated (emphasis added):

*“The Commission and commenters have noted limited IFRS guidance in two respects. First, IFRS **lacks broad guidance** for: (1) certain topical areas, such as accounting for certain common control transactions, recapitalization transactions, reorganizations, acquisitions of minority shares not resulting in a change of control and similar transactions, and the push down of a new accounting basis in an entity’s separate financial statements; (2) certain industries, such as those related to utilities, insurance, extractive activities, and investment companies; and (3) disclosures in order to provide better transparency regarding the application of accounting principles.*

*Second, where IFRS provides broad guidance, the IASB, as a matter of operating practice, has elected to make guidance **less detailed and prescriptive** than U.S. GAAP.”⁴²*

The first of these factors relates to how comprehensive IFRS is as a set of financial reporting requirements. The second factor is related to what many describe as a debate about principle-based versus rule-based standards.

Comprehensiveness

To assess the comprehensive of IFRS, the SEC staff used a comparative approach with US GAAP to provide a context in which to frame its evaluation of IFRS, rather than establishing a minimum threshold of development that must be met.⁴³

Differences between IFRS and US GAAP

The SEC Staff Report describe some of the differences between IFRS and US GAAP as *fundamental differences* while others are described as differences because of *US GAAP industry guidance*.

The *fundamental differences* identified by the SEC were:⁴⁴

- (a) the non-financial asset impairment requirements (in particular, that IFRS permits the reversal of impairments, which could make earnings reported in accordance with IFRS more volatile than US GAAP) and the recognition of non-financial liabilities (such as lawsuits or environmental cleanup obligations) earlier than they would be recognised under US GAAP;

⁴² SEC Staff Report, pp.8–9, referring to See SEC Release No. 33-8982 (Nov. 14, 2008), Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers [73 FR 70816 (Nov. 21, 2008)]

⁴³ SEC Staff Report, p.9.

⁴⁴ SEC Staff Report, p.14.

- (b) the ability to re-measure property, plant and equipment and investment properties at fair value, which is permitted by IFRS but not US GAAP;
- (c) the ability for US companies to use an inventory measurement method called LIFO, which is not permitted by IFRS;
- (d) the requirement in IFRS for development expenditure to be capitalised, whereas US GAAP requires all development expenditure to be recognised as an expense as incurred;
- (e) specific requirements in US GAAP relating to uncertain taxation positions, whereas IFRS has a more general contingency model; and
- (f) a requirement in IFRS to depreciate components of an item of property, plant and equipment in some circumstances, which is not a requirement in US GAAP.

The *industry guidance* mentioned in the SEC Staff Report was in relation to rate-regulated industries, oil and gas, investment companies and broker-dealers. US GAAP has specific requirements for these industries, whereas IFRS does not.

IFRS covers a broad range of activities, and is generally considered to be comprehensive. However, there are clearly some gaps that should over time be addressed. The IASB has recently identified a number of these as a result of its consultation on its future agenda, and priorities have been established.

Around the time the EU, Australia and New Zealand adopted IFRS as a replacement for their domestic requirements, many accounting firms compared International Accounting Standards (IAS), the basis for IFRS, with the local requirements. The comparison identified broad alignment of the topics covered by IAS and the standards in those jurisdictions. Nevertheless, there were differences. In some cases IFRS did not have an equivalent of a local requirement. In other cases IFRS covered topics not covered by the adopting jurisdictions, including some topics not covered by US GAAP today.⁴⁵

Before adopting IFRS, most jurisdictions have identified the differences between their local financial reporting requirements and the requirements in IFRS. Some of these jurisdictions have questioned whether there is some aspect of their domestic requirements that that will be lost by adopting IFRS. In some cases, the local standard-setter has concluded that, for a particular type of transaction or activity, their local requirements provide a better financial reporting outcome than the equivalent Standard. In some cases their assessment could well have merit, but there are cases in which the IFRS requirements will provide a better financial reporting outcome. However, the relevant question is not whether some individual requirements will change but whether the portfolio of Standards is of a high enough quality for the adopting jurisdiction.

⁴⁵ For example, barter transactions were a significant factor in the growth of dotcom companies in the early 2000s. IAS and UK GAAP included recognition and measurement requirements for barter transactions, but US GAAP did not. This led to significant differences in financial reporting requirements. Other examples of transactions that are not found in US GAAP include service concessions, rights issues, investment properties and agriculture.

Domestic topics not in IFRS

There will be cases when a jurisdiction will have requirements that do not have a direct equivalent in IFRS. Australian GAAP had standards related to insurance contracts for which there was no equivalent in IAS. In 2004 the IASB issued an interim IFRS (IFRS 4 *Insurance Contracts*) that requires an entity to retain its pre-IFRS accounting for such insurance contracts, unless it changes to a treatment that is more relevant and no less reliable or more reliable and no less relevant. Australia has retained its insurance contracts standard as part of Australian GAAP. The effect is that their requirements work in conjunction with IFRS to ensure that their financial reporting requirements are comprehensive. The SEC Staff Report identified a similar concern, with US GAAP having more comprehensive requirements than IFRS for insurance contracts.⁴⁶

Similarly, US GAAP has requirements for extractive activities for which there is, effectively, no equivalent in IFRS. As with insurance contracts, the IASB has an interim IFRS that uses domestic reporting requirements to fill the gap in IFRS until the IASB can develop its own comprehensive requirements. Although this is not an ideal solution, it does preserve comparability within a particular jurisdiction by preserving its domestic financial reporting practice until the IASB is able to improve international comparability by developing its own requirements.

This concept has more general application. IFRS contains a general requirement that, when it does not have requirements that apply to a particular transaction, an entity must select a relevant and reliable policy by following a hierarchy of authoritative sources that includes pronouncements of other standard-setting bodies.⁴⁷ One such example, which was highlighted in the SEC Staff Report, is how a business combination is accounted for when the acquired entities are ultimately controlled by the same parent.⁴⁸ If the US retained its existing GAAP, perhaps for private entities, setting out requirements for business combinations under common control, it is likely that those requirements would act to preserve US practice until the IASB completes its project on business combinations under common control.⁴⁹

To summarise: IFRS covers a broad range of topics, but the range of topics covered is not identical to those found in other sets of standards, such as UK, Australian, New Zealand, Japanese and US GAAP. When IFRS does not cover a topic it has mechanisms that can incorporate, by reference, domestic requirements. The IASB also has an active research programme to assess priorities for new projects.

⁴⁶ SEC Staff Report, p.4.

⁴⁷ IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, paragraph 10.

⁴⁸ SEC Staff Report, p.8.

⁴⁹ The IASB's agenda consultation highlighted a widely held view that addressing the accounting for business combinations under common control should be a priority for the IASB, and that neither IFRS nor US GAAP, despite clear requirements, are perceived as helpful.

The IASB's public agenda consultation

Although IFRS covers a broad range of topics, there will clearly be some aspects of financial reporting that should be addressed over time. In particular, the IASB has been working on a proposed IFRS on insurance contracts since its inception and plans to release a revised proposal in the first half of 2013. In 2012 the IASB recommenced work on projects addressing business combinations under common control and extractive activities. Under its *Constitution*, the IASB has complete responsibility for all IASB technical matters, including the setting of project priorities. Identifying how it should set priorities can be challenging.

The Trustees recognises the importance of ensuring that the IASB establishes its priorities in an open and considered manner. The Trustees have recently enhanced the IASB's agenda-setting process by adding a public consultation process every three years, in order to provide a clear demonstration of how priorities on its agenda are set.⁵⁰

The first public consultation on the IASB's work programme, which began in July 2011, provided the wider IFRS community with the opportunity to help the IASB to set its priorities. Many of the topics identified by respondents to the IASB agenda consultation were also topics mentioned by respondents to the SEC. This is not surprising. The IASB received many comment letters from parties in jurisdictions that have yet to adopt IFRS, including Japan, India, China and the US.

In May 2012, the IASB established its technical programme for the next three years. The IASB decided to start work on five new projects:

- (a) possible amendments to the reporting requirements for agricultural assets;
- (b) rate regulated activities;
- (c) business combinations under common control—assessing when fresh-start or 'purchase' accounting should be required, including when an entity should use these new values in the financial statements of a subsidiary it has acquired—so called 'push-down accounting';
- (d) emission trading schemes; and
- (e) separate financial statements—use of the equity method.

In addition, the IASB is starting work on seven research projects:

- (a) research and development activity, covering intangible assets and extractive activities;
- (b) discount rates—many Standards refer to discount rates. The research will assess perceptions that there are inconsistencies in the discount rates incorporated in different Standards;
- (c) the equity method of accounting—a fundamental review of the relevance of this methodology;
- (d) financial instruments with the characteristics of equity;

⁵⁰ The Trustees' report *IFRSs as the Global Standards: Setting a Strategy for the Foundation's Second Decade*, paragraph C3.

- (e) foreign currency translation—focusing initially on concerns expressed by some jurisdictions on the financial reporting consequences of volatile exchange rates;
- (f) liabilities—amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, which addresses matters such as lawsuits and environmental remediation responsibilities; and
- (g) hyperinflation and high inflation.

Differences on first-time adoption

As we have noted, most jurisdictions experience changes to financial reporting when they adopt IFRS. It would be a surprise if there were no changes.

The US as a first-time adopter

The SEC Staff Report documents what it considers to be fundamental differences between US GAAP and IFRS. The SEC staff note that their analysis was designed to document differences, not to assess which solution might be a better financial reporting outcome. Accordingly, they emphasise that their analysis does not imply that US GAAP or IFRS is the better solution, only that the requirements are different. If the US were to move from US GAAP to IFRS, US entities would need to change their financial reporting in relation to the fundamental differences.

However, two examples are worth focusing on. The first relates to the ‘LIFO’ method of costing inventory. This example demonstrates that some financial reporting differences are influenced by matters other than a financial reporting objective, in this case, tax. The second is the component depreciation requirements, which is an example of a perceived difference that, in practice, is not as significant as was first believed from a desktop assessment of the requirements.

- (a) IFRS does not allow for the use of a costing methodology for inventory commonly referred to as LIFO, which is permitted under US GAAP. The SEC asserts that this difference “could have a significant impact on the operating results and income taxes payable of certain US issuers.”⁵¹ In the US, its taxation authority—the Internal Revenue Service (IRS)—has a rule that the LIFO methodology can be used for tax purposes only if the entity also uses that method for financial reporting purposes.⁵² The statutory link between the taxation and financial reporting requirement means that adopting IFRS in the US would eliminate LIFO from US GAAP and make it unavailable for tax purposes as well. The SEC staff think that this difference is an issue of tax policy rather than of financial reporting. Even though the SEC staff view this as a tax matter,

⁵¹ LIFO stands for last in, first out. The methodology assumes that the last item of inventory acquired by an entity is the first one sold next. If costs are rising the LIFO methodology gives an entity a higher cost of sales, and hence lower reported profit, than other accepted methodologies. Entities able to use LIFO for tax purposes would have a lower taxable income than an entity using one of the other methodologies.

⁵² LIFO is not the only accounting policy for which the US IRS requires conformity between the taxation and financial reporting policies, but it is one that generates the most discussion.

they also state that the LIFO difference “remains an element of the staff’s overall consideration of the incorporation of IFRS.”⁵³

- (b) IFRS includes a requirement that components of an item of property, plant and equipment must be depreciated separately, in some circumstances. This requirement has also attracted attention in Japan and Canada. The initial view in these jurisdictions mirrored that of the respondents to the SEC. There was a concern that the requirement would cause a major change in depreciation policies and would be one of the more costly provisions to apply. Adopters of IFRS in Japan and Canada found that this fear was unfounded. We are confident that what might appear at first glance to be fundamental differences to some do not always lead to fundamental change once they are understood better by preparers in the adopting jurisdiction.

When the US first began considering adopting IFRS there were many differences between US GAAP and IFRS. The number of differences has decreased as a consequence of the convergence efforts of the IASB and FASB.

Other jurisdictions

Inevitably, there will be types of activities that are particularly important to a jurisdiction and for which the IFRS requirements will attract special attention when that jurisdiction is considering adopting IFRS. The IASB considers such matters when it is developing its technical programme and has demonstrated that it is prepared to respond to concerns raised by jurisdictions, as evidenced by its active technical programme.⁵⁴ Over the last seven years the IASB has initiated projects related to, for example:

- (a) puttable shares (responding to ownership structures prevalent in New Zealand and Germany);
- (b) related party disclosures (responding to the pervasiveness of ultimate government control in emerging and transitioning economies, such as China);
- (c) investment entities (reflecting structures more commonly found in Canada and the US); and
- (d) rate-regulated activities (responding to regulatory activities that are more prevalent in Canada, the US and India).

In May 2012 the IASB decided to examine the financial reporting of agricultural bearer assets (such as fruit trees, grape vines, palm oil trees and dairy cows) in response to a request from Malaysia, where such assets are a significant part of the economy.

⁵³ SEC Staff Report, p.16.

⁵⁴ In Section 2 we set out the steps we are taking to have jurisdictions more actively involved in working with the IASB on individual projects. These initiatives should provide jurisdictions with more comfort that they will be active participants in projects that are particularly important to them and for which they may have some experience.

There are times when a jurisdiction decides that it cannot wait for the IASB to complete, a project and will feel compelled to make an exception to IFRS. For example, in adopting IFRS, the Canadian authorities created a temporary exception for investment companies, preferring to retain an industry-specific requirement, pending the outcome of related IASB projects. This is an example where the Canadian requirements could not be kept in place alongside IFRS because they conflict.⁵⁵

We have also seen examples of jurisdictions embellishing IFRS by adding disclosure requirements and, in some cases, eliminating reporting options in IFRS. Australia and New Zealand did both. Neither of these actions prevents an entity from asserting compliance with IFRS, but they do create some uncertainty in the minds of some as to whether these *adapted* requirements can still be classified as IFRS. Interestingly, both jurisdictions have subsequently decided to remove these local additions and restore the options.

