Accountants of the World Unite!
By Christian Leuz

The debate over whether the U.S. should abandon its long-standing accounting standards and adopt international rules that are used by most other countries often misses an important point.

While the economic case for the switch isn't strong, failure to act carries substantial political risks for the U.S. It could also imperil the push for a global reporting regime and weaken efforts to reform other areas of global financial regulation.

At the Group of 20 meeting in Pittsburgh in 2009, the international accounting bodies were charged with devising a single set of high quality, global accounting standards by June 2011. This deadline is fast approaching, but the two key players, the International Accounting Standards Board (IASB) and the U.S.'s Financial Accounting Standards Board, have recently indicated they will need more time. Moreover, there is still no decision by the Securities and Exchange Commission as to whether the U.S. will give up Generally Accepted Accounting Principles, known as GAAP, and instead use International Financial Reporting Standards (IFRS), which are applied by over 100 countries.

By rejecting IFRS, the U.S. would deal a major blow to the prospect of unified global accounting standards -- a goal that is widely endorsed, including by many American companies and investors. The U.S. would almost certainly lose its current major influence on the setting of international rules including its role in the oversight of the IASB. That would be a loss: The U.S. has been a positive influence bringing authority and expertise in accounting matters. That influence would also benefit global capital markets and investors by countering the growing clout of countries that may pursue less capital-market oriented goals with financial reporting.

Perhaps even more importantly, a perceived unwillingness by the U.S. to cooperate in accounting matters could spill over into other areas of global financial regulation where reforms and international coordination are much needed. This could happen not only because accounting numbers are a mainstay for other financial regulation, but also because the world’s reporting convergence project is one of the longest and most advanced attempts to build a global regime. If it were to fail, it would undermine other efforts to create global standards, for example, in banking or capital-market regulation.

So what is holding the U.S. back?

The possibility that the U.S. could give up GAAP, which Larry Summers called the single-most important innovation shaping U.S. capital markets, has stirred a heated debate. Yet many of the arguments aren’t convincing. Proponents of IFRS often claim that the new standards will deliver significant capital-market benefits. For instance, the international rules are said to improve the transparency and comparability of corporate reporting around the world, which, in turn, could lower firms’ capital costs and increase market liquidity. These alleged benefits are almost certainly overstated, at least, as far as U.S. firms are concerned. The U.S. already has a system of high-quality accounting standards and it is unlikely that financial reporting practices by U.S. firms will improve significantly as a result of IFRS adoption.

Similarly, the benefits of IFRS in creating cross-country comparability are exaggerated. With or without IFRS, there will be divergent reporting practices around the world because accounting standards are only one of many inputs that determine companies’ reporting practices. Other factors include countries’ legal institutions, their capital markets, firms’ business and governance practices, and managers’ personal motives. As long as these factors continue to vary across companies, industries and countries, reporting practices will differ, too. Worldwide, IFRS adoption would narrow the set of accounting rules and treatments that investors need to follow, which would yield savings for investors. But it won't bring true comparability of reported numbers across companies and countries.

The argument that IFRS adoption would allow U.S. multinationals to move to a single reporting system for their global operations, leading to substantial cost savings, has limitations as well. Foreign subsidiaries of U.S. firms still have statutory reporting requirements to the local authorities that often aren't based on IFRS. This means separate accounts or some reconciliation to local standards regardless of the company’s global reporting system. Thus, while there can be cost savings for U.S. multinationals, they will be limited until IFRS are more widely accepted for statutory reporting.
purposes around the world.

Still, even if many of the selling points of IFRS are overstated, the risks to the U.S. of adopting those rules are exaggerated, too. For instance, opponents of adopting IFRS often claim that those standards are inferior to GAAP. They point out that IFRS offer more discretion and less guidance than GAAP. Again, these arguments miss the crucial point that factors beyond the accounting standards play a significant role in determining companies’ reporting practices. That is, even if IFRS were inferior to GAAP, the standards would be applied within the U.S. institutional infrastructure, which features strong capital markets, SEC enforcement and private securities litigation. This environment provides many incentives for transparent and truthful reporting, and these safeguards would remain in place after the adoption of IFRS. As a result, it is unlikely that U.S. reporting quality would deteriorate significantly.

Similarly, the frequently voiced concern that the IASB could set new IFRS that may not suit U.S. firms or investors could be addressed by having a national endorsement protocol for new and amended IFRS, which is what most countries that already follow international standards have in place as well.

From an economic perspective, the decision to adopt IFRS in the U.S. involves mainly a cost-benefit tradeoff of three factors, as I and other contributors have argued in a research report for FASB: (1) recurring, albeit modest, comparability benefits for investors, (2) recurring future cost savings that will largely accrue to multinational companies, and (3) one-time transition costs borne by all firms and the U.S. economy as a whole. Their net effect depends on how one weighs the future benefits against the current costs. Moreover, these factors likely differ across firms and industries.

In light of these economic and political considerations, one way for the SEC to move forward is to offer U.S. companies a choice for some time. That is, the regulator could give U.S. firms an option to apply IFRS, perhaps even starting in 2012, and then set a longer deadline for IFRS adoption for the rest of the economy. Having some U.S. firms report under the international standards wouldn’t have dramatic comparability consequences. Moreover, American investors are already familiar with IFRS reports from foreign firms that list on U.S. exchanges. But such a move by the SEC would be viewed as a commitment to IFRS, which would help the U.S. politically. It also would give American companies more time to adjust: Firms for which the benefits outweigh the costs would move first, which would allow auditors and others to learn from the process, which in turn should bring down the costs of IFRS adoption for other firms with smaller benefits.

While the SEC would probably prefer to study the matter further, it is time to decide. The case in favor of IFRS is largely political and the U.S. cannot afford to sit on the sidelines of this global effort.

(Christian Leuz is a professor of international economics, finance and accounting at the University of Chicago Booth School of Business and a co-director of its Initiative on Global Markets. The opinions expressed are his own.)

To contact the writer of this column: Christian.leuz@chicagobooth.edu
To contact the editor repsonbible for this column: Max Berley at mberley@bloomberg.net

-0- Jun/24/2011 19:13 GMT