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

Luzi Hail
The Wharton School, University of Pennsylvania

Christian Leuz
The University of Chicago Booth School of Business,
NBER, ECGI and FIC

Peter Wysocki
Sloan School of Management, Massachusetts Institute of Technology

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Abstract

Drawing on the academic literature in accounting, finance and economics, we analyze economic and policy factors related to the potential adoption of International Financial Reporting Standards (IFRS) in the U.S. We highlight the unique institutional features of U.S. markets to assess the potential impact of IFRS adoption on the quality and comparability of U.S. reporting practices, the ensuing capital market effects, and the potential costs of switching from U.S. GAAP to IFRS. We discuss the compatibility of IFRS with the current U.S. regulatory and legal environment as well as the possible effects of IFRS adoption on the U.S. economy as a whole. We also consider how a switch to IFRS may affect worldwide competition among accounting standards and standard setters, and discuss the political ramifications of such a decision on the standard setting process and on the governance structure of the International Accounting Standards Board. Our analysis shows that the decision to adopt IFRS mainly involves a cost-benefit tradeoff between (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, including those from adjustments to U.S. institutions. We conclude by outlining several possible scenarios for the future of U.S. accounting standards, ranging from maintaining U.S. GAAP, letting firms decide whether and when to adopt IFRS, to the creation of a competing U.S. GAAP-based set of global accounting standards that could serve as an alternative to IFRS.

JEL classification: G14, G15, G30, K22, M41, M42

Key Words: *Accounting, Regulation, IFRS, U.S. GAAP, SEC, Standard setting, U.S. equity markets, Mandatory disclosure, Political economy*

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1. Introduction and Overview

This report provides an analysis of economic and policy factors surrounding a possible decision by the U.S. Securities and Exchange Commission (SEC) to mandate that publicly listed U.S. companies prepare and file financial reports in accordance with International Financial Reporting Standards (IFRS). Based on our review of the academic literature in accounting, finance and economics, we discuss possible economic consequences as well as political ramifications of such a decision for U.S. firms, investors, other stakeholders, standard setters, legislators and the economy as a whole. In doing so, this report discusses many issues that the SEC raised with the release of its proposed "Roadmap" for the potential use of IFRS by U.S. issuers on November 16, 2008.

The key parts of our economic analysis are organized as follows. Section 2 provides the conceptual underpinnings and delineates, in general terms, benefits and costs of improving the quality and comparability of firms' financial reporting and disclosure practices. Section 3 discusses the role of accounting standards, relative to other factors, for achieving high quality and comparable financial reporting. Section 4 applies the analysis to the question of IFRS adoption in the U.S. It highlights the unique institutional features of the U.S. setting, analyzes potential costs and benefits of IFRS adoption to U.S. firms and investors, and examines macroeconomic consequences of such a move. Section 5 discusses the economics of the standard setting process and assesses the political ramifications of IFRS adoption in the U.S. In Section 6, we apply the concepts from our economic analysis to discuss a set of possible future scenarios for U.S. accounting standards. The example scenarios should not be viewed as exhaustive, mutually exclusive, or advocating a particular course of action. Instead, our discussion of the scenarios is intended to highlight the tradeoffs between various policy choices.

Overall, our economic analysis yields several key insights, which we summarize below. However, we stress that this report should be read and evaluated in its entirety.

Summary of Key Insights

What are the potential costs and benefits of high-quality and comparable reporting?

1. Important potential benefits of high-quality and more comparable corporate reporting practices are greater market liquidity, a lower cost of capital and a better allocation of capital.

2. The *net* benefits of high-quality and more comparable reporting vary significantly across firms, industries, markets and countries, and they can be negative.

What role do accounting standards play in achieving high quality and comparable reporting?

3. The importance of accounting standards for the quality of corporate reporting is more limited than often thought. Other supporting institutions play an important role in determining reporting outcomes. Academic studies suggest that firms' reporting incentives and enforcement of standards are at least as important as accounting standards in influencing reporting *practices*.

4. A single set of accounting standards by itself does not guarantee the comparability of firms' reporting practices, neither within a country nor across countries. This applies to any set of standards (not just IFRS) and it is true even when the enforcement of standards is very high, indicating that reporting comparability is not only a matter of enforcement. Comparability in reporting practices is unlikely to occur as long as firms' reporting incentives differ.