US GAAP industry-specific requirements

One of the concerns raised to the SEC when it was preparing its Staff Report was that many US GAAP users think that it would be essential for IFRS to have more industry-specific guidance if they are to be adopted by the US.⁵⁶ The SEC Staff Report stated that:

“... the Staff believes that the industry guidance should not be removed from U.S. GAAP until the IASB has had the ability to evaluate fully the guidance for each particular industry, including performing outreach to investors, considering the effects of removing such guidance, and developing guidance, as appropriate, to the extent a void is identified in IFRS.”⁵⁷

An example of industry-specific guidance would be to develop financial reporting requirements for investment property companies rather than investment properties—a property that an entity holds primarily for capital appreciation or rental returns rather than to occupy itself.

Many businesses hold investment properties and the IASB has always advocated that the accounting should be the same whether the investment property is held by a company that invests only in properties or whether the company has other unrelated activities.

Notwithstanding the benefits of developing Standards that focus on activities, the IASB also understands that there are circumstances in which the nature of an entity can lend itself to industry-specific requirements. An example of this is the recent work by the IASB on the accounting for subsidiaries by investment entities, which was identified in the SEC Staff Report as a difference between IFRS and US GAAP. In this particular case, because the activities of the entity as a whole are so closely related, the IASB saw benefits to investors in allowing a narrow-scope exception to the general principles in IFRS related to controlled investments. This exception is industry-specific.

⁵⁵ The IASB expects to finalise amendments to IFRS in the second half of 2012 that relate to investment entities.

⁵⁶ SEC Staff Report p.83, for example.

⁵⁷ SEC Staff Report, p.18.

The SEC considered industry-specific standards in a separate, and parallel, piece of work. In 2008, the SEC published *Improvements to Financial Reporting* (the Pozen Report).⁵⁸ The Pozen Committee included many senior figures from the financial reporting sector and was supported by SEC and FASB staff. One of the matters considered was industry-specific guidance. The Pozen Report stated that:

“... we generally believe that industry-specific guidance should be eliminated to reduce avoidable complexity. We acknowledge that the elimination of existing industry-specific guidance may result in more complexity over the short-term, particularly for the industries losing special treatment. Nonetheless, we believe that is an acceptable cost for a long-term reduction in avoidable complexity.”

The Pozen Report went on to recommend that the SEC should encourage the IASB to limit future industry-specific guidance.

That said, the IASB acknowledges that the issue of industry-specific guidance would need to be addressed as part of the transition to IFRS.

Principle-based standards

The SEC Staff Report noted that there is a perception that IFRS is more principle-based than US GAAP.⁵⁹ We believe that both sets of standards are principle-based—US GAAP requirements, like IFRS, are drawn, largely, from a conceptual framework. Nevertheless, the term ‘principles versus rules’ is used widely to describe the differences in detail between IFRS and US GAAP and is used here to discuss the different approaches between IFRS and US GAAP.

US GAAP tends to be more detailed and use more quantitative ‘bright-line’ tests than IFRS. IFRS places more reliance on establishing clear objectives and expressing the requirements as principles. This is likely to be, at least partly, attributable to the fact that US GAAP has been developed, over many decades, “from the collective efforts of various standard-setters that served different purposes.”⁶⁰ In contrast, IFRS has been developed by a much smaller number of standard-setters “that generally have focused on developing principles that are to be applied by entities in all industries.”⁶¹ As well as leading to fewer industry-specific requirements, IFRS tends not to have transaction-specific requirements whereas US GAAP does.⁶²

The SEC Staff Report does not question the benefits of having more objective-based standards, and therefore fewer detailed rules. In 2002 the SEC was required to undertake a study of principle-based standards as part of the Sarbanes-Oxley reforms that were developed following several US

⁵⁸ Final Report of the Advisory Committee on Improvements to Financial Reporting to the SEC, 1 August 2008.

⁵⁹ SEC Staff Report, p.27.

⁶⁰ SEC Staff Report, p.17.

⁶¹ SEC Staff Report, p.18.

⁶² As an example, the revenue recognition requirements in US GAAP are more detailed than those in IFRS. Some observers characterise the detailed requirements as industry-specific whereas others would characterise them as transaction-specific.

accounting scandals. The SEC concluded that the FASB should “develop standards on a principles-based or objectives-oriented basis.”⁶³ The SEC staff explained that objective-based standards are those that have:

- (a) an accounting objective that is clearly incorporated into the standard;
- (b) few, if any, exceptions or internal inconsistencies in the standard;
- (c) an appropriate amount of implementation guidance but no bright-line tests; and
- (d) a coherent conceptual framework, from which such standards are derived.

Support for principle-based standards has continued. In 2007 the SEC staff acknowledged that more prescriptive requirements do not necessarily lead to more comparable financial information:

“Comparability under a rule-based system can be an illusion. Similar transactions may be structured to fall just barely on opposite sides of a bright line, thereby receiving potentially very different accounting treatments. ... Objective-based standards, if properly constructed, should help to achieve actual comparability, based on economics, rather than illusory comparability.”⁶⁴

They also noted that the change requires some refocus by accounting professionals:

“... it is impossible ... and certainly not desirable to eliminate professional judgment from accounting and I don't believe we should try to do so. Instead, if we are to move toward an objectives-based regime, we need to re-focus accounting professionals to spend their time applying judgment in the right areas – the principles or objectives, rather than specific rules. Of course, this may require some training to refocus accounting professionals. However, if professional judgment of preparers and auditors is exercised in the interest of investors, principles-based standards have the potential to increase the transparency and comparability of financial reporting. In this regard, disclosure of transactions in which significant judgment is required seems like an extremely useful tool for management to describe the economics of a transaction, the business purpose and the judgments involved in reaching an accounting conclusion.”⁶⁵

The convergence work between the IASB and the US FASB has resulted in that the US incorporating more objective-based requirements into US GAAP. The joint projects on share-based payments and business combinations resulted in more principle-based standards, which are part of US GAAP. The FASB is continuing to work with the IASB on joint standards for revenue recognition, leases and financial instruments. The FASB has also developed new requirements related to special, structured

⁶³ Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System.

⁶⁴ Speech by SEC staff: remarks before the 2007 Conference on Principles-Based Accounting and the Challenges of Implementation by James L. Kroeker. April 4, 2007.

⁶⁵ Ibid.

vehicles called variable interest entities that require ‘significant judgement’⁶⁶. The new requirements replace a standard that relied on bright-lines and quantitative assessments.

Comparability, implementation and enforceability

The SEC Staff Report notes that the early experiences with new principle-based requirements in US GAAP illustrates that “objectives-based standards are not necessarily problematic in their auditability or enforceability.”⁶⁷ However, the SEC Staff notes commentators concerns that the Interpretations Committee should become more active to reduce diversity in the application of IFRS. Without sufficient guidance stakeholders have suggested to the SEC that principle-based standards:

- (a) result in less comparability, because of inconsistency in application; and
- (b) are less auditable, because they are more subjective and allow companies more leeway in application.

The SEC Staff Report identified concerns about the comparability and enforceability of IFRS financial statements.⁶⁸ The SEC Staff Report mentions differences in impairment provisions of government securities of troubled economies, such as Greece in 2011.⁶⁹ There is always the potential for differences in how entities exercise judgement, but when impairment levels range from zero to 50 per cent for identical bonds the obvious question is whether there is consistent application. As with any case of diversity, it is important to understand whether the requirements are unclear or whether the preparers, auditors or regulators are not applying the requirements appropriately, or whether there are specific circumstances that might create complexity and diversity (such as the dealing with sovereign debt problems in the Eurozone, as presented in this specific example).

However, the SEC Staff Report also quotes a respondent who states that “principle-only standards are problematic whenever practice interprets the standards differently, and resulting reporting is excessively diverse. In those cases, interpretation/guidance is needed to narrow practice to acceptable levels of diversity.”⁷⁰

The IASB is also aware of cases in which similar contracts seem to be reported differently across jurisdictions. While this may suggest an inconsistent application of IFRS, in most cases the different financial treatment arises because of differences in factors related to the transactions, such as related legislation. For example, contracts to construct property are often subject to special legislation, which means that the enforceability of identical contracts can vary from jurisdiction to jurisdiction. The fact that IFRS generates different financial reporting outcomes in such cases is appropriate. To do otherwise would mask real economic and legal differences.

⁶⁶ SEC Staff Report, p. 27

⁶⁷ SEC Staff Report, p.27.

⁶⁸ SEC Staff Report, p.22.

⁶⁹ SEC Staff Report, p.24.

⁷⁰ Comment letter of IMA on the May 2011 SEC Staff Paper, referred to on page 25 of the SEC Staff Report.

IFRS Interpretations Committee

The IASB does listen to concerns about inconsistent application across jurisdictions or industries to determine whether additional guidance would reduce diversity in practice or would clarify the IASB's objective with respect to particular accounting requirements. In the previous section we acknowledged that the Interpretations Committee has not been sufficiently responsive to requests for assistance. We set out the changes that were made to ensure that the Interpretations Committee is more responsive. In addition, as part of its 2011 agenda consultation, the IASB will give priority to enhancing its *Conceptual Framework*. A robust *Conceptual Framework* is the basis from which the accounting objectives are defined and standards are interpreted and results in greater consistency in application.

Consistent application

The IASB has a responsibility to develop Standards that are understandable, auditable, enforceable by regulators and globally accepted—a necessary condition for global comparability, but it is not a sufficient condition. Those Standards must also be enforced in order to truly achieve global comparability. Research commissioned by the IFRS Foundation shows that the benefits of IFRS depend on the level of enforcement in a country.⁷¹ Consistent enforcement of the Standards is the responsibility of regulatory authorities of both financial markets and auditors. Consistent enforcement of IFRS will require action by the international community, such as securities regulators and the audit oversight bodies.

The auditing of financial statements is an important independent oversight function to also ensure the consistent application of IFRS. The auditors' role is subject to independent oversight by public sector agencies accountable to governments (in the US the role is performed by the PCAOB, which is a member of IFIAR).

The IASB can support this work, but has no authority or ability to enforce consistent application.

Notwithstanding this clear division of responsibilities, the IASB stands ready to co-operate closely with the regulatory authorities to mutually benefit from our experiences. This was a recommendation of the Trustees' Strategy Review and discussions with bodies such as IOSCO are already under way.

The SEC Staff Report acknowledges that, if IFRS is incorporated into the US financial reporting system, a greater emphasis will be placed on the SEC staff to work more co-operatively with regulators in other jurisdictions. The SEC Staff Report also acknowledges that the financial reporting community, including the SEC, can be a constructive influence on the consistent application and enforcement of IFRS.⁷²

We welcome the commitment expressed in the SEC Staff Report to work with the IASB, other securities regulators and the accounting profession to improve consistency in the application and

⁷¹ Tarca et al (2012) (see appendix).

⁷² SEC Staff Report, p.5.

enforcement of IFRS on a global basis. As the current Chair of the IOSCO policy committee 1 on Multinational Disclosure and Accounting, and with a large number of foreign SEC registrants now reporting using IFRS, we believe that the SEC has both an important role to play and a vested interest in a successful outcome.

If the SEC decides to adopt IFRS, enforcement in the US will always remain the sole responsibility of the SEC, so there is no danger of US standards of enforcement being eroded by outside influences. Furthermore, if and when the US completes its transition to IFRS, the SEC could provide an effective leadership in worldwide enforcement, while sharing with rest of world its experience and practices in accounting standards enforcement.

It is however clear that, without a single set of global standards, consistent application of accounting standards across the world will by definition remain impossible.

4. Transition to IFRS: adoption and endorsement challenges

The decision to adopt IFRS is an internal decision taken at jurisdictional level. The SEC Staff Report discusses numerous issues related to possible incorporation of IFRS in US GAAP. Many of these issues are specific to the US and can only be addressed by US authorities in the environment in which they operate.

The IFRS Foundation staff are not in a position to be able to give definitive answers or suggestions to the observations made by the SEC staff. Instead, in this chapter we refer extensively to the way in which many IFRS jurisdictions have dealt with different issues while adopting IFRS. Every jurisdiction has its unique challenges and we believe that this variety of experience provides a useful backdrop for analysis.

Endorsement approaches

The SEC staff state that it became apparent that pursuing the designation of IFRS as authoritative was not supported by the vast majority of participants in the US⁷³ and that “most jurisdictions generally rely on some mechanism to incorporate IFRS into their domestic reporting system.”⁷⁴

In terms of its own endorsement mechanism, the SEC Staff Report notes that the vast majority of commentators on the 2011 May Staff Paper supported the concept of retaining the FASB in a substantive, standard-setting role if the SEC were to proceed with an incorporation of IFRS. This would allow the FASB to act in the interests of the US and ensure that a strong US voice is considered in the development of IFRS.⁷⁵ The SEC Staff Report⁷⁶ suggests that the FASB role can be considered “on a continuum” between more and less discretion, considering the advantages and disadvantages of different approaches on that continuum, but without coming to any recommendation on the extent of the FASB’s role on incorporation.

In their Strategy Review, the Trustees acknowledged that jurisdictions would need to establish their own mechanisms for bringing IFRS formally into law and that those jurisdictions were unlikely to completely cede sovereignty in this area. As set out below, a number of jurisdictions have introduced endorsement mechanisms for the adoption of IFRS into law, both on first-time adoption and on an ongoing basis. The IFRS Foundation respects the fact that jurisdictions have sovereignty within their own territories and accepts that endorsement mechanisms are legitimate. It is also clear that the US’s contributions to Accounting Standards Forum, which will be established to formalise the IASB relationship with national standard-setters and regional bodies (see Section 2), would be more significant if the US were to employ an endorsement approach to the use of IFRS.

⁷³ SEC Staff Report p.2

⁷⁴ SEC Staff Report, p.3.

⁷⁵ SEC Staff report, p.85.

⁷⁶ SEC Staff Report, pp.84–88.

Having said that, the IFRS Foundation believes that any threshold for non-endorsement has to be set very high and that any jurisdiction introducing such a mechanism should still support the fundamental mission of a single set of high quality standards as developed by the IASB. The SEC Staff Report⁷⁷ acknowledges the risks to IFRS as a single set of high quality globally accepted Standards if the process of incorporating IFRS into US GAAP resulted in material differences being introduced. Such an outcome might be viewed by other jurisdictions as legitimising their own customisation of IFRS to meet local requirements. In the case of jurisdictions such as the EU and Australia, endorsement mechanisms have been put in place because the Standards are incorporated into the body of law.⁷⁸ As described in a European Commission Communication from June 2000, an endorsement mechanism is necessary to achieve legal certainty.

