Research Committee
of the American Accounting Association's International Accounting Section

Response to the U.S. Securities and Exchange's Proposed Rule: ROADMAP FOR THE POTENTIAL USE OF FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH INTERNATIONAL FINANCIAL REPORTING STANDARDS BY U.S. ISSUERS (Release No. 33-8831; 34-56217; IC-27924; File No. S7-20-07)[1 2]

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I. INTRODUCTION

In this paper, prepared at the request of the International Accounting Section of the American Accounting Association, we respond to the U.S. Securities and Exchange Commission's (SEC's) request for comments on its proposed rule concerning a "Roadmap" for the use of financial statements prepared in accordance with International Financial Reporting Standards (IFRS) by U.S. issuers.[3 4]

The Roadmap is a multi-year plan presenting milestones that, if achieved, could lead to the use of IFRS by all U.S. issuers beginning in 2014. Under the proposal, the SEC would decide in 2011 whether adoption of IFRS would benefit investors and be in the public interest.[5] The proposal includes 70 questions for comment, many of which relate to two alternative proposals

[1] We gratefully acknowledge helpful comments and suggestions from Mark Kohlbeck, Cheryl Linthicum, Xiang (Samantha) Liu, Dhananjay (DJ) Nanda, Donna Street, Lili Sun, Clark Wheatley, and Ya-wen Yang.
[2] This paper is the sole responsibility of the authors and is independent of the International Accounting Section of the American Accounting Association.
[3] The SEC voted on August 27, 2008 to publish the proposed rule for comment (SEC 2008b). The proposal itself was released on November 14, 2008.
[4] The term "issuer" as used in this paper means any entity subject to the SEC's financial reporting requirements under the Securities Exchange Act of 1934 (15 U.S.C. sect. 78a).
[5] The SEC has also used "Roadmap" to refer to the steps leading to the elimination for the need for non-U.S. companies that prepare IFRS-based financial statements to reconcile to U.S. GAAP financial statements (SEC 2007e).

under which U.S. issuers that elect to use IFRS would disclose supplemental U.S. GAAP-based information.[6]

Under a staged transition, large accelerated filers[7] would begin filing IFRS-based statements for fiscal years ending on or after December 15, 2014, with early adoption allowed for some companies. Other accelerated filers would begin IFRS-based filing for years ending on or after December 15, 2015. Non-accelerated filers would begin one year later. The proposal's seven milestones are: (1) Improved accounting standards; (2) accountability and funding for the International Accounting Standards Committee (IASC) Foundation; (3) improved ability to use interactive data for IFRS reporting; (4) education and training; (5) limited early use of IFRS where this would enhance comparability for U.S. investors; (6) anticipated timing of future rulemaking by the Commission; and (7) implementation of mandatory use of IFRS.

In this paper we focus on the potential contribution of empirical accounting research to the SEC's Roadmap questions. Empirical research potentially can provide descriptive evidence useful to the SEC in its deliberations. However, traditional research methods cannot resolve the issue of appropriate regulatory requirements because decisions on the appropriate trade-offs among conflicting interest groups and regulatory objectives are not empirical questions. Furthermore, accounting regulatory policy is strongly influenced by lobbying and other political influences.[8] We do not provide an exhaustive survey of the literature, nor an in-depth review of existing research. Instead, we use specific papers to illustrate broader points.

[6] The questions range from being broad and conceptual to narrow and procedural. Many of the questions consist of multiple parts.

[7] Refer to the Securities Exchange Act Rule 12b-2 (17 CFR 240.12b-2) for definitions of accelerated filer and large accelerated filer. Non-accelerated filers are issuers that meet neither the accelerated nor large accelerated filer conditions.

[8] Watts and Zimmerman (1986), Ball (2008, 2006), and Zeff (2002) are among the many studies that discuss the influence of politics on financial reporting standard-setting. See Watts (2006) for discussion of the influences of private market forces and political forces (the legal system, the political system and regulation) on financial

We address the following questions (cross-referenced to the Roadmap questions in sections below): First, would U.S. investors, U.S. issuers, and U.S. markets benefit from the development and use of a single set of globally accepted accounting standards? Second, if the SEC chooses to change to IFRS for U.S. issuers, how might the change be accomplished? Third, what are the auditing implications of a transition to IFRS by U.S. issuers?

Our main comments and conclusions are as follows. First, little existing research directly addresses whether U.S. investors, issuers, and markets would benefit from implementation of IFRS in the U.S. One reason is that comparative evidence on IFRS versus U.S. GAAP financial reporting by U.S. issuers is not available because U.S.-domiciled issuers have exclusively used U.S. GAAP in their financial reporting.[9] Also, because U.S. capital markets, financial reporting regulation, and many other environmental and issuer characteristics differ substantially from those in other parts of the world, conclusions from non-U.S.-based research are not necessarily valid in the U.S. context.

We therefore recommend that the SEC conduct a more thorough analysis of the costs to issuers, investors and markets of a transition to IFRS – and perhaps more importantly, a thorough analysis of the potential *benefits* to issuers, investors, and markets.[10] While the SEC has estimated the transition costs to issuers, it is essential to address the overall costs as well as the potential benefits in order to evaluate the economic desirability of those costs. As part of this analysis, we suggest that the SEC more thoroughly review the many responses to its earlier related requests for comment. The November 2008 Roadmap document, for example, gives only

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reporting. Refer to Barth (2008) for discussion of the extent to which academic research can contribute to standard-setting debates.