5. The effects of accounting standards cannot be viewed in isolation from other elements of a country's institutional infrastructure. In well-functioning economies, the key elements of the institutional infrastructure fit and reinforce each other. Thus, changing one element of the

institutional infrastructure (e.g., the accounting standards) can lead to undesirable outcomes for the economy as a whole, even if the change unambiguously improves the element itself.

6. There is mixed evidence on the capital-market and other effects around IFRS adoption by firms around the globe. Not all countries and firms see benefits and, more importantly, it is not clear that the documented effects can be attributed solely or even primarily to the adoption of new accounting standards per se.

How will switching to IFRS affect U.S. investors and firms individually and in the aggregate?

7. The direct effects of IFRS adoption on the *quality* of U.S. reporting are likely to be small. U.S. GAAP constitute a set of high-quality standards, and it is difficult to argue that a move to IFRS would bring a significant improvement of the standards within the U.S. context.

8. IFRS adoption likely generates comparability benefits for U.S. firms and investors. These effects arise from the widespread adoption of a single set of accounting standards around the world, and not because IFRS is per se better or worse than U.S. GAAP. However, the comparability benefits to U.S. firms and investors will be limited for at least three reasons. First, the U.S. is a large economy with many firms. Comparability effects are likely to be larger for smaller economies with fewer firms. Second, firms *and* countries have incentives to implement IFRS in ways that fit their particular institutional infrastructure and meet the specific needs of their stakeholders. Third, U.S. GAAP and IFRS are already fairly close and are expected to be even closer by the time the U.S. might adopt IFRS.

9. Thus, the capital-market benefits of IFRS adoption are likely to be limited. We expect the main impact of IFRS adoption to be on firms' reporting costs (including potential cost savings), on the U.S. reporting system, and on the supporting infrastructure. In this regard, our report identifies both transitional as well as recurring costs from a move to IFRS. There may also be benefits

from evaluating current processes and using the regulatory change to upgrade previous practices. Moreover, certain U.S. firms, such as U.S. multinationals, likely have (recurring) cost savings from IFRS adoption because they can use a single reporting system for their operations around the world. However, despite the widespread acceptance of IFRS for financial reporting purposes, it is generally not used for statutory reporting and tax purposes. Therefore, the magnitude of the cost savings to U.S. multinationals depends on the (future) use of IFRS for statutory reporting around the world and the acceptance of U.S. GAAP in foreign jurisdictions.

10. Based on our analysis, IFRS adoption in the U.S. primarily involves a trade-off between (i) the short-term costs of transitioning to a new system, (ii) the comparability benefits, which are relatively modest but accrue over a much longer horizon, and (iii) the recurring cost savings of reporting, which accrue primarily to U.S. multinational companies. The net effect for a given company or the U.S. economy as a whole is not obvious, and crucially depends on the time horizon and the discount factor used in the analysis.

11. As the outside world is changing, simply maintaining the regulatory status quo in the U.S. will not guarantee economic status quo. Put differently, delayed or non-adoption of IFRS can have (recurring) costs for firms and investors as well.

Are IFRS compatible with the current reporting and institutional infrastructure in the U.S.?

12. One of the major perceived differences between IFRS and U.S. GAAP is that the former allegedly provides more discretion (i.e., less specific standards and less implementation guidance). We highlight that more reporting discretion is not necessarily a problem and that firms' reporting incentives, which are shaped by the U.S. institutional framework, play a major role in how firms would apply the discretion under IFRS.

13. U.S. GAAP started out as “principles-based” and evolved into a more detailed set of standards in response to changes in the U.S. institutional environment (e.g., litigation). IFRS will be subject to the same forces once adopted in the U.S. These forces will likely influence IFRS reporting in the U.S. over time and can hinder the international comparability of U.S. reporting (even after switching to IFRS).

14. There do not appear to be major incompatibilities between IFRS and other elements of the U.S. reporting environment and institutional framework. However, various U.S. institutions will have to be adapted to better match with IFRS. This takes time and introduces transition costs.

Are there any other macro effects from switching to IFRS reporting in the U.S.?

15. Given the already strong institutions in the U.S., IFRS adoption is unlikely to have major direct macroeconomic effects (e.g., on economic growth). However, certain re-distributional effects across firms and service providers are to be expected. In addition, there could be smaller effects from comparability on trade flows, portfolio flows and foreign direct investments, including international mergers and acquisitions. However, these effects hinge critically on the magnitude of the comparability effects and the future role of IFRS for statutory reporting around the world.

Are there economic and political considerations with respect to the standard setting process?