There is a wide spectrum of endorsement processes throughout the jurisdictions that have adopted IFRS, as the following examples demonstrate.

The endorsement process of the European Commission demonstrates one of the more complex processes in adopting a Standard once it is issued by the IASB. Each Standard goes through a process involving technical analysis and recommendation by EFRAG. An endorsement proposal is then considered by the Accounting Regulatory Committee (ARC), after which a draft Regulation is considered by the European Parliament and the Council of the European Union before being adopted into law.⁷⁹ The process of endorsement typically takes 8–10 months.

The criteria for adoption is that standards are:

- (a) not contrary to the principles⁸⁰ that the accounts shall give a true and fair view of the company's⁸¹ or group's⁸² assets, liabilities, financial position and profit or loss and are conducive to the European public good; and
- (b) that they meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.⁸³

In 2008, a European Commission report on the application of IFRS in the EU noted that “the basic idea behind the IAS Regulation is that IFRS and IFRIC should be of high quality and obtain such

⁷⁷ SEC Staff Report, p.88.

⁷⁸ In the EU, the text of endorsed standards are published in the *Official Journal*, and in Australia they are lodged in the *Federal Register of Legislative Instruments*.

⁷⁹ http://ec.europa.eu/internal_market/accounting/docs/ias/endorsement_process.pdf.

⁸⁰ Article 2 (3) of Directive 78/660/EEC and in Article 16(3) of Directive 83/349/EEC.

⁸¹ EU 4th Company Law Directive (78/660/EEC).

⁸² EU 7th Company Law Directive (83/349/EEC).

⁸³ Regulation (EC) no 1606/2002 of the European Parliament and of the Council of 19 July 2002.

general support that they can be endorsed in the EU.”⁸⁴ The European Commission has used its ability not to endorse IFRS sparingly. In adopting the set of Standards for use in 2005, the European Commission ‘carved-out’ two aspects of IAS 39: the requirements relating to the full fair value option and those on macro hedging. The first carve-out has subsequently been deleted but the second remains.⁸⁵ Although one could debate the relative merits of this remaining ‘carve-out’, the fact is that it exists. Entities that have activities to which the omitted paragraphs relate risk not being able to assert compliance with IFRS. Fortunately only a very small percentage of EU entities are in this position.⁸⁶

In Canada, the accounting standard-setting body, the Accounting Standards Board (AcSB), has a policy to adopt IFRS in full and without modification, reasoning that “to do otherwise would result in multiple and possibly conflicting versions of IFRSs globally, if enough other national standard-setters did the same. That would defeat the purpose of global convergence, which is to move toward a single set of high-quality accounting standards for use throughout the world.”⁸⁷ To be adopted in Canada, a Standard must be officially sanctioned by the AcSB—although the IASB’s due process is considered sufficient assurance that a new or amended Standard is suitable for adoption, the AcSB takes the additional step of identifying whether there is any reason the Standard would not be suitable for application in Canada.⁸⁸ However, “since the AcSB’s policy is to adopt IFRSs as they are issued by the IASB and not to modify them, it would be a significant decision not to approve a final IFRS after it has been issued by the IASB.”⁸⁹ Underlying this approach is a robust process of active contribution to the development of IFRS, including creating its own advisory committees, promoting participation by its stakeholders in the IASB’s consultations and reviewing Canadian comment letters to the IASB to determine whether concerns of Canadian stakeholders have been appropriately addressed. A working group assists the AcSB in considering issues relating to the applications of IFRS in Canada, and makes recommendations on issues to be referred to the IASB or IFRS Interpretations Committee.

In adopting IFRS the Canadian authorities created exceptions for a category of entities known as investment companies, preferring to retain an industry-specific requirement. Some of the requirements were designed to be temporary pending the outcome of related IASB projects. In July 2012 the IASB voted to finalise a Standard related to investment entities.⁹⁰

⁸⁴ http://ec.europa.eu/internal_market/accounting/docs/ias/com-2008-0215_en.pdf.

⁸⁵ The IASB has a project on Portfolio Hedging that, if successful, may allow the EU to remove this discrepancy

⁸⁶ The European Commission has also delayed the mandatory effective date in the EU of some Standards (most recently IFRSs 10–12) but allows entities to early adopt these.

⁸⁷ CICA Handbook—Accounting, Part 1: Adoption of International Financial Reporting Standards, Background Information and Basis for Conclusions.

⁸⁸ AcSB Due Process paragraph 26.

⁸⁹ <http://www.frascanada.ca/accounting-standards-board/what-we-do/due-process/index.aspx>.

⁹⁰ IN May 2012 the IASB voted to give priority to a project on rate-regulated activities.

In some jurisdictions, the responsibility for setting standards has been delegated to the accounting standard-setter, while the government maintains ultimate authority. In South Korea, the Korean Accounting Standards Board (KASB) translates and assesses the Standard, but may issue the Standard into legislation only after receiving confirmation from the government.

For other countries, each new Standard requires an amendment to the relevant law. For example, in Norway, which, as part of the EEA but not of the EU, takes the Standards from the European Commission. After the EU endorsement procedures mentioned above are completed, there is an extra layer to the legal process for adoption into law—the Standard has to be put in force as part of Norwegian law via a separate bylaw to the Norwegian Accounting Act.⁹¹

In Brazil, the Comit  de Pronunciamentos Cont beis (CPC) comprises all key stakeholders in the process of issuing accounting standards (preparers, auditors, users, academics and the government) and is responsible for studying IFRS in order to issue technical pronouncements to be endorsed by the regulatory bodies (for example, the securities commission). Because the CPC is committed to IFRS adoption, its role is mainly to facilitate the process of incorporating IFRS into the Brazilian regulatory framework.

Finally, for other jurisdictions, including South Africa, Botswana, Ecuador, Guatemala, Israel and Samoa, there is no endorsement process. For such jurisdictions there is simply a reference in law that IFRS as issued by the IASB must be applied. For South Africa, for example, Act 71 of the Companies Act 2008⁹² states that financial statements must comply with either IFRS or *IFRS for SMEs*, depending on the company category. While IFRS as issued by the IASB is mandatory for listed companies, and other public companies and other for-profit companies with a ‘public interest score’⁹³ of at least 350 have the choice of using the IFRS for SMEs or IFRSs, South Africa maintained SA GAAP as a choice for other companies with a public interest score of below 350. In 2003, the South African Institute of Chartered Accountants issued a circular in which it stated “... the Accounting Practices Board took a decision to, in future, issue the text of IFRS in South Africa, without any amendments. Future Statements of GAAP will therefore be the exact replica of the relevant IFRS.”⁹⁴ Since the Financial Reporting Standards Council (FRSC) was established to replace the APB in 2011, a decision was announced in May 2012 that SA GAAP will be withdrawn and will

⁹¹ Norwegian Accounting Standards Board <http://www.regnskapsstiftelsen.no/a9084301/english>.

⁹² Act 71 of the Companies Act 2008, paragraph 29 (5) states: Any regulations contemplated in subsection (4)-(a) ...

(b) in the case of financial reporting standards for public companies, must be in accordance with the International Financial Reporting Standards of the International Accounting Standards Board or its successor body;

⁹³ The Companies Regulations (2011), Section 26(2) specify the calculation of points to determine a company’s public interest score, based on criteria such as the average number of employees and turnover.

⁹⁴ SAICA Circular 5/2003: Alignment of the text of Statements of Generally Accepted Accounting Practice with that of International Financial Reporting Standards.

cease to apply for financial years commencing on or after 1 December 2012, with IFRS or *IFRS for SMEs* being the applicable Standards from that date.⁹⁵

The SEC Staff Report indicates that, if any endorsement approach is used, the US might also consider whether it should make exceptions.⁹⁶ The examples above show that, for the most part, IFRS as developed by the IASB have been endorsed for use in jurisdictions. The EU and Canadian exceptions are relatively narrow in scope, each in turn affecting a relatively narrow range of activities. However, while the IFRS Foundation respects that jurisdictions have the ability and the right to use endorsement mechanisms, we believe that any exception is unhelpful because it reduces the international comparability of financial reports and undermines the benefits of global standards. Consequently, it should be activated as rarely as possible.

Transition approaches

The SEC Staff Report does not mention first-time adoption or have a clear recommendation on the preferred pathway to that point. However, throughout the report, the alternative of a phased incorporation is analysed and in some cases its advantages are emphasised, although without expressing a clear view as to what type of phased approach should be followed:

- (a) In terms of costs, the staff notes respondents' comments that savings could be achieved through a more "gradual" development of the systems and processes necessary to implement IFRS.
- (b) In terms of the effect of the transition on a stable platform (ie the need for certainty and stability so that issuers will be able to cope with change), the staff states that it believes that an endorsement-like approach that is "gradual" and incorporates IFRS into US GAAP would address this difficulty.⁹⁷
- (c) in the terms of the possible effect of the transition method on issuers' litigation contingencies, the staff notes that a "phased approach" would allow the opportunity to explore solutions.⁹⁸

The SEC Staff Report also notes that, in response to an earlier (2011) consultation by the SEC staff,⁹⁹ some respondents favour a gradual transition to IFRS. The 2011 report had explored a method—

⁹⁵ Joint announcement by the Accounting Practices Board (APB) and the Financial Reporting Standards Council (FRSC) regarding SA GAAP, May 2012.

⁹⁶ SEC Staff Report, page 10, the existence of differences between US GAAP and IFRSs "Indicates a need for the Staff to determine whether investors and other users of the financial statements would be losing or gaining significant informational content and to determine the effect on transitional considerations if IFRS were to be incorporated."

⁹⁷ SEC Staff Report, p.108.

⁹⁸ SEC Staff Report, p.118.

⁹⁹ SEC Staff paper May 2011 *Exploring a Possible Method of Incorporation*.

colloquially referred to as ‘condorsement’—under which IFRS would be gradually incorporated into US GAAP over some defined period of time (for example, 5–7 years).

In their Strategy Review, the Trustees reaffirmed that the ultimate long-term goal is the global adoption of IFRS as developed by the IASB. That said, the Trustees recognise that different jurisdictions are at different stages on the way to adopting IFRS. They also recognise that jurisdictions have taken different paths to get to the point when they are ready to move on to IFRS.

For example, the EU, Australia and New Zealand took what some describe as a ‘big-bang’ approach. Having made the decision to move to IFRS those jurisdictions simply set a date and the entities affected undertook the work necessary to make the switch. The Institute of Chartered Accountants in England and Wales (ICAEW), from the evidence of its report on the EU experience, noted¹⁰⁰ that a one-time adoption provided certainty, well-understood deadlines, and a clear focus and sense of purpose from all participants.

The Canadian experience is also relevant, with the AcSB adopting an IFRS implementation plan to ease the period of transition leading up to the date of IFRS adoption. Other jurisdictions have taken a more incremental approach by changing their domestic requirements to be more closely aligned with IFRS on an issue-by-issue basis before making the decision to move fully to IFRS. This convergence approach spreads the reporting changes over a longer period but reduces the size of the final step.

In the case of the US, the Memorandum of Understanding, known as the Norwalk Agreement, set a framework for both boards to work on common new Standards. The boards successfully completed projects on share-based payments, business combinations and fair value measurement and are working together on financial instruments, revenue recognition and leases. Other projects involved either the IASB converging with US GAAP (such as operating segments and borrowing cost) or the FASB converging with IFRS (such as acquired R&D and the fair value option). The convergence efforts of the IASB and the FASB have helped bring IFRS and US GAAP closer together.

In researching the use of IFRS around the world, we find no evidence of a jurisdiction having successfully adopted IFRS by following a Standard-by-Standard approach. Those jurisdictions that have evaluated this model (such as the UK) have ultimately concluded that it is not workable. As the ICAEW noted in 2011 on the UK experience:

“Much time and effort over several years was expended in bringing individual standards into line with IFRS before it became clear that completing the process was impractical ... The market is better able to deal with a single, well-understood change rather than a complex and protracted process of change.”¹⁰¹

¹⁰⁰ ICAEW response of 26 July 2011 to SEC Staff Paper *Exploring a Possible Method of Incorporation* available at <http://www.sec.gov/comments/4-600/4600-37.pdf>.

¹⁰¹ ICAEW response to SEC Staff paper *Exploring a Possible Method of Incorporation* available at: <http://www.sec.gov/comments/4-600/4600-37.pdf>.

We believe that a Standard-by-Standard approach to incorporation may prove costly and disruptive to US entities without the commensurate benefit of adoption of IFRS being achieved. The experience of ten years of convergence has shown that independent boards are likely to achieve independent outcomes.¹⁰² The potential result is a multitude of smaller or bigger exceptions to IFRS, which would defeat the purpose of adopting a single set of global standards.

There are also practical reasons against taking this approach. There are 13 IFRSs, 41 IASs, 20 IFRICs and 8 SICs that make up the set of Standards. A Standard-by-Standard evaluation over a prolonged period could result in a period of sustained disruption to US preparers, the risk of transition fatigue for both preparers and users, significant ongoing costs and difficulties in comparability with either the original US GAAP or current IFRS.¹⁰³ Given that few Standards as issued by the IASB are stand-alone Standards that function in isolation, a Standard-by-Standard method of incorporation will present numerous challenges when dealing with cross-references between Standards and fitting them into the existing body of national standards. As set out in section 5 of this paper (human capital readiness), such an approach would also not provide the incentive for entities within jurisdictions to devote the resources to develop their knowledge and expertise to implement IFRS.