[9] This is in sharp contrast to questions related to IFRS adoption in other parts of the world, where at least some empirical evidence is available on non-U.S. companies that voluntarily adopt IFRS or are required to do so.

[10] Assertions made by Wright et al. (2008) concerning the limitations of cost-benefit analyses in the standard-setting process are applicable to the SEC's IFRS-related regulatory choices. Note, however, that even a simple survey regarding costs and benefits might provide a useful addition to existing evidence. (See, for example, SEC 2008d.)

passing reference to the many dozens of responses made to the SEC's 2007 concept release on allowing U.S. issuers to prepare financial statements in accordance with IFRS.[11]

In response to the second broad question of how a change to IFRS for U.S. issuers might be accomplished, we note that the SEC could either mandate the change or allow the change to occur more gradually. A gradual change could occur via the combined effects of (a) continued convergence of the two sets of standards and (b) granting U.S. issuers an option to move to IFRS. Regarding an *optional* transition to IFRS, we recommend that the SEC further evaluate the justification for denying U.S. issuers an option that is currently available to all non-U.S. issuers – the option to report either under U.S. GAAP or under IFRS (with no reconciliation to U.S. GAAP). Specifically, we question whether the currently less-favorable treatment of U.S. issuers is consistent with the principle of equal treatment of foreign and domestic firms. As a part of this evaluation, the Commission may wish to consider that its allowing the current U.S. dual-standards reporting environment implicitly presumes that such an environment does not unduly jeopardize investor protection.

Regarding our third broad question of auditing implications, we observe that requiring U.S. issuers to use IFRS would create at least one potential challenge to maintaining high quality audits because IFRS permits wider use of fair value as a basis of measurement than does U.S. GAAP, and auditing fair value has presented challenges to auditors. With respect to concerns about concentration among audit firms, we note the following: provision of auditing services to U.S. public companies is already highly concentrated; concentration need not indicate a deterioration of audit quality; and concentration may be driven primarily by issuers' defensive responses to the litigious environment of the U.S., and thus would be relatively unaffected by a change in the set of accounting standards used in reporting.

[11] See SEC (2007b) and SEC (2008c) for the concept release and comments on that release, respectively.

To motivate our discussion of research, we first briefly discuss the goals of U.S. financial reporting and summarize recent SEC developments. We then discuss findings from academic research concerning whether U.S. issuers should use IFRS financial statements in their filings with the SEC. The purpose of this discussion is to highlight the differences of opinion (even when based on academic research) regarding the question of whether IFRS should be adopted in the U.S. We then comment on how a move to IFRS for U.S. issuers could be accomplished if the SEC decides to mandate such a change, including responses to several specific Roadmap questions, and discuss its potential impact on auditing. The final section presents a summary and conclusions.

II. BACKGROUND AND RECENT SEC DEVELOPMENTS

Goals of Investor-Oriented Securities Regulation

The two main objectives of securities regulation in investor-oriented markets are to promote investor protection and market quality.[12] Investor protection includes (1) providing investors with material information (financial transparency), (2) monitoring and enforcing market rules, (3) inhibiting fraud in the offering, trading, voting and tendering of securities, and (4) seeking comparability of financial information.[13] Market quality includes (1) promoting equitable access to information and trading opportunities (market fairness), (2) enhancing liquidity and reducing transaction costs (market efficiency), (3) promoting freedom from abuse

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[12] The International Organization of Securities Commissions (2003) lists as a third goal the reduction of systemic risk (financial failure of market intermediaries) through capital and internal control requirements. See Frost and Lang (1996) for a framework that synthesizes views presented in SEC (1995, 1987), the U.K. Securities and Investment Board (1994), and related documents. See also SEC (2009a) for related discussion.

[13] Comparability refers to the extent to which investors can compare financial information between companies and across industries and domiciles.

through monitoring and enforcement, (4) fostering investor confidence, (5) facilitating capital formation, and (6) seeking market orderliness.

The SEC's reporting requirements are generally consistent with both the investor protection and the market quality objectives.[14] Although many speak as if enhancing investor protection and increasing market quality are the same,[15] this is not the case. For example, highly stringent reporting requirements may satisfy the investor protection objective at the cost of market quality, either by reducing investors' investment opportunities or by imposing high transaction costs on taking advantage of available opportunities. In addition, opinions about the effects of accounting regulations vary depending on the individuals' economic incentives and subjective judgments. For example, former SEC chair Christopher Cox aggressively promoted a move to IFRS in the United States. In contrast, Mr. Cox's replacement, Mary Schapiro, has expressed concerns about the SEC's IFRS initiatives, stating "I would proceed with great caution so we don't have a race to the bottom."[16]

Recent U.S. Regulatory IFRS-related Activities

The SEC and FASB have long supported the development of a "single set of high-quality globally accepted accounting standards."[17] In 2002 the FASB and the IASB issued the "Norwalk