16. Switching to IFRS would essentially confer monopoly status to the IASB. In general, monopolies tend to curb innovation, slow down progress, and are prone to political lobbying. Having a choice between U.S. GAAP and IFRS would help limit those tendencies, but only to the extent that firms (within a country) can choose between standards. Competition between regional or national monopolies is less likely to be effective. In addition, changes in the capital and product markets, and not just regulatory competition, can be an important force for innovation in accounting standards.

17. IFRS adoption has political benefits, signaling a willingness by the U.S. to cooperate internationally. At the same time, there are political challenges to global standard setting. Countries have different goals for financial reporting given the differences in their institutional frameworks, and they will likely influence the IASB towards their respective goals, which could lead to standards that are less suited for the U.S. environment. Therefore, reforms to the governance structure of the IASB should be closely followed by the U.S.

Are there ways to address concerns about IFRS adoption in the U.S. and what are their tradeoffs?

18. Maintaining legislative power for the accounting standards in the form of an endorsement process for IFRS provides a safeguard against future developments in standard setting that are not in the interest of the U.S. However, national endorsement mechanisms tend to slow down the process of standard setting, impede changes in standards and could even lead to national or regional versions of IFRS.

19. The U.S. could add specific disclosure requirements on top of IFRS. Supplemental disclosure requirements do not (directly) hurt the cross-border comparability of U.S. reporting, allow for a customization of IFRS to the U.S. environment, and help achieve the desired level of transparency by U.S. firms and for U.S. investors. Such a disclosure overlay could provide an opportunity for the U.S. to assert its leadership in the area of capital-market oriented reporting (while delegating the formal setting of the accounting standards to the IASB).

20. However, these additional disclosures do have costs to firms. They also affect firms' reporting incentives and thereby, indirectly, influence reporting practices and reporting quality, which implies that additional disclosures can have adverse effects on the comparability of U.S. accounting numbers.

2. *Conceptual Underpinnings*

This section provides the conceptual underpinnings for our report. As the case for IFRS adoption in the U.S. and in other countries is generally made on the basis of improvements in reporting quality and comparability across firms and countries, we focus on these two concepts and their economic consequences. First, we describe how financial reporting and disclosure quality are linked to important economic outcomes, i.e., market liquidity, firms' costs of capital and corporate decision-making. Second, we discuss how better comparability of reporting across firms and countries can affect these economic outcomes. Third, we emphasize that there are direct and indirect costs to improving corporate reporting and that these costs need to be traded off against the benefits of reporting improvements. It is important to note that, in this section, we use the terms "reporting" and "disclosure" in a very broad sense, encompassing the wealth of corporate information that firms provide to investors and other outside parties through various channels. Moreover, the terms "reporting" and "disclosure" refer to firms' *practices*, rather than the standards that govern them.

2.1. *Effects of Improved Reporting and Disclosure Quality*[1]

Corporate reporting can have many economic consequences and it is impossible to enumerate all of them. Moreover, not all effects are well understood and supported by evidence. The one that is probably best supported by theory and evidence is the effect of reporting quality on market liquidity.[2] The idea is that information asymmetries among investors introduce adverse selection into securities markets, i.e., less-informed investors are concerned about trading with better-informed investors. As a result, less-informed investors lower (increase) the price at which they are willing to buy (sell) a

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[1] This section draws heavily on Leuz and Wysocki (2008).

[2] We note that "reporting quality" is hard to define and a concept with multiple (possibly conflicting) dimensions. We use it as a placeholder for desirable properties of corporate reporting, in particular the usefulness of corporate information to outside investors for decision making and contracting.

security to protect against the losses from trading with better-informed counterparties. Similarly, information asymmetry and adverse selection reduce the willingness of uninformed investors to trade. Both effects reduce the liquidity of securities markets, i.e., the ability of investors to quickly buy or sell shares at low cost and with little price impact. Corporate disclosure can mitigate the adverse selection problem and increase market liquidity by leveling the playing field among investors (Verrecchia, 2001). Empirical studies support this argument and provide evidence that better disclosures reduce information asymmetry and increase market liquidity (e.g., Welker, 1995; Healy et al., 1999; Leuz and Verrecchia, 2000; Bushee and Leuz, 2005).