Voluntary adoption

The SEC Staff Report¹⁰⁴ notes some support among its constituents for voluntary adoption.¹⁰⁵ This alternative is used in Japan. A former SEC commissioner, Kathleen Casey, supported voluntary adoption,¹⁰⁶ arguing that the US already operates in a ‘two-GAAP world’ and that valuable experiences would be learned during the transition period and enable the development of increased IFRS expertise and capacity in the USA, including investor understanding. Another advantage of such an approach is that it would save costs by permitting companies who are prepared to adopt IFRS to do so, especially those that operate internationally. US respondents also noted that it would facilitate investor education, auditor effectiveness, willingness to make judgements under IFRS and the implementation for later adopters.¹⁰⁷

Based on international experience, this might be a workable, gradual approach for a particular jurisdiction. The challenge it poses is that it results in the co-existence of two (or three, in the case of Japan) sets of accounting standards, and this could affect the ability of users to achieve

¹⁰² Speech by Hans Hoogervorst, November 2011, www.ifrs.org.

¹⁰³ Street (2012), page 17 highlights that users stress the need for comparability and the support from larger issuers for a single-date approach.

¹⁰⁴ See page 108, plus pages 36–39 of the Summary of Comments (dated 26 April 2012) to the SEC Staff paper May 2011 Exploring a Possible Method of Incorporation.

¹⁰⁵ See also Street (2012), pages 18–20 for further expressions of support for voluntary adoption.

¹⁰⁶ Keynote Address at the Society of Corporate Secretaries and Governance Professionals 65th Annual Conference (29 June 2011) available at: <http://www.sec.gov/news/speech/2011/spch062411klc.htm>.

¹⁰⁷ Page 38 of the Summary of Comments (dated 26 April 2012) to the SEC Staff paper *Exploring a Possible Method of Incorporation*.

comparability in their analysis of financial statements. However, the problem of reduced comparability could be mitigated by limiting the voluntary adoption to a subset of companies with major international activities, thereby offsetting the reduction of domestic comparability by an increase in international comparability.

However, voluntary adoption without a specific date for a full transition to IFRS has the potential to result in continued uncertainty about the future of the national GAAP and the jurisdiction's commitment to global accounting standards. While voluntary adoption is useful to consider as an arrangement for making the transition to IFRS, it should not be seen as a long-term strategy in its own right.

Phased adoption

Another temporary alternative would be to initially make IFRS mandatory for only a subset of internationally active companies, while companies that are mainly active in the domestic US market would retain US GAAP for a longer period. This alternative would result in fewer issues of comparability, because all internationally active companies would report under IFRS. Again, their loss in domestic comparability would be compensated for by a gain in international comparability.

5. Other challenges in the transition to IFRS

In this section we address some of the other main practical challenges in the adoption process of IFRS, which were identified by the SEC Staff Report. Adoption of IFRS is a significant reform that will necessitate efforts and resources by all market participants and will have widespread effects on the US domestic market, which is large and complex.

Again, most of the challenges that were raised by the SEC staff are not unique to the US. Countries that have gone through the process often report similar or identical challenges. Many jurisdictions have successfully addressed these challenges, and their respective markets can now make use of the benefits of transition.

Regulatory environment

The SEC Staff Report analysed the extent to which adopting IFRS will impact the US regulatory environment.

Impact on industry regulators

One of the key concerns expressed in the report¹⁰⁸ is that regulators other than the SEC rely on the financial reporting of regulated entities that is provided in accordance with US GAAP (for example, prudential regulators). Transition to IFRS might limit their ability to present their views and concerns throughout the standard-setting process to a global body compared to the present availability of the FASB. Some regulators noted that the loss of industry-specific standards would impair their regulatory regime.

Any transition to IFRS had an impact on the local jurisdiction's regulatory environment and presented a challenge to the various regulatory bodies impacted, as the following examples demonstrate.

Brazil, the largest economy in Latin America, set 2010 as the first year in which all publicly-listed companies on Brazil's stock exchange and financial institutions had to move to IFRS. The transition process required significant changes to the regulatory environment, some of which were recommended as necessary preparatory steps for the transition to IFRS by a World Bank ROSC report.¹⁰⁹ These included, among others, the need to streamline the standard-setting process by establishing an independent accounting standard-setter that would issue pronouncements for all general-purpose, corporate financial statements. This reform affected many regulatory agencies: before that change, many regulators (the securities market, banking, insurance and the two associations of accounting professionals) were devoted to developing and issuing accounting standards. In 2005, the national standard-setter (Comité de Pronunciamentos Contabeis (CPC)) was tasked with the issuing of accounting standards.¹¹⁰

¹⁰⁸ SEC Staff Report, p.83.

¹⁰⁹ http://www.worldbank.org/ifa/rosc_aa_bra.pdf.

¹¹⁰ <http://www.cpc.org.br/pdf/MoU.pdf>.

In the EU, a decision was taken by the European Council in March 2000 to have comparable financial reporting by 2005 as part of a fully integrated European market. The legislation to bring this into effect was passed in July 2002,¹¹¹ requiring EU-listed companies to prepare their consolidated financial statements in accordance with IFRS from 2005. The transition affected regulators across Europe. In 2000, the European Commission issued a publication that highlighted the implications and challenges for its regulatory environment. This publication called upon EU securities market regulators to be actively involved in enforcement issues, which presented a major challenge. In recognition of this, the preamble to the 2002 Regulation noted the intention of the European Commission to work with the Committee of European Securities Regulators (CESR) to develop a common approach to enforcement. The EU implementation report referred to above includes an analysis of the process that securities regulators have applied in setting up enforcement activity relating to IFRS application in the EU, including the work by CESR¹¹² to develop a common approach to enforcement.

In Australia the decision was taken in 2002 to adopt IFRS from 2005, in line with the EU timetable. The Australian Accounting Standards Board (AASB) originally included numerous disclosure requirements specific to Australia. However, to avoid confusion about the adoption of IFRS and to remove an additional disclosure burden, the AASB subsequently removed most of these disclosure requirements. The Australian Securities and Investment Commission (ASIC) supported this decision. A regulatory view of the adoption of IFRS in Australia was outlined in Ernst and Young's *IFRS Outlook* (January/February 2011 edition). Doug Niven, Senior Executive Leader in ASIC's Accountants and Auditors stakeholder team, made his view clear in an interview with *IFRS Outlook*:

"I certainly believe the objectives have largely been achieved and the adoption of IFRS in Australia has been successful. It has created a level playing field for Australian entities internationally by promoting greater confidence in Australian financial reporting."

In Canada, the AcSB worked with regulatory agencies, primarily the Canadian Securities Administrators and the Office of the Superintendent of Financial Institutions, to facilitate the initial adoption of IFRS. In its 2012 Annual Report, the AcSB highlighted the challenges that have been faced in Canada, but assessed that developments have "continued to validate the AcSB's original strategic decision to adopt IFRSs as Canadian GAAP." Canada has addressed the lack of specific accounting standards or guidelines in two main industries:

- (a) for entities with qualifying rate-regulated activities, the AcSB decided to defer the mandatory IFRS changeover date for (this has now been extended to 2013); and
- (b) for investment companies and segregated accounts of life insurance enterprises, the AcSB decided to give the option to defer their changeover to 2014 (because of the timing of the related IASB project).

The concerns expressed by US industry regulators about their ability to be heard and considered by the IASB in the standard-setting process is understandable, though not specific to the US, as the

¹¹¹ Regulation 1606/2002.

¹¹² Now superseded by the European Securities and Markets Authority (ESMA).

previous example illustrated. The IASB is aware that prudential supervisors, for example, rely on financial reports for some of their functions. To assist prudential supervisors, the IASB maintains an enhanced dialogue with such authorities, particularly through the Federation of Small Business (FSB) and the Bank of International Settlements.¹¹³ Other relevant regulatory agencies around the world may have access to the IASB and may express their views directly throughout the standard-setting process, or indirectly through national standard-setters and other regulators who represent their region or jurisdiction when they comment on IASB projects on a regular basis.

References to local financial reporting requirements

The SEC Staff Report raised concerns that the US regulatory body of literature relies heavily on references to US GAAP. This challenges direct incorporation of IFRS.¹¹⁴

Many jurisdictions have references to the local financial reporting requirements embedded in regulations, and many contracts refer to those requirements. Changing each reference to IFRS could be complex and costly. As a result, some jurisdictions prefer to retain the references to their local requirements, using an endorsement mechanism to effect the adoption of IFRS.

New Zealand and Australia, who were early adopters of IFRS, have retained references to their domestic requirements. New Zealand retained a statutory definition of ‘applicable financial reporting standards’ and Australia retained the term ‘Australian Accounting Standards’. Neither definition, nor any part of their related legislation, refers to IFRS. In each case, the bodies charged with approving the financial reporting requirements have specified that IFRS are, respectively, ‘applicable financial reporting standards’ and ‘Australian Accounting Standards’.

In presenting their financial reports, entities within these jurisdictions refer to the local requirement as well as IFRS.

This approach has also been taken by other countries, such as Canada and Korea. The approach provides the assurance that the entity has complied with IFRS as issued by the IASB while preserving domestic references. This remains an option available to countries such as the US, where the term US GAAP is widely used in many pieces of legislation.

Impact on tax regime

The SEC Staff Report raises concerns about the possible effect on federal and state tax regulations, for example, on the ability of companies to use LIFO inventory and its effect on taxable income.¹¹⁵ The SEC staff’s view is that the LIFO difference “remains an element of the Staff’s overall consideration of the incorporation of IFRS.”

Experience in other countries demonstrates that, although there are often separate taxation and accounting rules, there are examples of tax authorities using selected financial reporting

¹¹³ Excerpted from the IASB and IFRS Interpretations Committee draft *Due Process Handbook*.

¹¹⁴ SEC Staff Report, p.91.

¹¹⁵ SEC Staff Report, p.94.

requirements. *In New Zealand*, for example, the taxation treatment for leases and research and development activities is linked to financial reporting requirements.

In Korea, concerns were raised that the difference between IFRS and tax accounting would increase the burden of tax adjustments on entities:

“Consequently, the government set out the policy that where there is only a small difference in the tax burden between applying IFRS and applying the tax accounting, entities should be allowed to apply IFRS-based accounting in order to reduce the tax adjustment burden, and amended the Tax Law accordingly. For example, while IFRSs have adopted the concept of functional currency,¹¹⁶ the tax law does not recognize such concept, resulting in the need for a tax adjustment into Korean won. The government amended the Tax Law to recognize functional currency accordingly.”¹¹⁷

The EU tax rules were kept unchanged, with the decision about whether to adopt IFRS-based accounts for taxation purposes and, if so, to what extent, resting with the individual tax authorities in each member state. A review of the implementation of IFRS in Europe noted that links between tax and financial reporting created among the more challenging difficulties. Countries have dealt with this in different ways. *In Germany*, the tax requirements are linked to separate financial statements and a decision was made not to apply IFRS to those separate financial statements. *In Italy*, the tax and financial reporting requirements are intertwined. The Italian authorities have the ability to create exceptions to reporting requirements for taxation purposes. *In the UK*, tax legislation provides that the financial statements (whether prepared under IFRS or UK GAAP) must be used as the starting point for tax calculations and the UK government has maintained this policy, although it has resulted in some consequential and sometimes complicated amendments to the UK tax rules (in particular, in relation to financial instruments).

In Australia the Australian Tax Office recognised that a coherent set of tax legislation and administrative rules would be required to allow full adoption of IFRS by Australian taxpayers. The Australian Tax Office worked closely with the Australian Treasury, the AASB, Australian Securities and Investments Commission (ASIC) and others in relation to IFRS implementation and established an IFRS subcommittee of its National Tax Liaison Group (NTLG) to examine the effects of IFRS on taxation.

In Brazil, however, the introduction of IFRS resulted in a separation of tax rules from accounting standards. Before full adoption of IFRS, general purpose financial statements were tax-biased.¹¹⁸

¹¹⁶ Functional currency refers to the main currency used in the primary economic environment in which the economic entity operates. If a functional currency is used, it becomes possible to prepare the financial statements using a currency other than the Korean won.

¹¹⁷ From the Korean Government Draft Report *IFRS Adoption and Implementation in Korea, and the Lessons Learned*.

¹¹⁸ One example was depreciation expense in general purpose financial statements, which was based on tax rates determined by law for wide-range categories of property, plant and equipment items. Depreciation rates for tax purposes can differ significantly from those based on the economic useful life of the underlying asset (ie an entity-specific estimate as prescribed by IFRS).

Disentangling tax rules from general purpose financial reporting was an important policy decision that allowed full IFRS adoption. On the one hand, the government's tax policy autonomy has been preserved, which was essential to obtaining the support of IFRS adoption from tax authorities. On the other hand, releasing general purpose financial statements from tax rules and influence enhanced the usefulness of financial information to capital market participants.

In some jurisdictions the economic consequences of linking, or de-linking, tax and financial reporting can be significant. In the US the LIFO Coalition estimates that adopting IFRS in the US without removing the link between the tax and financial reporting requirements would cost the affected entities between USD60 and 70 billion.¹¹⁹ The LIFO Coalition acknowledges that the use of LIFO is fundamentally a taxation matter and avoids any justification of the method for financial reporting purposes. The LIFO Coalition asserts that changes to financial reporting requirements should not influence a decision on whether to repeal the LIFO inventory method for tax purposes. They also observe that the US Treasury has broad discretion to permit the continued use of the LIFO inventory method. Hence, as with other jurisdictions, the US has the ability to ensure that a decision about financial reporting for investors is insulated from tax consequences.

Investor understanding and education

The SEC Staff Report states that investors "generally support the idea of transitioning the US to a single set of high-quality, globally accepted accounting standards."¹²⁰ However, the SEC Staff Report also notes that such support is conditional. One of the main concerns relates to how well prepared investors are for a transition from US GAAP to IFRS, for example:

- (a) Do investors know enough about the differences between US GAAP and IFRS to understand the new financial information that will be reported?
- (b) If not, how long will it take them to become familiar with that new information?
- (c) How will they go about being educated?

A lack of active participation from the wider investment community in accounting standard-setting is a worldwide problem that the IASB and others are seeking to address. This section describes the activities the IASB has undertaken to educate investors around the world, including within the US.