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[14] For example, substantial empirical evidence is consistent with the view that enhanced quality of financial reporting and disclosure is associated with capital markets benefits such as lower transaction costs. Refer to Healy and Palepu (2001) and Wright et al. (2008) for references and discussion.
[15] See, for example, FAF (2007, second paragraph).
[16] See, for example, Roland (2009).
[17] Refer to SEC (2008a), Barth (2008), and Larson and Street (2006) for further background on accounting convergence and development of the SEC's and FASB's policies related to IFRS. The SEC's November 2008 proposed rule and many other SEC and FASB documents refer repeatedly to "high-quality accounting standards," and financial statement "compatibility" and "comparability." However, precise definitions are not provided. The Financial Accounting Standards Advisory Council (FASAC 2005) defines convergence as follows: "[The IASB and FASB] rejected the dictionary definition of convergence, moving toward union or uniformity, as an end in itself, agreeing instead to focus on convergence as described in the 2002 Norwalk Agreement – the development of high-quality compatible accounting standards that could be used for both domestic and cross-border financial reporting. Under that view of convergence, a change to either IASB or FASB standards must both converge standards *and* improve financial reporting." Ball (2006) states that high quality financial statements provide useful information to

Agreement," in which they pledge to seek (1) to make their existing financial reporting standards fully compatible as soon as practicable, and (2) to coordinate their future work programs to ensure that once achieved, compatibility is maintained.[18] Barth (2008) notes that since the Norwalk Agreement, the IASB/FASB convergence relationship has developed and strengthened. Today, most major agenda projects are joint projects. The boards' new business combinations standards, IFRS 3 (revised) and SFAS No. 141R (IASB 2007; FASB 2007) are the first jointly-issued standards that are almost word-for-word the same. Moreover, the boards have an active agenda for joint projects continuing until the end of 2011.[19]

In December, 2007 the SEC issued its final rule to eliminate the U.S. GAAP reconciliation requirement for foreign private issuers that file their financial statements with the SEC using IFRS as issued by the International Accounting Standards Board (IASB).[20] During 2007, the SEC also became more active in considering the use of IFRS by U.S. issuers. In August, 2007 the Commission published a concept release asking for comments on 35 questions related to whether U.S. issuers should have the option of choosing, or be required, to prepare financial statements under IFRS as issued by the IASB.[21] That concept release's first two questions are: (1) Do investors, U.S. issuers, and market participants believe that the Commission should allow U.S. issuers to prepare financial statements in accordance with IFRS

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many types of users, and that high quality requires: (1) Accurate depiction of economic reality; (2) low capacity for managerial manipulation; (3) timeliness; and (4) timelier recognition of bad news, relative to good news. Ball questions the usefulness of the FASB's Conceptual Framework accounting quality criteria of "relevance" and "reliability."

[18] See FASB (2002a, b).

[19] Refer to the Deloitte website http://www.iasplus.com for extensive information about IFRS and the IASB. The IASPlus ongoing survey of the use of IFRS by jurisdiction reports that, as of January 5, 2009, 109 of the 162 jurisdictions surveyed now either require (85 jurisdictions) or permit (24 jurisdictions) IFRS for all domestic listed companies.

[20] Refer to SEC (2007c) for the final rule, and to SEC (2007a) for the proposed rule. Refer to Street (2008) for discussion of the debate on whether the reconciliation requirement should be dropped. Note that two groups of academic respondents, both drawing on research evidence to support their analyses, presented dramatically different conclusions about the advisability of eliminating the reconciliation requirements (Jamal et al. 2008, Hopkins et al., 2008).

[21] See SEC (2007c). Refer to SEC (2008b) for comment letters on that release.

as published by the IASB?, and (2) What would be the effects on the U.S. public capital market of some U.S. issuers reporting in accordance with IFRS and others in accordance with U.S. GAAP?[22]

The SEC received more than 100 comments on its August 2007 Concept Release, and held three roundtables, two in December, 2007, and a third in August, 2008.[23] Many roundtable participants and commenters supported allowing U.S. issuers to use IFRS. However, some commenters stated that U.S. issuers should continue to use U.S. GAAP and supported continuing convergence efforts.[24] A third group of commenters recommended that IFRS should be mandated for all U.S. issuers rather than being limited to a specific group of U.S. issuers.[25] The Financial Accounting Foundation (FAF) supported the view that all U.S. public companies should prepare their financial reports following "accounting standards promulgated by a single global standard setter," and argued that "permitting extended periods of choice between US GAAP and IFRS results in an unnecessarily complex two-GAAP system" (FAF 2007).[26]

Evidence on Accounting Convergence and the IASB's and FASB's Joint Work Plan

In theory, both the costs to issuers and the potential benefits to investors of switching standards decline as the two sets of standards converge. Thus, evidence of convergence and expectations about eventual convergence are important in evaluating the desirability of moving the U.S. towards IFRS adoption.

