

SUMMARY

“Global Accounting Convergence and the Potential Adoption of IFRS by the United States: An Analysis of Economic and Policy Factors”

by Luzi Hail, Christian Leuz and Peter Wysocki:

In the world of accounting, abandoning the United States' Generally Accepted Accounting Principles (U.S. GAAP) in favor of the International Financial Reporting Standards (IFRS) would represent a seismic shift that would require changing what has been the country's accounting gold standard for decades. This is what the Securities and Exchange Commission (SEC) is contemplating for all publicly listed companies, starting in 2014. But according to a study released today (Friday, March 6) it is not clear whether such a major shift in standards would translate into large (net) benefits for most companies or the entire U.S. economy. The study, “Global Accounting Convergence and the Potential Adoption of IFRS by the United States: An Analysis of Economic and Policy Factors,” was done by Christian Leuz of the University of Chicago Booth School of Business, Luzi Hail of the Wharton School at the University of Pennsylvania and Peter Wysocki of the MIT Sloan School of Management.

One of the touted benefits of moving to IFRS is that it can enhance the liquidity of capital markets and reduce companies' costs of capital by providing investors with better information on corporate performance. However, the authors argue that this is true only if adopting a new set of standards actually improves the quality of reporting and the comparability of reporting practices around the world.

Professors Hail, Leuz and Wysocki argue that it is unlikely that a switch to IFRS will have a substantial impact on the reporting quality of U.S. companies. Yet, this is not really a question of which set of accounting rules is better. Rather, companies have an incentive to report

their numbers in a way that is shaped not just by accounting standards but also by the strength of a country's legal institutions and enforcement efforts, the companies' needs to satisfy investors' demand for high-quality information in order to raise outside funds in capital markets, product market competition, and firms' business and governance practices. All of these factors have contributed to the high-quality reporting practices that exist in the U.S. today. As long as these factors are not changing, it is unlikely that U.S. companies' financial reporting practices would improve significantly as a result of IFRS adoption. The authors also note that, for exactly the same reasons, it is unlikely that a switch to IFRS would worsen the quality of reporting by U.S. companies because these other forces remain in place.

Proponents of IFRS claim that there would be benefits for U.S. companies and investors because companies' reporting practices become more comparable around the world. But again, accounting standards are only one of many factors influencing firms' reporting incentives, making it doubtful that moving to IFRS would lead to significant comparability benefits. If the other factors besides the accounting standards continue to differ across countries and industries, then companies' reporting incentives and practices will always vary in some way – with or without IFRS. Evidence from other countries demonstrates that there is wide variation in how firms apply IFRS and that companies show a tendency to refer to their previous local GAAP when making accounting judgment calls. Hail, Leuz, and Wysocki expect U.S. companies to do the same. Moreover, since U.S. and international standard setters have pursued various convergence activities over the years to reduce the differences between IFRS and U.S. GAAP, the claimed advantage of being able to make cross-border IFRS comparisons is likely to be modest.

On the costs side, adopting IFRS would require various upfront costs for companies, investors, auditors and regulators. During a transition phase, companies would have to modify their accounting systems and processes as well as provide comparative financial information between their previous U.S. GAAP reports and their new IFRS-compliant reports. In addition, companies would have to train their employees and outside stakeholders such as analysts and investors in preparing and using IFRS numbers. Financial contracts with components tied to accounting numbers may have to be revisited too. In the current economic environment, many companies may be reluctant to incur these upfront costs, which could be substantial.

However, one must also consider the potential long-run benefits of IFRS adoption. For example, U.S. firms with operations around the world could potentially save a lot of money by avoiding the costs of translating their financial reports into several local accounting languages, especially if IFRS eventually become the global set of accounting standards for statutory reporting as well. In this case, moving to the IFRS would enable U.S. multinationals to maintain and track a single set of accounts.

But while U.S. multinationals would benefit from a transition to IFRS, at least in the long-run, it is unlikely that purely domestic U.S. companies would realize substantial cost savings if they switch to IFRS. In addition, large companies would be better able to absorb the costs of a transition to IFRS because these expenses involve a fixed component. Companies with Big Four auditors will also have an advantage because these auditing giants have experience in implementing and working with IFRS reports and can rely on their global network of professionals.

Given all of these factors, measuring the overall impact of adopting IFRS in the U.S. comes down to a trade-off between the one-time costs of transitioning to a new system, and the

relatively modest but recurring benefits of being able to compare reports across borders as well as the recurring cost savings of using a single reporting standard for some firms. The authors point out that it is not obvious what the net effect of this cost-benefit trade-off is going to be for a given company or for the U.S. economy as a whole; it depends on how one chooses to weigh the future benefits against the current costs.

But if IFRS adoption by the U.S. turns out to be the likely course of action, Hail, Leuz and Wysocki think that giving firms a choice or, alternatively, a transition that is more flexible than the proposed SEC schedule should ease this trade-off. The authors could envision a two-stage adoption process. In the first stage, any company can voluntarily choose to switch to IFRS or keep reporting under U.S. GAAP. Companies' choices would provide further information on the costs and benefits of IFRS adoption. In the second stage, if universal IFRS adoption is deemed to be appropriate, companies not yet reporting under IFRS would be required to switch, but this mandate could depend on the voluntary adoption patterns in the first stage. For instance, universal IFRS adoption would be required only if, say, at least 50 percent of companies switched to the IFRS in the first stage.

This two-stage process allows companies with "low net costs of IFRS" to move first and this would give regulators, auditors and other companies an opportunity to observe and learn from other companies' efforts to switch from U.S. GAAP to IFRS. For instance, auditors could learn how to smoothly transition to IFRS, which in turn reduces costs for companies that adopt the new standards at a later date. Over time, more and more companies could find it attractive to make the shift, eventually making it easier to require all other companies to do the same.

Professors Hail, Leuz and Wysocki note that the network benefits of a single set of accounting standards can only be fully realized when a large fraction of companies adopt the

standards. Thus, the authors believe that the current SEC proposal that makes only a small number of firms eligible for early IFRS adoption could be self-defeating, because the economies of scale and network effects will not be evident for such a small group.

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