Educating investors and analysts on accounting matters

The SEC Staff Report notes that:

- (a) institutional and professional investors are generally aware of the ongoing consideration of IFRS in the US;
- (b) investors are already familiar with, and actively use, financial statements prepared in accordance with IFRS from foreign issuers registered in the US and elsewhere; and

¹¹⁹ The LIFO Coalition is a US lobby group whose purpose is to preserve LIFO for tax purposes.

¹²⁰ SEC Staff Report, p.72.

- (c) most of these investors do not see investor preparedness being a major hurdle to incorporating IFRS.¹²¹ Many of these large investors are already in contact with the IASB, either directly or through one of the advisory bodies mentioned previously.

At the other end of the spectrum, the SEC Staff Report notes that some smaller investors, private investors or those focused purely on the domestic US market are less familiar with IFRS, and that this group is understandably reluctant to commit to developing a competence in IFRS until it becomes clear how the SEC will proceed with IFRS.

We believe that once the SEC has determined how it will proceed with IFRS, a combination of sufficient time allowance alongside investor education programmes will help to alleviate the burden of a transition to IFRS among this important group of investors. Experience from other jurisdictions has shown¹²² that once a decision is made regarding IFRS, even domestic investors have sufficient time and resources to support the transition.

Furthermore, we recognise the role we have to play in this endeavour.

The IASB's Investor Liaison Programme

In 2009, the IASB established an Investor Liaison Programme with its own dedicated resources to:

- (a) ensure that the IASB is well informed about investors' views on reporting requirements and priorities;
- (b) inform the investor community about the IASB's work; and
- (c) represent investors in the standard-setting process. (it should be also added that there are currently three IASB members from the investment community and at least one member of the Interpretations Committee represents the investment community)

The Investor Liaison Programme also focuses on fostering the IASB's relationships with the investor community. For example:

- (a) *Capital Markets Advisory Committee (CMAC)*: the CMAC, which meets publicly with IASB representatives three times a year in London, is an advisory body made up of 15 members of the investor community from 8 countries. The aim of the CMAC is to provide the IASB with regular views from users of financial statements worldwide and to offer advice to the IASB on the practical implications of its intended proposals.
- (b) *Investor representatives of the IFRS Advisory Council*: the IASB meets with the investor representatives of the Advisory Council three times a year in London. During those meetings, the Advisory Council members provide feedback on particular aspects the IASB's investor engagement strategy, such as how the IASB can improve its engagement with investors and

¹²¹ SEC Staff Report, p.76.

¹²² Based on the results of an informal survey of investors and analysts in Australia, Brazil, Canada, Europe, Hong Kong and South Korea, conducted by the IASB staff during August 2012.

how to build its investor network. The Advisory Council also provides input on specific topics, such as how best to get input from investors on the Agenda Consultation 2011.

- (c) *National standard-setters and their user groups*: some national standard-setters have user groups that meet regularly and the IASB staff is often invited to present on a topic on which they need the views of investors and analysts. Examples of user groups include the Accounting Standard Board of Canada's User Advisory Council (UAC) and the FASB's Investors Technical Advisory Committee (ITAC) and EFRAG's User Panel.
- (d) *Other relationships*: the IASB has relationships with many investor representative organisations throughout the world, for example:
 - (i) We have regular meetings with the CFA Institute's Corporate Disclosure Policy Council (CDPC), which addresses issues affecting the quality of financial reporting and disclosure worldwide.
 - (ii) We discuss accounting issues and get input on projects at meetings of the Corporate Reporting Users' Forum (CRUF).
 - (iii) We meet with members of the Financial Accounting Commission of the European Federation of Financial Analysts Societies (EFFAS) who, along with other EFFAS members, provide input to project teams when necessary.
 - (iv) We meet with members of the Corporate Accounting Committee (CAC) of the Security Analysts Association of Japan (SAAJ) who, along with other SAAJ members, provide input to project teams when necessary.
 - (v) We also have relationships with many investors and analysts who give us their views on our activities in their personal capacities.

Although input from the investor community is critical to accounting standard-setting, it is often difficult to obtain. The level of accounting knowledge held by investors and analysts around the world varies widely. In many cases, a self-perceived lack of specialist knowledge can result in investors being reluctant to talk to standard-setters about technical accounting issues. In reality, as highly qualified financial professionals who analyse financial information and who, in many instances, have taken accounting courses in university or through professional examinations such as the CFA Program, this is often far from the case. Many of those who say they know little about accounting are, in fact, very knowledgeable because of their ongoing reviews of financial statements.

Smaller verses larger issuers

The SEC staff analysed the extent to which any incorporation of IFRS would affect smaller issuers differently to larger issuers¹²³ and the extent of, logistics for, and estimated time necessary to undertake any changes. Specifically, the staff sought to determine:

¹²³ SEC Staff Report, p.99.

- (a) the manner in which the impact of such incorporation varies based on issuer size; and
- (b) possible approaches to mitigate concerns regarding any disproportionate effects on smaller issuers.

Most jurisdictions have a different financial reporting framework for companies whose securities do not trade in public capital markets (private companies) from the framework required for companies whose securities do trade in public capital markets (public companies). Indeed, quite a few jurisdictions have more than one framework applicable to private companies, and quite a few (the US included) do not impose any financial reporting obligation on all or most private companies.

We are not aware, however, of any jurisdiction that has adopted two different financial reporting frameworks for domestic publicly traded companies on the basis of size—one framework for larger companies and another for smaller companies. The IASB has taken the view—explained in paragraph BC58 of the basis for conclusions of the *IFRS for SMEs*—that “regardless of size, entities whose securities are traded in a public market should follow full IFRSs.” This approach is not different from general securities laws that apply equally to all companies traded in public markets, larger or smaller.

The SEC Staff Report makes the point that smaller public companies generally have fewer internal resources available to dedicate to non-routine projects such as a transition to IFRS and, hence, the impact may be more burdensome to smaller issuers on a relative basis. However, whether a switch from US GAAP to IFRS would impose a disproportionate cost or burden on smaller public companies as compared to larger public companies will depend on a range of factors, including:

- (a) the degree of complexity of the transactions entered into by the smaller public company;
- (b) the nature of the remaining differences between US GAAP and IFRS and the degree to which those differences affect a particular company;
- (c) the accounting policy choices that the company has made in accordance with US GAAP; and
- (d) the accounting policy choices that the company makes in accordance with IFRS.

We question the comment that “the costs of applying IFRS on a go-forward basis (ie not just transitioning to it) are prohibitive”¹²⁴ for smaller public companies. This respondent was of the view that “IFRS has more extensive requirements to use fair value.” The main area where IFRS requires fair value but US GAAP does not is agriculture, and even in this case, IAS 41 reverts to cost measurement if an entity is not able to measure its biological assets and agricultural produce reliably.

Moreover, IFRS is required for all public companies, large and small, in roughly 120 jurisdictions. In many of those jurisdictions, the size of the largest companies would be at the very bottom end of the US public company-size scale. Indeed, many IFRS jurisdictions have only a few public companies

¹²⁴ See comment letter of Zions on the 2011 May Staff Paper. 530 See SEC IFRS Round table transcript (comments of Rowland and Greene).

with more than 500 employees. Yet those jurisdictions have not found the costs of applying IFRS on an ongoing basis to be prohibitive. If that were the case, surely they would have adopted some other financial reporting framework.

This is illustrated in the report on the results of transition to IFRS in the EU [emphasis added]:

“The experience of smaller quoted companies was often very different from larger companies because, for example, of limited resources and a lack of prior experience of IFRS. Nonetheless, there was little evidence of problems being identified.”¹²⁵

Human capital readiness

The SEC Staff Report notes that the large US international public accounting firms and multinational companies that have foreign entities that report in IFRS jurisdictions, or are in the process of doing so, have an extensive understanding of IFRS.

However, the report cites concerns about human capital readiness and auditor capacity and the impact to the availability and cost of qualified auditors in the event of a US transition to IFRS. Such concerns appear to relate primarily to those domestic US preparers that do not operate internationally and to smaller and mid-sized audit firms.

The following considerations are relevant when addressing the concerns about IFRS human capacity in the event of IFRS adoption:

“Firstly, there is substantial IFRS human capital in the large US international public accounting firms and multi-national companies.¹²⁶ Furthermore, it seems reasonable to assume that many other interested parties in the US have an understanding of IFRS, mainly because, as a result of numerous US subsidiaries of IFRS reporting foreign groups¹²⁷ and because Foreign Registrants have, since 2009, raised capital in the US using IFRSs without reconciling to US GAAP, US investors increasingly invest internationally.”¹²⁸

¹²⁵ http://ec.europa.eu/internal_market/accounting/docs/studies/2007-eu_implementation_of_ifrs_summary.pdf.

¹²⁶ SEC Staff Report, p.122.

¹²⁷ The US Chamber of Business report “Americans derive important benefits from US investment abroad. In addition to exporting, US corporations can access new customers in foreign markets by investing abroad, creating foreign affiliates and becoming multi-nationals in the process. Sales by these foreign affiliates reached nearly \$5 trillion in 2009—a sum representing more than one-third of US multi-national corporations’ total sales. Many of America’s largest companies earn more than half their revenue in this way.” (See <http://www.uschamber.com/international/agenda/secure-us-investment-overseas> downloaded 17 September 2012.)

¹²⁸ For example, James K. Jackson, Congressional Research Service report *U.S. Direct Investment Abroad: Trends and Current Issues*, concludes “American direct investment abroad has grown sharply since the mid-1990s” (February 2011). (See <http://www.fas.org/sgp/crs/misc/RS21118.pdf>.)

Secondly, many other industrialised nations (for example, the EU and Canada) successfully developed the human capacity to adopt IFRS at an acceptable cost.¹²⁹ If the SEC were to set a definite date for the domestic adoption of IFRS, we have every confidence that the US accounting profession would deliver the human capital needed for the adoption of IFRS.

Moreover, the differences between IFRS and US GAAP are relatively small when compared to the previous GAAP of many jurisdictions that have adopted IFRS—IFRS and US GAAP have the same objective, are built on shared concepts and, largely as a result of the FASB–IASB Memorandum of Understanding, share common and substantially converged requirements. Furthermore, the human capacity of those nations that have already adopted IFRS (for example, Canada) could potentially be attracted to the US. Evidence of the portability of professional accountants from jurisdictions that use IFRS is demonstrated by the increasing numbers of professional accountants working abroad.¹³⁰

Furthermore, the IFRS Foundation’s Education Initiative is ready to work with the relevant US institutions to support increased IFRS knowledge and skills in the US. The Education Initiative has already:

- (a) arranged jointly with the American Institute of Certified Public Accountants (AICPA) two multi-day IFRS conferences (in 2009 in New York and in 2011 in Boston); and
- (b) each year since 2009, facilitated a half-day workshop at the American Accounting Association (AAA) to support those teaching IFRS (or planning to do so) to focus on developing their students’ ability to make the judgements and estimates that are necessary to apply principle-based accounting standards.

In addition to the in-house IFRS resources possessed by US entities, the SEC Staff Report refers to the extensive IFRS resources made publicly available by the largest accounting firms, professional associations and other providers of technical guidance. IFRS publications prepared by the Education Initiative include:

- (a) *A Briefing for Chief Executives, Audit Committees and Boards of Directors*. The text sets out in non-technical language the main principles in each IFRS, the judgements and estimates that are often necessary when applying the standards and the main considerations when adopting IFRS for the first time.
- (b) *A Guide through IFRS*. Cross-references guide readers through Standards and facilitate their understanding by providing the connection between related requirements and their

¹²⁹ For example, in the preamble to its August 2010 Update of *IFRS Transition Support Strategy* the CICA reported “By developing and implementing a robust, nationally coordinated strategy, we have provided members with the information, training, and practice support tools they require for a successful transition.”

¹³⁰ The UK FRC (2012) *Key Facts and Trends in the Accountancy Profession* report that in 2011 28.8 per cent of members of the UK and Ireland professional accountancy bodies are from outside the UK and the Republic of Ireland (see <http://www.frc.org.uk/getattachment/395dede0-38d4-40d6-93a5-9545fd47d177/Key-Facts-and-Trends-2012.aspx>). Similarly, in August 2012, 20.8 per cent of the members of the SAICA are not resident in South Africa (see <https://www.saica.co.za/Portals/0/Members/documents/LocaAbs2012.pdf>).

accompanying Illustrative Examples, Implementation Guidance and the IASB's main considerations in reaching its conclusions (ie the bases for conclusions). In addition, footnotes summarise technical issues that were considered but rejected by the Interpretations Committee.

- (c) Extensive training material to support those teaching and training others in IFRS and the *IFRS for SMEs* are available for free download from the IASB's website in a number of languages (see <http://www.ifrs.org/Use+around+the+world/Education/Education.htm>).

When a jurisdiction is considering adopting IFRS, many entities that would be affected by the adoption decision, after becoming aware of the issues related to adoption,¹³¹ are understandably reluctant to invest significant resources in preparing for IFRS adoption until it is apparent to them that they will be required (or allowed) to adopt IFRS. In other words, entities typically wait for confirmation that IFRS will be incorporated before devoting resources to developing their IFRS knowledge. Until then, they tend to confine themselves to identifying third-party training resources that are currently available that could supplement or provide IFRS training, if it turns out that they will eventually be required to use IFRS.¹³² Once a definite date for the domestic adoption of IFRS has been set, those affected are motivated to develop the knowledge and expertise to implement IFRS with the support of the accountancy profession. For example, following the announcement of a definite date for the adoption of IFRS in Canada, the Chartered Accountants (CA) of Canada successfully initiated a comprehensive three-pronged (awareness, education and training and implementation) IFRS Transition Support Strategy enabling the Canadian financial reporting community's move from awareness to technical knowledge and expertise for applying IFRS.¹³³

The Education Initiative is now focusing on its latest 'flagship' project—supporting those teaching IFRS (or planning to do so) to develop in their students the ability to make the judgements and estimates that are necessary to apply principle-based accounting standards.¹³⁴ This project was developed from the Education Initiative's participation in supporting IFRS expertise ahead of the adoption of IFRS in Canada.¹³⁵ A series of regional workshops, sometimes held jointly with others (eg the IAAER), and that take place around leading academic accounting associations' conferences in 2012, including the American Accounting Association (AAA) and the European Accounting

¹³¹ For example: Chartered Accountants of Canada IFRS Transition Support (Update to August 2010): leading up to the announcement of a 'date certain' for the adoption of IFRSs focuses primarily on "... building IFRS awareness among key stakeholder groups ..." p.3.