Academic research provides mixed evidence of convergence, as reflected in results reported under U.S. GAAP and under IFRS. Henry et al. (2008) present evidence suggesting that

[22] Only the first part of question (2) is presented here. Refer to SEC (2007b) for the complete question and the complete set of 35 questions.
[23] The SEC Web site provides information on the roundtables and other relevant items. See SEC (2009b, 2007d).
[24] As used here, convergence refers to the narrowing of differences between IFRS and U.S. accounting standards.
[25] See SEC (2008a).
[26] See FAF (2009) for the FAF's and FASB's more current thinking on this and related issues.

the IASB's and FASB's convergence projects have increased the similarity, on average, of results reported by European companies under U.S. GAAP and under IFRS. They find that the average gap between U.S. GAAP and IFRS income and between U.S. GAAP and IFRS shareholders' equity declined from 2004 to 2006. Similarly, Haverty (2006) shows evidence of convergence of results reported under the two sets of standards by a sample of Chinese companies during the 1996 to 2002 time period. In contrast, Gray et al. (2009) provide evidence of divergence between IFRS and U.S. GAAP for income determination for European companies adopting IFRS for the first time in 2005, and for shareholders' equity for companies previously reporting under U.K. GAAP.

Any research on continuing convergence of financial results reported under IFRS and U.S. GAAP will be limited by the SEC's recent decision to eliminate the reconciliation requirement for non-U.S. issuers. Evaluation of the progress of convergence will likely rely on qualitative assessments of differences in the standards themselves rather than on quantitative assessments of the differences in the results reported under the standards, unless the SEC imposes a reconciliation requirement on U.S. issuers adopting IFRS.

Going forward, additional research that monitors the fundamental accounting differences between U.S. GAAP and IFRS as the convergence projects progress could usefully inform policy choices regarding the relative costs and benefits of U.S. issuers adopting IFRS.

III. SHOULD A SINGLE SET OF ACCOUNTING STANDARDS BE DEVELOPED AND USED?

The SEC's first Roadmap question is:

> Do commenters agree that U.S. investors, U.S. issuers and U.S. markets would benefit from the development and use of a single set of globally accepted accounting standards? Why or why not? What are commenters' views on the potential for IFRS as issued by the IASB as the single set of globally accepted accounting standards?

This question (or set of questions) is multi-dimensional and is not specific about what types of investors and issuers are being considered, what "global acceptance" entails, and – importantly – how a global transition to a single set of accounting standards might proceed. Indeed, it can be argued that these first Roadmap questions make little sense unless they are based implicitly on the question of whether IFRS should be mandated for U.S. issuers.

Many empirical research studies examine the economic consequences of IFRS adoption (mandatory or voluntary) in other countries around the world. [27] However, those studies are not directly relevant to the question of whether U.S. issuers should use IFRS. U.S. GAAP financial reporting is widely regarded as high quality, and assertions that IFRS are "better" than U.S. accounting standards are difficult to defend. IFRS supporters argue that cross-country comparability of accounting numbers would improve if U.S. issuers were required to use IFRS. However, even this assumption is questioned by many who argue that differences in financial reporting quality cannot be eliminated through uniform accounting standards. Furthermore, considering earnings quality as a concept distinct from financial reporting quality, research suggests that earnings quality is significantly affected by investor protection and legal enforcement but not by accounting standards (Luez et al. 2003).

Barth (2008) argues that global financial reporting (presumably, IFRS) provides better information to investors and other financial statement users, and thereby improves the functioning of global capital markets. Barth asserts that global financial reporting offers three benefits: (1) Global firms avoid the costs related to the preparation and audit of financial statements using several sets of standards, (2) comparability of accounting information is improved, and (3) global firms' cost of capital is reduced. In her discussion of academic

[27] See Barth (2008) for references to key IFRS-related studies, including Barth, Landsman, Lang, and Williams (2008), Barth, Landsman, and Lang (2008), and Armstrong et al. (2007). Also see Daske (2006), and Daske et al. (2007). Refer to Hail et al. (2009) and Bothwell (2009) for analyses commissioned by the FAF/FASB.

research, however, Barth refers to studies of IFRS adoption outside of the U.S., and does not discuss any direct evidence on effects of adopting IFRS in the U.S. With regard to U.S. companies, Barth (2008, 1160) states that: "…if IFRS-based financial statements are adequate to protect U.S. investors in non-U.S. firms (listed in the U.S.), then why would they not be adequate to protect U.S. investors in U.S. firms?" Collectively, the reasoning in this body of research appears to be: (1) global financial reporting is desirable, (2) non-U.S. SEC registrants are permitted to use IFRS, therefore (3) U.S. registrants should also be permitted (or required?) to use IFRS.

Former Public Company Accounting Oversight Board (PCAOB) member Charles Niemeier presents a contrasting view. He argues that switching to IFRS would not enhance comparability of financial reports, and that IFRS would not improve investor protection.[28] Niemeier asserts that research consistently shows reconciliations provide value-relevant information, and that IFRS has not yet resulted in convergence with, or comparability to U.S. GAAP.[29] Niemeier also refers to evidence, for example in studies such as Ball et al. (2003), supporting the view that the incentives of managers and auditors strongly influence financial reporting quality. Thus, high quality financial reporting standards will not assure high quality financial reports.[30]

Some commenters argue that U.S. GAAP and IFRS should be allowed to compete in the U.S., and that accounting uniformity reduces the usefulness of financial reporting. For example, Dye and Sunder (2001) argue that regulatory competition allows different standards to develop for different corporate clienteles, allows corporations to send more informative signals by their