¹³² For example: SEC Staff Report, p.123.

¹³³ Chartered Accountants of Canada IFRS Transition Support (Update to August 2010), pp. 1–6.

¹³⁴ IFRS requirements are principle-based only when they are consistent with the concepts set out in the IASB's *Conceptual Framework for Financial Reporting* (see Wells M, "Framework-based Approach to Teaching Principle-based Accounting Standards", *Accounting Education an international journal*, August 2011, p.304).

¹³⁵ Chartered Accountants of Canada and University of Toronto, *Leveraging Change – The New Pillars of Accounting Education* (edited by Irene M. Wiecek, FCA and Gordon Beal, CA, M.Ed) (see <http://www.cica.ca/becoming-a-ca/supporting-ca-academics/item62031.pdf>).

Association's (EAA) annual meetings, use the material to train teachers in its effective use.¹³⁶ The first instalment of the new material (including notes for students, tutorials and a comprehensive case study) focuses on the teaching of accounting for assets at three stages in the CPA/CA-stream students' progress towards qualifying.

The SEC staff observe that:

"the majority of investors that the Staff has contacted or that have commented directly to the Staff do not have much familiarity with IFRS".

and:

*"These investors seem to be understandably reluctant to commit extensive resources to develop a better understanding of IFRS until (1) it becomes clear whether and, if so, how, the United States might incorporate IFRS and ..."*¹³⁷

In response to these observations the Education Initiative and Investor Liaison staff propose a number of IFRS education activities that focus specifically on investor education for delivery. These activities will start in 2013 and will include:

- (a) the development of an *IFRS Briefing for the Investor Community* (Investor Briefing). The staff envisage that the Investor Briefing will provide, in the language of the Investor community, a summary of the main features of each Standard, including the effect of those features on IFRS financial statements. It will also include a summary of the significant judgements and estimates made by those preparing financial statements that are compliant with IFRS; and
- (b) investor-focused IFRS education webcasts and special-interest sessions in advance of the regional IFRS conferences held each year. Such special-interest sessions would be presented by IASB members from the investor community and leading IFRS analysts and investors. The sessions would cover IFRS topics of interest to the investor community.

Other proposed activities are set out in the section on investor outreach of this report.

Cost of transition

The SEC Staff Report does not mention a specific numeric cost analysis that was provided to the SEC in the comment letter process¹³⁸. Most comment letters that raised the issue of cost as a concern addressed the challenge of costs more generally, providing general qualitative, rather than specific and substantiated, estimates of conversion costs.

¹³⁶ see <http://www.ifrs.org/Use+around+the+world/Education/IFRS+Teaching+Sessions.htm>.

¹³⁷ SEC Staff Report, p.73 and 74.

¹³⁸ Although the SEC Staff report, page 107, refers to a cost estimate from one large multinational issuer of over \$400 million for full retrospective application of four major joint IASB-FASB joint projects.

In this regard, some initial points should be mentioned:

- (a) A distinction should be made between IFRS-related system upgrades costs and US GAAP costs. The Memorandum of Understanding projects that were mutually agreed by the FASB and the IASB are expected to result in substantive changes to US GAAP. The costs of implementing the new converged Standards (Such as Fair Value Measurement Revenue Recognition and Leases) will be borne by US preparers, regardless of whether the US moves to IFRS or retains US GAAP. The costs associated with these amendments are therefore outside of the scope of transitioning to full IFRS.
- (b) Elective costs should be differentiated from required IFRS transition costs. For example, application of the new MoU Standards may legitimise recommendations for entirely new accounting systems, but these costs are not necessarily 'requirements' of IFRS implementation.
- (c) As noted in the SEC Staff Report, for a significant group of multinational companies, transition to IFRS can result in cost savings and simplification of their internal systems.

The challenge of costs has been carefully considered by all countries in which adoption was ultimately achieved, however, most reports tend to conclude that the costs were reasonable in view of the benefits.

Experience reveals that an important factor that will affect the cost of transition is the extent to which the local GAAP was different from IFRS before transition. In countries like Canada, Australia and the UK, this has been mentioned as an important factor that may result in relatively lower transition costs.

The following examples illustrate how authorities around the world considered transition costs in the assessing the transition process to IFRS:

A *European Commission* report on the implementation of IFRS concluded that:

*"Analysis of implementation costs and subsequent recurrent application costs in the ICAEW study ... has shown that they appear higher for smaller companies (turnover below €500m) amounting respectively to 0.31% and 0.06% of their turnover, which remains an acceptable level. Smaller quoted companies have also faced more difficulties in applying IFRS because of limited resources and a lack of prior experience of IFRS."*¹³⁹

In *Canada*, a study performed by the Canadian Financial Executives Research Foundation (CFERF) on IFRS Readiness in Canada (2010–Executive Research Report) surveyed 146 individuals and focused, among other topics, on IFRS conversion budgets (measured in Canadian dollars) and conversion resources.

¹³⁹ Report from the European Commission dated 24 April 2008 on the operation of Regulation 1606/2002.

The respondents reported on the conversion budgets:

“The majority of respondents (68%) had budgeted \$500,000 or less for the conversion in Canada; 36% planned to spend between \$100,000 and \$500,000, and 32% planned to spend less than \$100,000. Another 15% had reserved between \$1 million and \$5 million for the transition, while about 7% had budgeted between \$500,000 and \$1 million. A small minority (5%) had budgeted more than \$5 million, and the remainder did not have a cost estimate.”

The survey further reported that:

“The vast majority of finance executives surveyed said that their companies had adequate resources devoted to the IFRS conversion (88%), compared to 9% that didn’t.”

In Korea, the costs for non-financial companies making the transition to IFRS were estimated to be \$250,000 US dollars while the total cost for financial companies was \$2,400,000 US dollars¹⁴⁰.

In Australia, evidence on the costs and benefits of IFRS adoption appears to be thin. In a September 2009 presentation, the AASB identified a number of factors that affect cost, namely:

- (a) the initial upfront costs of adoption, particularly in implementing IAS 39 for entities such as banks and insurers;
- (b) the pace of change in Standards, with numerous amendments to IFRS often driven by issues not of concern to Australia; and
- (c) issues of concern to Australia, such as emission trading rights, that may not be a global priority.

However, the AASB also highlighted a number of benefits:

- (a) Australian entities’ financial reports are more readily understood worldwide;
- (b) synergies in the preparation, audit and analysis of Australian financial reports for entities that are part of a multi-national group; and
- (c) the filling of gaps in AGAAP, in particular in the area of the recognition and measurement of financial instruments. In his interview referred to on page 53 of this report, Doug Niven had this to say on the theme of costs and benefits:

“Increasingly, the use of a single set of financial reporting standards within the global capital markets has clear benefits for all stakeholders. It is very difficult to quantify those benefits in terms of the monetary impact on measures such as cost of capital, but users of financial reports have clearly benefited from having a common financial reporting language. This is particularly true of overseas users who are now better able to understand the financial reports of Australian companies in comparison with other international companies.

It is very difficult to quantify the cost-benefit equation. The main costs were identifying the differences between Australian GAAP and IFRS, staff training, system and process changes

¹⁴⁰ <http://ifrs.fss.or.kr/ifrs/bbs/view.jsp?menuCode=frs030400&idx=1268699040498&bbsid=1207915090632>

and educating the market on the impact of the changes. The costs were incurred at the time of transition and were not recurring. For large corporations, those costs were typically a small proportion of revenue. Once these costs have been incurred, the benefits to both users and preparers are ongoing. As well as consistent and comparable high-quality financial information for users, there are savings for many preparers in the ultimate reduction in costs of capital and consistent financial reporting within groups.”

Finally, *in Brazil*, the Brazilian Institute of Investor Relations and Deloitte performed a survey in 2011 to depict investor relations after the adoption of IFRS by public companies. Although the survey collected inputs from public companies just a few months after the publication of first-time adoption IFRS financial statements, some benefits were already perceived. The majority of respondents believed that IFRS brought more transparency to financial information. Transition costs were less than \$1 million for 77 per cent of respondents and the main cost drivers were the acquisition of technical knowledge of IFRS and the preparation of comparative information.

The SEC Staff Report does not contain an analysis of the benefits of the use of IFRS in the US. The IFRS Foundation has recently commissioned Ann Tarca, Professor of Accounting at the University of Western Australia and former Academic Fellow of the IASB, to examine and summarise current academic research that has sought to observe and quantify the benefits derived from widespread adoption of IFRS. That research is included in the appendix to this report. In summary, the research finds that capital markets benefit after adopting IFRS, even in countries with strong investor protection and high quality financial reporting and enforcement. Such benefits include:

- (a) market efficiency—market liquidity increases following the introduction of IFRS, while firms benefit from a reduction in the cost of capital and an increase in equity value (Daske et al, 2008).
- (b) investment decisions—analysts that review IFRS firms have more accurate forecasts compared to those forecasts of analysts following non-IFRS firms (Horton et al, 2012). Furthermore, when a country’s GAAP is closer to international standards, foreign analysts are more likely to follow and provide more accurate forecasts for firms in that country (Bae et al, 2008).
- (c) quality of financial information—in Europe, there was a general perception among preparers, auditors, investors and enforcers that the application of IFRS has improved the comparability, quality and transparency of financial reporting (European Commission, 2008).
- (d) foreign investment—IFRS is a vehicle through which countries can improve investor protection and make their capital markets more accessible to foreign investors (Hope et al).
- (e) capital market integration—higher correlations of market indices were observed between markets in which firms use IFRS and markets in which firms generally do not use IFRS (Cai and Wong, 2010).
- (f) method of application—the success of common standards depends not just on the quality of the Standards issued by the IASB. Critically, success also requires an infrastructure to support IFRS to be in place at a national and international level (Tarca, 2012).

These results, however, cannot be simply projected on the US. The US already has high quality accounting standards with a solid reputation. The immediate benefits for the US will be smaller than those for countries that started out with standards that were only understood domestically.

Yet, also for the US, incorporation of IFRS is likely to have benefits. US private assets invested in foreign securities as of 2009 were valued \$5.47 trillion¹⁴¹. In addition, the growing capital flows from the US into emerging markets in recent years cannot be ignored. It follows that an increasing number of US investments will be in IFRS-reporting entities. Obviously, increased transparency and comparability in international capital markets is in the US investor's interest.

Furthermore, as IFRS has spread around the world, US companies have an interest in being able to use it on a global scale, particularly if they already have subsidiaries who are IFRS reporting entities.

Finally, the US stands to gain by the beneficial impact of a single set of global standards on the world economy as a whole.

IFRS has become a global standard, the US has a clear interest in participating in its development and application, as expressed by the SEC Staff Report.¹⁴²

¹⁴¹ Speech by SEC Commissioner Kathleen L. Casey: Keynote Address at the Society of Corporate Secretaries and Governance Professionals 65th Annual conference:

<http://www.sec.gov/news/speech/2011/spch062411klc.htm>

¹⁴² SEC Staff report, p.1.

Appendix

The Case for Global Accounting Standards: Arguments and Evidence

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Abstract

This paper outlines the arguments for a common set of accounting standards and the forces that have promoted adoption of International Financial Reporting Standards (IFRS). Widespread use of IFRS since 2005 provides an opportunity for empirical investigation of the benefits of IFRS. I summarise results of studies that are relevant for assessing the role of IFRS in both developing and developed capital markets.

Introduction

The expected benefits of global accounting standards are compelling. The use of one set of high quality standards by companies throughout the world has the potential to improve the comparability and transparency of financial information and reduce financial statement preparation costs. When the standards are applied rigorously and consistently, capital market participants will have higher quality information and can make better decisions. Thus markets allocate funds more efficiently and firms can achieve a lower cost of capital. These arguments have been used to support the adoption of International Financial Reporting Standards (IFRS) for financial reporting for consolidated listed entities in European Union (EU) member states (EC1606/2002). Other jurisdictions have cited similar reasons for adoption of IFRS (see Brown, 2011), reflecting the demand for high quality standards that can improve the quality and comparability of financial reporting and promote the development of national capital markets and the integration of markets internationally.

For the first time in history, we have substantial numbers of firms domiciled in different countries using common standards. Consequently we can collect evidence about the extent to which we observe benefits in capital markets. This paper presents research findings about the impact of adoption of IFRS since 2005 when they became the legally required accounting standards for over 6,000 EU firms and for firms in several other countries including Australia and South Africa. The next section outlines the evidence about the impact of IFRS on the efficient operations of capital markets, considering data relating to share prices and returns and also the activities of international investors and securities analysts. The following sections consider the impact of IFRS in both developing countries

¹⁴³ The views expressed in this article are those of the author. They are not the views of the IASB or its members, which are arrived at after extensive due process and deliberation.

and those where capital markets are more mature and present evidence that is relevant to evaluating the role of IFRS, both prior to and subsequent to the financial crisis of 2007-2008. The final section concludes the paper.

IFRS adoption and market efficiency

A fundamental question is whether IFRS have changed the information available to market participants in a way that is beneficial, that is, are markets more efficient when IFRS are used? We expect that IFRS information provided by firms to market participants may differ significantly from information based on prior national GAAP, due to differences between requirements of national standards and IFRS. The extent to which the change to IFRS provides more useful information that translates into benefits observable in capital markets is a question currently being addressed in research.

Some studies gather evidence about changes in market liquidity and firms' cost of capital, as a way of measuring the impact of IFRS. In one of the first large scale studies of firms adopting IFRS in a mandatory setting, Daske et al. (2008) conclude that market liquidity increases following introduction of IFRS. They also find evidence of a decrease in firms' cost of capital and an increase in equity value occurring prior to the official adoption date. In a related study, the authors find benefits such as improved liquidity and lower cost of capital are more likely for firms that are 'serious' adopters of IFRS (defined as firms with a commitment to transparency) (Daske et al., 2011).

Li (2010) finds IFRS mandatory adopters benefit through reduced cost of capital in the immediate mandatory adoption period, reflecting increased disclosure and enhanced information comparability. However, the reduction occurs only in countries with strong legal enforcement.¹⁴⁴ Palea (2007) considers costs of capital effects for financial institutions. She reports lower cost of capital for EU financial firms using IFRS compared to others following national standards and the Fourth and Seventh Directives, a result that is consistent with IFRS adoption objectives of the European Commission (EC1606/1202).

Researchers have long used share prices to reveal information about the usefulness of financial data (Ball and Brown; 1968 and Beaver, 1968). In this tradition, Beuselinck et al. (2009) investigate stock return synchronicity¹⁴⁵ for mandatory IFRS adopters in the EU. They conclude that IFRS adoption reveals new firm-specific information and subsequently reduces the surprise in future disclosures. Landsman et al. (2011) consider the impact of the use of IFRS on share prices and trading (abnormal return volatility and trading volume). They conclude that the information content of earnings announcements has improved for IFRS reporters by reducing reporting lag, increasing analyst following and increasing foreign investment. They also find the IFRS effect depends on the level of enforcement in a country.

¹⁴⁴ Researchers use the term enforcement to refer to the national legal setting in which the financial reporting takes place, that is, the legal and governance systems that protect investors and creditors and discipline others for illegal activities.

¹⁴⁵ Synchronicity refers to the extent to which individual stock prices move with overall market prices.

Other studies explore the impact of IFRS for market participants. In relation to investors, studies provide evidence of various benefits that can be linked to firms' use of high quality, comparable standards. Brüggemann et al. (2009) consider the investments in foreign firms made by individual investors on the Open Market at the Frankfurt Stock Exchange (4,869 firms from 31 countries). They report an increase in trading activity following the adoption of IFRS. Thus the authors conclude IFRS have the potential to promote more foreign equity investments by individual investors.

DeFond et al. (2011) also investigate the relationship of IFRS and cross border investment. They find US mutual fund ownership increases for mandatory adopters, but only when adoption is seen as 'credible'. Thus, like Daske et al. (2009), they point to benefits from IFRS arising from improvements in comparability but caution that the way the standards are implemented (that is, the manner in which they are used by firms) is of crucial importance for realising benefits from IFRS. Shima and Gordon (2011) show that both legal standards and enforcement are necessary to increase foreign investment.

Yu (2010) also examines mutual fund holdings. She concludes adoption of IFRS increases cross border holdings by reducing the information processing costs of foreign investors, through improving comparability of financial information and indirectly by lowering other barriers such as geographic distance. Her evidence also suggests that harmonisation across accounting reporting regimes is a more effective way to attract foreign capital than improvements in individual country's reporting regimes. Francis et al. (2012) report a higher volume of merger and acquisition (M&A) activity and higher takeover premiums when countries have more similar GAAP. They also find more M&A activity in countries adopting IFRS in 2005, a trend more pronounced in countries with low similarity of GAAP and IFRS pre-adoption. The authors conclude that similar GAAP reduces information costs, thus increasing competition among bidders and permitting greater gains for target shareholders.

Flourou and Pope (2011) explore the question of whether mandatory IFRS lead to an increase in institutional ownership of equity. Considering the year of adoption and one subsequent year, they report increases in ownership and consequently show that IFRS affect allocation decisions of institutional investors. The IFRS-related ownership changes are higher for value and growth investors, who are more likely to make use of financial statements in their investment decision processes. An important caveat in their study is that the positive IFRS ownership effects are found only in countries with strict legal enforcement and low levels of corruption. I return to this point later in this paper.

Many studies investigate the effects of mandatory IFRS for security market analysts because they are important users of financial statement information. The IFRS studies build on a pre-existing literature that suggests high quality financial statement information assists analysts (Lang and Lundholm, 1996; Hope, 2003). Consequently, analysts are expected to benefit if IFRS improve the relevance, transparency and comparability of information. A study by Bae et al. (2008) of analysts following foreign firms suggests that they benefit when accounting standards are more similar. Specifically, when a country's GAAP is closer to international standards (IAS in their study), foreign analysts are more likely to follow and to provide more accurate forecasts for firms from that country.

Several studies set in the mandatory IFRS period conclude that IFRS adoption has benefited security analysts. Horton et al. (2012) find that analysts following IFRS firms have greater

accuracy in their forecasts compared to analysts following non-IFRS firms. They conclude IFRS have improved the information environment by increasing both information quality and comparability. Other researchers also find improvements in forecast accuracy based on studies of EU companies (Jiao et al., 2012) and those from individual countries, including developed and developing market economies (Panaretou et al., 2009; Choi et al., 2010; Ernstberger et al., 2008; Hodgson et al., 2008; Cotter et al., 2012). Beuselinck et al. (2010) find that IFRS improve the ability of analysts to incorporate firm-industry information in share prices and reduce the private information advantage held by institutional owners. In another study of IFRS firms, Beuselinck et al. (2009) report that the precision of information increases post 2006 but consensus among analysts does not change, suggesting an increase in precision of both common information and private information. Analysts who follow firms in more than one country experience the largest post IFRS improvement in private information precision.

Byard et al. (2011) note benefits for analysts in the immediate post IFRS adoption period for EU firms. The benefits are observed in countries where the national GAAP and IFRS had the greatest differences and where there were strong institutions to support IFRS adoption, that is, the legal system of a country is sound and offers protections to investors. Tan et al. (2011) report that mandatory IFRS attract foreign analysts to a firm and also improve their forecast accuracy. The increase in analyst following is positively associated with the extent of difference between local GAAP and IFRS and the extent to which adoption eliminates this difference. IFRS adoption also attracts more local analysts although it does not significantly influence their forecast accuracy.

Most research focuses on IFRS effects related to trading in securities markets. However, Beneish et al. (2012) find that IFRS have a greater impact in debt markets than equity markets. The authors observe that increases in foreign equity investment in the post-adoption period are limited to countries with high (or improving governance quality). However, increases in foreign debt investment flows are not dependent on governance quality, consistent with covenants in bond contracts being used to offset country-level weaknesses in investor protection. The increase in investment derives from both the US and other non-adopting countries, suggesting it is linked to the quality of IFRS.

The results of these studies provide evidence that the widespread adoption of IFRS has brought benefits to capital markets. Researchers generally conclude that the benefits arise from the nature of IFRS (compared to prior GAAP) and the use of common standards by firms from different countries, which improves the comparability of information for international investors and analysts.

A common thread in the academic literature is that the benefits of common standards cannot be achieved by the standards alone. The issue was raised prior to widespread adoption of IFRS. Ball et al. (2000; 2003) highlights the importance of incentives in determining how standards are used in practice. The point has also been taken up by IFRS researchers, notably Christensen et al. (2008) who argue that firm incentives are more important than the accounting standards themselves in understanding IFRS effects. Using data relating to the post 2005 adoption period, many researchers have concluded the setting in which IFRS reporting takes place has a strong influence on whether potential benefits of IFRS can be realised (Daske et al., 2008; Beuselinck et al., 2009; Flourou and Pope,

2011; Landsman et al., 2011; Christensen et al., 2010 and 2012). The success of common standards depends not just on the quality of the standards issued by the IASB. Critically, success also requires an infrastructure to support IFRS to be in place at a national and international level.

Consequently, not all studies report improvements when companies adopt IFRS. As noted above, benefits are strongly linked to the extent to which prior national GAAP and IFRS differ and the level of enforcement (or, put another way, the legal setting and business and financial reporting culture) in individual countries. Researchers concerned with managers' reporting incentives argue that IFRS benefits will only emerge if firms have incentives to provide high quality IFRS reports, either due to their individual circumstances or in response to legal, reporting and governance requirements in the countries where they operate and the markets where they are listed. Wang and Yu (2009) find better accounting standards (for example, IFRS) have beneficial effects for the information content of share prices in countries with common-law legal origins, better shareholder protection and stricter legal enforcement. These studies emphasise the point made by many researchers: institutional setting will affect the extent to which IFRS benefits can be realised.

Not all research supports the claim that IFRS are beneficial for capital markets. Some researchers question whether comparability improves following IFRS adoption, pointing to evidence of continuation of pre-IFRS policy choices (Kvaal and Nobes, 2010; 2011). Lang et al. (2010) measure both earnings comovement (based on the covariation in earnings between firms in different countries) and accounting comparability (based on the relationship of earnings and returns of a firm, compared between firms in different countries). They find that while comovement increases for IFRS firms, comparability does not. Further, the increase in comovement is associated with a poorer information environment (measured as a decrease in analyst coverage and forecast accuracy and an increase in bid-ask spreads).

IFRS and economic development

Studies of capital market development show strong links between a country's legal and financial infrastructure and the maturity of its capital market. In a study of 49 countries using data from 1994, La Porta et al. (1997) show that countries with poorer investor protection (measured by both the character of legal rules and the quality of law enforcement) have smaller and narrower capital markets. In a related study, La Porta et al. (1998) conclude that common law countries have the strongest, and French civil law countries the weakest, legal protection of investors. The German and Scandinavian civil law countries are somewhere in-between. Jackson and Roe (2009) also explore the relationship of legal activity and capital market development. They argue that both public enforcement and private enforcement (typically associated with civil law and common law systems respectively) are important for development of markets, noting the practice in some common law countries to make use of mechanisms typically observed in civil jurisdictions.

Other studies point to the interrelationship of institutional setting and the quality of accounting information. For example, Leuz et al. (2003) conclude that a country's legal and institutional environment influences the properties of reported earnings. They find outsider

economies (those with large stock markets, dispersed ownership, strong investor rights and strong legal enforcement) feature larger stock markets, lower ownership concentration, more extensive outsider rights, higher disclosure and strong legal enforcement than insider economies. Financial reporting and disclosure is considered to be an important part of the institutional setting that affects transparency (Bushman et al., 2004). Frost et al. (2006) find the strength of a stock exchange's disclosure system (disclosure, monitoring and enforcement of financial information) is positively associated with market development, after controlling for legal system, legal protection of investors, market size and other relevant factors.

Given the importance of institutional setting for market development, it is not surprising that initiatives to promote capital market growth involve the development of sound financial infrastructure, including the use of high quality accounting standards. The World Bank and the IMF have encouraged the use of IFRS to support development of capital markets and, in turn, global economic growth and stability (Hegarty et al., 2004).

The World Bank's Review of Standards and Codes (ROSC) reports (World Bank, 2011) provide many examples of countries embracing IFRS to improve the quality of financial information about private sector firms and government business enterprises, to promote the development of technical accounting expertise within a country and to attract foreign capital. Hope et al. (2006) review 38 countries that voluntarily adopted IFRS before the end of 2004. They conclude IFRS are a vehicle through which countries can improve investor protection and make their capital markets more accessible to foreign investors. Subsequently Gordon et al. (2012) show that foreign direct investment inflows increased in developing countries adopting IFRS. They study firms from 124 countries during the period 1996-2009 and show a direct benefit for developing (but not developed) economies, providing evidence that the World Bank encouragement of use of IFRS is beneficial.

Countries using IFRS include Korea, where full IFRS became mandatory from 2011 in an attempt to improve transparency and international perceptions of the corporate culture in order to attract more international investment (Fifield, 2007). In Malaysia full IFRS applied from 2012. The Malaysian Accounting Standards Board Chairman stated that adoption in Malaysia was not about 'jumping on the bandwagon' but rather recognising that Malaysian companies operate in a global environment. IFRS allows Malaysian companies and markets to be recognised internationally (MASB, 2008). Malaysia has previously partially harmonised national standards with IFRS. Reviewing financial reporting under national GAAP and the harmonised standards, Wan Ismail et al. (2010) report higher quality of earnings and Kadri and Zulkifli (2008) find higher value relevance of accounting numbers for Malaysian companies under the revised (harmonised) standards. Future research can consider whether further improvements follow adoption of full IFRS.

Various studies have documented the process of adoption of IFRS in developing markets. For example, Jaruga et al. (2007) describe the difficulties of conversion to IFRS and impact of adoption on financial statements in Poland. Similarly, Ionas et al. (2007) and Albu and Albu (2012) describe the complicated nature of the process in Romania while Sucher and Jindrichovska (2004) discuss the Czech Republic's experience. A few studies provide evidence of economic or accounting outcomes of adoption of IFRS in developing markets. Dobija and Klimczak (2010) report that market efficiency and value relevant reporting were

achieved early in the development of accounting to support privatisation (from 1997), but these features did not improve further in the period 2005-2008 when IFRS was adopted. Marquez-Ramos (2008) provides evidence that adoption of IFRS is associated with more trade and foreign direct investment and these positive effects are stronger in the transition economies of eastern Europe.

Financial re-regulation

Financial regulation has emerged as a major policy issue following the economic crisis of 2007-08. In October 2007 the Financial Stability Forum (FSF) formed a working group to make proposals that would enhance market stability, discipline and institutional resilience following a liquidity squeeze in markets from June 2007 (Helleiner and Pagliari, 2009). A subsequent action plan from the G20 finance ministers, based on the work of the FSF, is described by Veron (2012, p. 2) as re-regulation: 'the renewed realisation that financial systems, including banking systems, could not be left to their own devices, both because of the large potential economic costs of financial crises and because public expenditure is often a key component of their resolution'. The G20 November 2008 action plan proposed a commitment to common principles for reform, encompassing strengthening transparency and accountability, enhancing sound regulation, promoting integrity in financial markets, reinforcing international cooperation, and reforming financial institutions. One set of global accounting standards, consistent application and enforcement and improved requirements in relation to recognition, measurement and disclosure for financial instruments and off-balance sheet entities were included in the action items (Rottier and Veron, 2012). Underlying the G20 proposals was the notion that accounting standards and the way they are applied and enforced must be improved, given their role in the events of the financial crisis (Walker, 2010).