[28] For further discussion of views expressed by Niemeier in late 2008, see Kranacher (2008), Leone (2008), and Chasan (2008). Refer to the PCAOB website (www.pcaob.org) for the text of Niemeier's September 10, 2008 speech that included discussion of some of his concerns about adopting IFRS in the U.S.
[29] Refer to Niemeier (2008) for many detailed cites.
[30] Also see, for example, Ball (2006), Lang et al. (2006) and Bradshaw and Miller (2008).

choice of accounting standards, and helps protect standard setters from excessive interest group pressures.[31] Ball (2006, 4) states that "…there is little settled theory or evidence on which to build an assessment of the advantages and disadvantages of uniform accounting rules within a country, let alone internationally."

In summary, many logical arguments have been offered both to support and to oppose the adoption of IFRS for U.S. issuers in the U.S. Little direct evidence has, however, accompanied those arguments. In the following section we turn to questions about how adoption of IFRS for U.S. issuers in the U.S. might occur.

IV. HOW MIGHT A MOVE TO IFRS BE ACCOMPLISHED?

If the SEC decides to allow or require the use of IFRS by U.S. issuers, the main implementation questions relate to timing. Specifically: should the timing of IFRS adoption (whether mandatory or optional) proceed in stages, depending on companies' size and/or industry, or be simultaneous for all listed companies (Reference Roadmap question 4)?[32] Further, if IFRS adoption were to proceed in stages, depending both on firm size (e.g., based on existing definitions of "large accelerated filer") and industry, how should the selection be made for inclusion in various categories (Reference Roadmap questions 19 and 20)? Finally, if companies had the option to file using IFRS, what would affect their willingness to do so (Reference Roadmap questions 18 and 32)?

Timing: Staged Versus Simultaneous

Regulation requiring public companies to change accounting standards would increase the cost of being public, with the cost likely to disproportionately and adversely affect smaller

[31] Also see Sunder (2007).
[32] Reference Roadmap question "x" refers to the questions as enumerated in the SEC's proposal.

firms. For example, academic research has examined the differential impact of costly regulation on small firms in the context of the Sarbanes-Oxley Act of 2002 (SOX).[33] The evidence gathered from that research suggests that SOX-related compliance costs weighed more heavily on smaller firms and contributed to the decision of some of those firms to delist (Engel et al. 2007). Smaller firms (but not larger ones) also exhibited a decreased preference for listing on U.S. exchanges versus U.K. exchanges following SOX (Piotroski and Srinivasan 2008). Similarly, Kamar et al. (2006) present evidence suggesting that an increase in the regulatory burden resulting from SOX induced small firms (but not large ones) to exit the U.S. public market, despite the exemption for small firms in annual evaluation of internal control effectiveness. To the extent that a staged implementation would mitigate the disproportionate impact on smaller firms, this research supports a staged rather than simultaneous implementation of a changeover from U.S. GAAP to IFRS.[34]

Implementation Under a Staged Timing Scenario

The staged versus simultaneous timing decision links closely with the choice between optional and mandatory changeover. Within a staged timing scenario, the SEC proposes offering an early-use option of IFRS to those U.S. issuers that are among the largest companies in an industry where competitors largely use IFRS. The proposal questions whether offering the early-use option to certain companies is advisable and whether limiting the option to the largest 20 companies in industries meeting specific criteria is appropriate (reference Roadmap Questions 16, 17, and 19).

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[33] The Sarbanes-Oxley Act of 2002 is available at: http://www.sec.gov/about/laws/soa2002.pdf.

[34] The costs of initial adoption of IFRS by U.S. firms would probably include market-wide start-up costs such as training, while subsequent adoptions, for example by smaller firms, could potentially benefit from the general knowledge base that would be built by those initial adoptions. In addition, even if a staged implementation did not reduce the undiscounted compliance costs for small firms, deferring the implementation date for small firms would reduce the discounted value of those costs.

For many years, SEC financial reporting options for *all* non-U.S. registrants have included both IFRS (with a reconciliation to U.S. GAAP) and U.S. GAAP irrespective of the issuers' industry membership or size. Furthermore, since March, 2008, non-U.S. issuers using IFRS are no longer required to provide a reconciliation to U.S. GAAP. Non-U.S. issuers that use IFRS in SEC filings vary widely in industry membership and size. For example, European non-U.S. issuers who elected to use IFRS for financial reports filed with the SEC in 2006 operated in 10 industries, as categorized by two-digit GICS[35] codes, and had market capitalization as small as $243 million (Henry et al. 2008). As another example, a study of all non-U.S. issuers that elected to use IFRS for 2006 financial reports filed with the SEC contained a Russian company with a market capitalization of only $55 million (Gordon et al. 2008).

These data beg the question of how the Commission can justify imposing more severe restrictions for using IFRS – such as industry and size requirements of any kind – on U.S. issuers than on non-U.S. issuers. In other words, if the option to report under either set of standards is a non-zero valued option, it is unclear on what basis the Commission could justify offering that option to non-U.S. issuers but not to U.S. issuers.

The SEC request for comments does include the following question about limiting the early-use option (Reference Roadmap question 19): To the extent additional U.S. issuers are not permitted to report using IFRS even if such a minimum threshold is met, are such non-eligible U.S. issuers placed at a competitive disadvantage vis-à-vis U.S. issuers reporting in IFRS? Some academic research suggests that denial of permission to report in IFRS could place the issuers at a competitive disadvantage because IFRS and U.S. GAAP yield differences in reported Return on Equity (ROE).

[35] Global Industry Classification Standard.

ROE is an important measure that investors use to assess performance of companies (e.g. Soliman 2008), to screen for desirable investments,[36] and to develop estimates of the intrinsic value of a company's stock (Lee 1999). Therefore, in general, an issuer using accounting standards that result in a higher ROE might appear more attractive to an investor focusing on ROE. As of the end of 2006 (when reconciliations were still required), European non-U.S. issuers reconciling IFRS financial results to U.S. GAAP, reported higher ROE under IFRS than under U.S. GAAP. The 2006 IFRS ROE was more than ten percentage points higher than U.S. GAAP ROE for 16.2 percent of the sample but ten percentage points (or more) lower for only 2.7 percent of the sample (Henry et al. 2008). To the extent that reporting a higher ROE results in the appearance of better performance and potentially higher value, the data suggest that the option to report using IFRS rather than U.S. GAAP creates an economic advantage in the global competition for capital and that non-eligible U.S. issuers would be placed at a competitive disadvantage.

An important factor mitigating the apparent advantage to IFRS is that some reported differences arise from legacy divergence, i.e. differences across accounting standards that have subsequently converged. Continued convergence of the standards should thus reduce reported differences on a going-forward basis. As an example of legacy differences, ROE for Novartis A.G. in 2005 was 19.05 percent under IFRS and 13.65 percent under U.S. GAAP. A significant part of the difference between shareholders' equity under IFRS and under U.S. GAAP for Novartis in 2004 and 2005 resulted from divergence in the standards for reporting business combinations in existence at the time of the company's historical acquisitions (Henry and Yang

[36] For example, Zacks, a well known investment research firm, includes the following in its Screening Education: "Return on Equity (or ROE) is a commonly used measure of management efficiency. It's a favorite screening criteria of many money managers and investors because it tells them how successful a company is at using its shareholders' capital" (http://www.zacks.com/research/screening/howto.php?id=2793).

2007). Given the convergence of standards (e.g. for business combinations), similar differences would not be expected to arise in the future.

In general, on a going-forward basis, convergence between the two sets of standards could be expected to reduce any apparent advantage of IFRS. Consider, however, the current situation where IFRS offers greater flexibility than U.S. GAAP in certain types of transactions and thus the potential for better reported results. For example, in recognizing revenue on sales with multiple components (e.g., software sales bundled with a contract for future service and upgrades), U.S. GAAP is more restrictive than IFRS in how the fair values of individual components are established and in the timing of revenue recognition (Harris 2008).

Among the implementation details of a staged-implementation scenario, the SEC proposal would permit a variety of industry classification schemes in determining eligibility for the early-use option. This raises the question of whether using multiple industry classification schemes might confuse issuers attempting to determine whether they meet the eligibility criteria. Data suggest that correspondence across classification schemes varies. Specifically, academic research on three of the proposed schemes shows a high degree of correspondence between two of the proposed classification schemes, but much lower correspondence with the third proposed scheme.[37] If one industry classification scheme is to be selected, the GICS industry classification scheme might be preferred to the SIC and NAICS systems, since it more closely reflects the economic relatedness of companies.[38] The question of requiring the use of a single classification scheme is one of policy, whose answer depends on the Commission's priorities. If the

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[37] Specifically, researchers show an 80 percent correspondence between firms' classifications as grouped by two-digit SIC codes and by their equivalent NAICS codes but only a 56 percent correspondence between firms' classifications as grouped by two-digit SIC codes and by GICS groupings (Bhojraj et al. 2003).

[38] In this context, proxies for economic relatedness are (1) contemporaneous correlation of stock returns, (2) similarity of valuation multiples to key accounting measures, (3) similarity across financial ratios, and (4) similarity of expected growth (Bhojraj et al. 2003). Borjraj et al. (2003) also find that the superiority of the GICS scheme is more pronounced for relatively large firms.

Commission wishes to be as inclusive as possible, with the objective of providing the IFRS early-use option to as many U.S. issuers as possible, it should permit more choices among industry classification schemes, or indeed simply eliminate the industry membership criteria.