Studies have investigated the impact of IAS 39 *Financial Instruments: Recognition and Measurement* on accounting for financial instruments following its adoption by EU banks from 2005 (prior to changes related to the G20 proposals). Leventis et al. (2011) study 91 EU listed banks over the period 1999-2008 and report earnings management (using loan loss provisions) is lower after adoption in 2005. The authors conclude the implementation of IFRS in the EU has improved the earnings quality of banks by mitigating the tendency of managers of commercial banks to engage in earnings management using loan loss provisions. Gebhardt and Novotny-Farkas (2011) study 90 EU banks in the period 2000-2007. They find the restriction to recognise only incurred losses under IAS 39 reduces income smoothing, although this result may be mitigated by bank regulators' preference for forward-looking loan loss provisioning. The application of the incurred loss approach results in less timely loan loss recognition, implying delayed recognition of future expected losses.

The G20 response also called for consistent application of accounting standards. Prior to the 2007-2008 crisis, the European Commission (EC) was positive about the quality and comparability of IFRS reporting. Based on a range of reports and reviews of financial

reporting,¹⁴⁶ an EC report concluded there was a ‘general perception among preparers, auditors, investors and enforcers that application of IFRS has improved the comparability and quality of financial reporting and has led to greater transparency’ (EC 2008: 6). Subsequently, the European Security and Markets Authority (ESMA) reported on the activities of EU enforcers, describing the level of activity of various national bodies and their interaction in the European Enforcement Coordination Sessions (EECS) (ESMA, 2011). Enforcers paid particular attention to accounting for financial instruments and found significant improvements in 2009 and 2010 in the level of compliance with disclosure requirements about valuation techniques, own credit risk, credit risk, day one profit or loss, and special purpose entities. However, they concluded some areas (including the fair value hierarchy and qualitative risk disclosures relating to financial instruments) required more attention by issuers. Berger (2010: 22) concludes the EECS have made a ‘significant contribution’ to uniform application of IFRS. He notes that different enforcement approaches and methods are used and they vary widely. In addition, the extent to which the bodies publicise their activities also varies, suggesting an area for improvement in the future.

In 2011 the SEC published a review of IFRS reporting, based on the 2009 financial statements of 183 IFRS applying companies listed in the US. The SEC staff found general compliance with IFRS requirements, but noted the transparency and clarity of disclosures could be enhanced. Further, they concluded diversity in application presented challenges to the comparability of financial statements across countries and industries (SEC 2011a: 2). The report also mentions the use of options in IFRS, insufficient and inconsistent disclosure and a lack of guidance in some areas as potentially undermining comparability.

IFRS in developed capital markets

The G20’s call for one set of common accounting standards, for use in markets throughout the world, raises question about the benefits of global standards in markets that already have high levels of transparency and investor protection. In the case of Australia and New Zealand policy makers considered that the future growth of their small domestic capital markets required international investment, which would be promoted by use of IFRS. In Australia, the decision was broadly supported in the business communities though not necessarily by all individual companies (Brown and Tarca, 2001). Some smaller companies considered they bore the costs of adopting international standards without the benefits that may be realised by larger firms with international investors and analysts (Jones and Higgins, 2006).

Studies suggest capital market benefits following adoption of IFRS, even in countries with strong investor protection and so-called high quality financial reporting and enforcement. Chalmers et al. (2011) report an increase in the value relevance and the persistence of earnings when IFRS were adopted in Australia. Bissessur and Hodgson (2012) observe a

¹⁴⁶ ICAEW (2007), CESR (2007) and reports from the European Commission’s Accounting Regulatory Commission (ARC).

decrease in synchronicity in the Australian market in the first two years post IFRS (which became higher in 2007-2008). Bissessur and Hodgson (2012) and Cotter et al. (2012) find lower forecast error post IFRS in Australia and Choi et al. (2010) report a similar result for the UK. Cheong et al. (2010) conclude that capitalisation of intangibles under IFRS provides value relevant information for companies from Australia, Hong Kong and New Zealand. Bayerlien and Farooque (2012) report greater comparability of policy choices for deferred tax and goodwill under IFRS for firms from Australia, the UK and Hong Kong. Brochet et al. (2011) also report improved comparability post IFRS for UK firms, based on the proposition that private information is reduced after IFRS adoption. Zéghal et al. (2011) report use of IFRS is associated with less earnings management for French firms during the period 2003-2006, particularly for firms with higher corporate governance and more involvement in foreign financial markets.

Sun et al. (2011) examine firms from 23 countries with cross-listings in the US. They explore whether accounting quality improves for these firms following adoption of IFRS. They find some evidence of an improvement, which is surprising given the US cross-listing provides incentives for high quality reporting, in place before adoption of IFRS. The study suggests IFRS can impact on accounting for firms from developed markets. It may also benefit investors within a country by widening their pool of potential investments. Lee and Farghar (2010) show IFRS adoption in Australia is associated with an increase in the level of investment in foreign equities by Australian investors. Other evidence about IFRS benefits for developed markets relates to capital market integration. Cai and Wong (2010) report higher correlations of market indices among markets where firms use IFRS (UK, France, Germany and Italy) than in markets where domestic firms generally do not use IFRS (US, Canada, Japan and Russia) during the period 1995-2008.

However, not all studies from developed markets provide evidence of benefits from IFRS adoption. Gjerde et al. (2008), studying firms in Norway, find little evidence of an overall increase in the value relevance of accounting information. However, they do find capitalisation of intangible assets under IFRS is value relevant. Jarva and Lantto (2010) conclude that IFRS do not provide more value relevant information or allow better prediction of future earnings or cash flows for firms in Finland.

In relation to other developed markets, evidence is not yet available for Canada, where IFRS were adopted from 2011. The reasons for adoption in Canada are similar to other jurisdictions: the use of IFRS provides more opportunities for Canadian businesses and investors by reducing the cost of capital, increasing access to international capital markets, and reducing costs by eliminating the need for reconciliations (CICA, 2012). Lefebvre, from the Certified General Accountants Association (CGA) Canada, held the view that national standards had served Canada well when it was a self-contained economic entity but with globalisation the country must capitalise on its ability to integrate within the global landscape (Jeffrey, 2011). In its annual report for 2011-2012, the Canadian Accounting Standards Board (AcSB) reflected on adoption of IFRS in Canada. While acknowledging that some individuals disagree with the strategy, the AcSB concludes there is no new evidence that would call the IFRS adoption strategy into question entities and states 'although IFRSs require improvement, they represent the only practical route to achieving the goal of a single set of high quality, globally accepted financial reporting standards contributing to the improved functioning of global capital markets' (AcSB, 2012).

The arguments about participation in global markets apply equally in the US and Japan even though historically these countries' markets have been among the world's largest and served by their own domestic standards and reporting and enforcement structures. The Japanese market has experienced many reforms in financial market regulation and accounting standards, particularly in the 1990s, as the country has sought a major role in international financial markets (Misawa, 2005). Saito (2008) argues that if Japan wants a leadership role it cannot be isolated from global accounting standards. Although US GAAP has been used by some large Japanese companies in the past, Saito (2008) states US GAAP cannot be the global accounting language so Japanese accounting standards must be harmonised with IFRS.¹⁴⁷ From 2005 the Accounting Standards Board of Japan (ASBJ) has pursued various harmonisation initiatives with the IASB, with the objective of achieving international convergence in standards as well as contributing to more integrated capital markets. Despite the size and importance of its capital market, Japan has experienced the pressure that follows from its standards being seen as 'not equivalent to IFRS'. The need for recognition of Japanese GAAP in EU markets (see Misawa, 2005) has been another incentive for the harmonisation of national GAAP and IFRS and for Japan to embrace IFRS.

Rottier and Veron (2010) note the geography of global finance is changing. Asian financial centres are increasing in importance and among the world's 100 largest banks, approximately one third are from developing markets. The authors argue that these changes in financial markets create a power shift in the global policy debate. Thus, the US and Japan can be expected to continually monitor their role and involvement in the international regulation of financial reporting and market activity in order to maintain their positions of influence.

Prior to the crisis of 2007-2008, increasing competition in capital markets led to calls in the US for changes to their regulatory framework to improve its efficiency while ensuring high standards of investor protection are maintained (Cox and Greene, 2007; Pan, 2008). The US market regulator, the Securities and Exchange Commission (SEC), considered various deregulatory proposals that would ease barriers to entry in US markets. In 2008 it removed the US GAAP-IFRS reconciliation requirement for foreign registrants and proposed a roadmap that would lead to the use of IFRS by domestic users by 2014 (Street, 2012). The actions responded to perceptions that the US capital markets were losing their previous dominance (Black, 2011) and recognised the widespread use and acceptability of IFRS financial statements.

The G20 proposals called for action from both international and national entities and institutions, including some in the US. Thus the Financial Accounting Standards Board (FASB) has worked with the IASB on projects addressing accounting standards about recognition, measurement and disclosure of financial instruments. However, the US position on some matters raised in the G20 proposals (specifically, one set of global standards) is less favourable than in earlier years. For example, Street (2012) notes the SEC's decision to defer release of a recommendation about use of IFRS by US domestic registrants.

¹⁴⁷ Saito (2008) does not provide reasons as to why US GAAP cannot be the global accounting standards. However, possible reasons are the rule-based nature of US GAAP, which is part of an extensive set of reporting regulations, designed for a complex regulatory environment specific to the US.

Although economic and political conditions may have changed post 2008, the incentives for the US to be a leading participant in operation and regulation of international capital markets remain. For example, Pan (2008) argues US securities regulation provides disincentives for companies, leading to less foreign issuers becoming US public companies and the foreign issuers and US investors (and financial service providers) moving their capital raising and investment activities away from the US markets. Jackson and Pan (2008) suggest the decline in competitiveness of US markets reflects more long standing trends than a response to the Sarbanes Oxley Act or federal securities law.

The events of 2007-2008 crisis do not remove the disincentives identified by Pan (2008). Thus there remain motivations for the US to be involved in convergence, harmonisation and mutual recognition, despite the difficulties involved in the process. The way in which the US and other countries manage the trade-off between competition and cooperation will be revealed in the future. Commentators point out that much is expected of global institutions in terms of regulation of capital markets, yet the involvement of significantly more countries and less domination by one country (or block of countries) will make decision making more difficult (Helliener and Pagliari, 2009). More transparency is called for, but Rottier and Veron (2010) opine that post 2007-2008 the level of internationally comparable information on financial systems and markets, including disclosure on government finances and their support of financial firms, remains insufficient.

The adoption of one set of global standards (IFRS), proposed as one element of plans to improve transparency in financial markets, appears to have less support in the US and Japan since the 2007-2008 crisis. However, researchers suggest adoption decisions involve more than a consideration of net benefits for domestic companies. Chua and Taylor (2008) caution against ascribing the diffusion of IFRS solely to economic factors, arguing that political and social factors have an important role. As one example, they point to the circumstance where 'strong nations' require others to adopt international best practice but can themselves not adopt certain standards when it suits them. Ramanna and Sletten (2009) conclude that IFRS adoption is more likely when governments are capable of timely decision-making and when the opportunity and switching costs are relatively low. However, they do not find that adoption decisions are related to the level of (or expected changes in) foreign trade and investment flows. Rather, they argue that a country is more likely to adopt IFRS when its trade partners or regional neighbours adopt. Perceptions of a network of benefits, related to lower transaction costs for foreign financial statement users, lead to countries taking the decision to adopt IFRS. Thus a country may adopt IFRS even if its domestic standards are particularly well-suited to its domestic institutions (Ramanna and Sletten, 2011).

Vacillations in the US about if, how and when IFRS may be adopted are consistent with the idea of a government being cognisant of the opportunity costs of change. Over the past decade US constituents have been exposed to a variety of strategies for incorporation or adoption of IFRS in the US (Erikson et al., 2009; Epstein, 2009). Interestingly, a US-based study finds academics and practitioners hold views about the benefits and costs of IFRS that are similar to their counterparts in other countries. Rezaee et al. (2010) report a survey of

124 academics and 120 practitioners (members of FEI)¹⁴⁸ in 2008. The first seven perceived benefits of US convergence to IFRS relate to global issues (including comparability, uniformity, cross border investment, and integration, efficiency and cost-effectiveness of markets). Although governments are often concerned about the issue of sovereignty (over accounting standards as part of corporate regulation) and firms' conversion costs, the survey respondents rank other factors highly as well. Education issues (lack of IFRS and International Auditing Standards based textbooks; lack of IFRS education, understanding and experience of preparers) are important. Other concerns are about the application of IFRS: uniformity of application; and coordination and collaboration among regulators. Practitioners rank the cost of conversion as the third most important obstacle while academics rank it as seventh.¹⁴⁹

Conclusion

In this paper I reviewed a range of studies that point to benefits from mandatory adoption of IFRS. Using a variety of research techniques, studies provide evidence that IFRS has improved efficiency of capital market operations and promoted cross border investment. In addition, many studies point to the importance of the infrastructure that surrounds the use of IFRS. Hegarty et al. (2004) state that a 'full and balanced combination of capacity and institutional incentives' for the rigorous application of international accounting and auditing standards is the key to their successful implementation. Research evidence consistently shows that IFRS benefits are more likely to be realised when IFRS application is supported by a framework that encompasses legal protections, competent professionals and adequate monitoring and enforcement.

The potential benefits of IFRS in developing markets can be strongly argued. The claims for benefits from use of IFRS in developed markets are more multi-faceted. Among the EU member states, countries have become mandatory IFRS adopters because of desired benefits for the group as a whole. However, the extent of change for an individual country and therefore the benefit for firms at a national level varies among EU members. Not surprisingly, many studies point to variation in IFRS benefits, when they are examined on a country by country basis (see Brown, 2011; Pope and McLeay, 2011; Brüggemann et al., 2012). If IFRS benefits are tied to factors such as national GAAP-IFRS differences and extent of legal enforcement, as explained above, then we should expect to see differences in benefits at an individual country level. However, an emerging body of research is pointing to global benefits from the use of IFRS, particularly when their application is supported by sound infrastructure.

¹⁴⁸ The Financial Executives International (FEI) is a US-based organisation with and international membership. The study does not report the number of respondents educated or domiciled in the US.

¹⁴⁹ The survey does not contain explicit reference to 'sovereignty' but responses relating to 'required changes in the regulatory regime' (preparers, sixth most important obstacle; academics, second) may refer to these concerns. However, we cannot be sure given the way the data is presented and analysed.

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