Underlying each implementation decision, including the decision about an early-use option for U.S. issuers meeting specific size and industry criteria, is an assumption of non-convergence between IFRS and U.S. GAAP. If complete convergence were achieved in all material respects (that is, if the two sets of standards became essentially identical), then a choice between IFRS and U.S. GAAP would be moot. As presented, Roadmap questions about issuer choice imply the replacement of U.S. GAAP by IFRS, with some interim period during which U.S. GAAP would continue to exist but with planned obsolescence. This approach raises questions about how standard setters would operate during the transitional period. The approach used by the Canadian Accounting Standards Board (AcSB) for managing the five-year transition period preceding that country's adoption of IFRS for public companies might provide useful ideas for the U.S. The AcSB adopted any converged standards resulting from joint projects, and avoided revising domestic GAAP in ways that would impose costly system changes that would become obsolete at the time of IFRS adoption.[39]

IFRS Option: Accounting Choice

What considerations might influence a U.S. issuer's decision concerning the optional use of IFRS if an implementation scenario were to create such an option (whether during a transitional period or as a more permanent choice such as that currently available for non-U.S. issuers in the U.S. [Reference Roadmap questions 18 and 32])? One obvious factor is the incremental costs of implementing IFRS. Such incremental costs include training personnel in

[39] See http://www.cica.ca/index.cfm/ci_id/39381/la_id/1.htm "AcSB Implementation Strategy" and http://www.cica.ca "Transition to International Standards."

international standards, revising affected contractual obligations based on reported financial information, and altering internal systems to accommodate the new standards.

A company's willingness to use IFRS might also be influenced by the effect of IFRS adoption on that company's eligibility for inclusion in market indices. The eligibility criteria of some market indices include the use of U.S. GAAP, [40] and the ability to be included in an index has economic consequences. A substantial amount of academic research provides evidence that the addition of a company to the S&P 500 index increases a company's stock price because inclusion in the index provides positive information about the firm (Dhillon and Johnson 1991), increases demand for the stock from index-tracking portfolio managers (Jain 1987), potentially increases the ability of companies to attract new capital and to broaden the stock's ownership (Chen et al. 2004), and/or increases the stock's liquidity (Hegde and McDermott 2003). The loss of eligibility for inclusion in an index would represent an economic cost to a company not currently in the index and would – depending on any offsetting benefits of adoption – be expected to make the company less willing to adopt the standards. Evidence is mixed, however, on the market impact of *removal* of a firm from a stock index, with some research showing that removal causes only a temporary decline in a firm's stock price (Chen et al. 2004). The loss of eligibility for inclusion in an index would thus also represent an economic cost, though perhaps a smaller cost, to a company already included in an index.

Offsetting the potential costs of voluntary early adoption of IFRS are, however, potential benefits that firms may realize. Research on the market reaction to IFRS adoption in the EU suggests that European investors viewed the benefits of EU-wide adoption as outweighing the costs (Armstrong et al. 2007). That research, however, suggested that one of the benefits of EU-

[40] Note, however, that if the SEC allows or requires U.S. issuers to adopt IFRS, market indices' eligibility criteria might change accordingly.

wide adoption was the expectation that IFRS would yield higher quality financial information than did the then-existing domestic standards.[41] In contrast with the issue addressed here, it is *not* expected that superior quality of financial reporting information would result from replacing U.S. GAAP with IFRS (Barth, Landsman, Lang, and Williams 2008; Gordon et al. 2008).

Daske et al. (2008) show capital markets benefits such as lower cost of equity and greater market liquidity accruing to non-U.S. firms voluntarily moving from domestic GAAP to IFRS, but note that many countries adopted international accounting standards concurrently with improving enforcement and governance. These findings are not, therefore, directly applicable to the U.S. setting. Overall, if an implementation scenario were to create an option for a U.S. issuer to use IFRS or U.S. GAAP, accounting research does not indicate whether expected market benefits would drive the decision to exercise that option.

V. IMPLICATIONS FOR AUDITING

We address two related questions concerning the auditing implications of adoption of IFRS by U.S. issuers (Reference Roadmap Question 8). First, would a requirement that U.S. issuers use IFRS have an effect on audit quality, and second, would such a requirement have an effect on concentration of market share among audit firms?

A requirement that U.S. issuers file financial statements prepared in accordance with IFRS would create at least one potential challenge to maintaining high quality audits: IFRS permits wider use of fair value as a basis of measurement than does U.S. GAAP, and auditing

[41] One study of German firms using international standards (then-IAS) and U.S. GAAP supports an expectation of minimal market benefits (e.g., cost of capital or liquidity) for a firm switching from U.S. GAAP to IFRS (Leuz 2003). However those findings should be interpreted with caution, since the study used a sample from the German Neuer Market. The Neuer Market was closed in 2003 after having been "plagued by incidents of accounting legerdemain" throughout its history (Landler 2002). The Neuer Market's reputation was also damaged by numerous bankruptcies and shareholder lawsuits. By 2002, when the decision to close the market was announced, the value of the companies listed on that exchange had dropped 96 percent from the peak in 2000.

fair value estimates has presented challenges to auditors. One example of IFRS's wider use of fair value is that IFRS provides entities with two alternatives for reporting property, plant, and equipment. One alternative is to use a cost model similar to U.S. GAAP, under which assets are carried at historical cost less accumulated depreciation and less any accumulated impairment losses. A second alternative, however, is to use a revaluation model, under which the basis of measurement is the asset's fair value.[42]

The use of fair value to measure property, plant, and equipment is not permitted under U.S. GAAP.[43] Fair value is, however, the U.S. GAAP basis for measuring many financial instruments, and auditing fair value in these instances has presented challenges for auditors. In a briefing paper to the Standing Advisory Group, the staff of the PCAOB noted that an increase in the use of estimates, such as those involved in fair values, increases the risks of material misstatements (PCAOB 2007). Some specific challenges that have confronted auditors in their audits of fair values include: (a) historically, a lack of auditor training in valuation techniques; (b) potential biases in fair value assessments; and (c) differences in internal controls required for fair value measurements (Martin et al. 2006; Olson 2007). In its 2008 summary of its previous four years of inspections, the PCAOB identifies fair value as a "critical and high-risk part" of audits in which "inspectors continue to find deficiencies" (PCAOB 2008, 2).

A requirement that U.S. issuers file financial statements prepared in accordance with IFRS also could potentially increase the degree of concentration in audit firms, because the large international firms likely have more ready access to employees trained in auditing IFRS and

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[42] Specifically, under the revaluation model, an item of property, plant, and equipment is "carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period." (IAS 16, *Property, Plant, and Equipment* ¶ 31.)

[43] It could be argued that auditing estimates of fair value in the area of property, plant, and equipment is not that difficult since appraisals are commonly used; however, given the challenges that have arisen in the existing context of auditing fair value accounting, this difference between IFRS and U.S. GAAP merits consideration.

more established international capabilities. However, it should be noted that – even in the absence of IFRS – auditing services for U.S. public companies are already concentrated, with the four largest firms serving as auditor for companies representing approximately 98 percent of the total market capitalization of U.S. issuers (PCAOB 2008).[44]

The suggested causes of auditor concentration include economies of scale, the ability of larger firms to offer a relatively broad array of specialized expertise, and financial statement users' perceptions that larger audit firms offer higher quality audits than do other audit firms. References to academic research in which these causes have been suggested are provided in DeAngelo (1981).

The existence of fewer and larger audit firms need not, however, indicate a deterioration of audit quality. Indeed, a large body of academic research has presented evidence that larger audit firms may provide higher quality audit services.[45] DeAngelo (1981, 186), who defined the quality of audit services as "the market-assessed joint probability that a given auditor will *both* (a) discover a breach in the client's accounting system, and (b) report the breach," argued that larger audit firms have greater economic incentives to provide higher quality audits. Palmrose (1988, 56), who defined audit quality in terms of assurances such that higher quality audit services correspond to a higher "probability [that] financial statements contain no material omissions or misstatements," used audit-related litigation activity as a measure of audit quality.She finds that Big-x auditors[46] have lower litigation activity than non-Big-x auditors. DeFond and Jiambalvo (1991) find that statements audited by Big-x auditors have a lower

[44] Concentration of auditing services for U.S. companies has existed for a number of years (Palmrose 1988; Lim and Tan 2008).
[45] See Watkins et al. (2004) for a review of the academic literature on audit quality.
[46] The composition of the group of largest audit firms has varied over time because of mergers and other corporate events, and academic research uses a size cutoff reflecting the industry concentration relevant at the time of the analysis. We use the term "Big-x" to refer to the largest firms in each academic study.

incidence of accounting errors than financial statements audited by smaller firms, and Becker et al. (1998) find a relation between higher earnings quality, measured by discretionary accruals, and Big-x auditors. Behn et al. (2008) find that investor decisions, as proxied by analysts' forecast accuracy, are better for Big-x client firms.

Capital markets research suggests that audit firm size is positively associated with users' perceptions of financial reporting reliability (Teoh and Wong 1993; Krishnan 2003). The perception of higher quality audits by Big-x auditors apparently exists, however, only in the litigious environment of the U.S. and not in other countries (Kurana and Raman 2004). If users' perceptions of higher quality reports have contributed to auditor concentration, then the research suggests that it is the U.S. legal environment that has exhibited the greatest influence on audit industry concentration. To the extent that the U.S. legal environment is the primary driver of concentration of audit firms, it is not likely that such concentration would be affected by a change in the set of accounting standards.

Overall, concentration of audit firms – which need not indicate deterioration of audit quality – has already occurred in the absence of any requirement that U.S. issuers use IFRS and therefore does not appear to be a key consideration that should be addressed in the SEC's current policy decisions.

VI. SUMMARY AND CONCLUSIONS

In this paper, we respond to the SEC's request for comments on its November 2008 proposed rule concerning use of financial statements prepared in accordance with IFRS by U.S. issuers. Our findings and recommendations are summarized as follows.

We find that little empirical evidence is directly relevant for the policy question of whether U.S. issuers should be required or permitted to adopt IFRS, although there are widely divergent opinions regarding this question. We recommend further analysis of the costs and benefits of a mandated transition to IFRS for U.S. issuers, investors, and markets. Notwithstanding the need for further analysis, we question the basis on which the Commission can justify withholding from U.S. issuers the option to use IFRS for financial reports based on the issuer's industry membership or size, when all non-U.S. issuers are provided the option to do so.

With regard to the impact on auditing, IFRS adoption could marginally increase the degree of concentration among audit firms because the large international firms may have more ready access to employees trained in auditing IFRS. The provision of audit services to U.S. issuers is, however, already highly concentrated, and a large body of academic research has presented evidence that concentration need not impact the quality of audit services. Finally, research suggests that concentration of audit services may be driven primarily by the litigious environment in the U.S., suggesting that concentration would be relatively unaffected by a change in accounting standards used by publicly-listed companies.

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