In addition, better reporting and disclosure can affect the cost of capital. First, there is the notion that investors require a higher return from less liquid securities, which is in essence a liquidity premium (e.g., Amihud and Mendelson, 1986; Chordia et al., 2000; Easley et al., 2002). Second, better disclosure can lower investors' estimation risks, i.e., make it easier for investors to estimate firms' future cash flows. This effect can directly reduce the required rate of return of an individual security as well as the market risk premium of the entire economy (e.g., Easley and O'Hara, 2004; Lambert et al., 2007 and 2008). Third, better disclosure can improve risk sharing in the economy, either by making investors aware of certain securities or by making them more willing to hold them, which again reduces the cost of capital (e.g., Merton, 1987; Diamond and Verrecchia, 1991). Empirical studies generally support a link between reporting or disclosure quality and firms' costs of capital (e.g., Botosan, 1997; Botosan and Plumlee, 2002; Hail, 2002; Francis et al., 2004 and 2005; Hail and Leuz, 2006; Leuz and Schrand, 2008), although some of the evidence is still debated (e.g., Leuz and Wysocki, 2008 Liu and Wysocki, 2007; Core et al., 2008).

It is also conceivable that better reporting improves corporate decision-making, for example the efficiency of firms' investment decisions. The idea is that higher quality reporting reduces information asymmetries that otherwise give rise to frictions in raising external capital. For instance,

high-quality reporting facilitates monitoring by outside parties, such as institutional investors and analysts, which in turn can reduce inefficiencies in managerial decisions (e.g., Bushman and Smith, 2001; Lombardo and Pagano, 2002; Lambert et al., 2007). The evidence on the effects of reporting quality on corporate decisions is still in its early stages, but there are a number of studies suggesting that better reporting leads to higher investment efficiency (e.g., Bens and Monahan, 2004; Biddle and Hilary, 2006; Bushman et al., 2006; Biddle et al., 2008).

Finally, it is important to note that the effects of reporting and disclosure often extend beyond the firm providing the information (e.g., Dye, 1990; Admati and Pfleiderer, 2000; Leuz and Wysocki, 2008). The disclosure of one firm can be useful to other firms for decision-making purposes but it can also help reduce agency problems in other firms. For instance, the disclosure of operating performance and governance arrangements provides useful benchmarks that help outside investors to evaluate other firms' managerial efficiency or potential agency conflicts and, in doing so, lower the costs of monitoring. While the incremental contribution of each firm and its disclosures is likely to be small, these information transfers could carry substantial benefits for the market or the economy as a whole. Empirically, the aggregate effects of such information transfers and governance spillovers are still largely unexplored, but this does not imply that they are less real or irrelevant.

2.2. Effects of More Comparable Reporting Practices

Another important dimension of corporate reporting is its comparability across firms. Making it easier and less costly for investors and other stakeholders to compare across firms can make corporate reporting more useful, even if the quality of reporting is held constant. For instance, more comparable reporting makes it easier to differentiate between less and more profitable firms or low-risk and high-risk firms, which in turn reduces information asymmetries among investors and lowers estimation risk. These improvements resulting from greater comparability can also increase market

liquidity and reduce firms' costs of capital (aside from the cost savings for investors). Similarly, more comparable reporting across firms from different countries facilitates cross-border investment and the integration of capital markets. Recent evidence supports this notion (e.g., Aggarwal et al., 2005; Leuz et al., 2008a). Making it easier for foreigners to invest in a country's firms could again improve the liquidity of the capital markets and enlarge firms' investor bases, which in turn improves risk-sharing and lowers cost of capital (Stulz, 1981; Cooper and Kaplanis, 1986).

In addition, better comparability can also have effects on corporate decisions and, in particular, gains from trade. More comparable reports allow firms to make better-informed investment choices due to a better understanding of competing firms, both within a country and across countries. Moreover, firms that have comparable financial reports can more efficiently contract with suppliers and customers in other countries. It may also enable them to bid more easily on government contracts in another country.

Comparability can also be viewed from a network perspective. Increasing the number of firms with directly comparable financial reports increases the number of two-way communication linkages in the "financial reporting" network, which enhances the value of the overall network to both investors and firms (e.g., Meeks and Swann, 2008). As the network perspective emphasizes, one firm's adoption of more comparable reporting practices creates externalities on other firms. That is, other firms may benefit from an individual firm's reporting choices.[3] However, firms themselves may not consider the aggregate positive externalities that arise from their own reporting choices. Therefore, this well-known property of externalities could lead to an economy-wide underinvestment in more comparable financial reports, and provides a rationale for creating a (private or public) standard setter who will mandate certain reporting provisions to internalize the positive externalities.

[3] The possible costs for a firm arising from greater comparability are discussed in the next subsection.

Generally speaking, there is less empirical evidence on the effects of reporting comparability than reporting quality. Most archival studies that speak to comparability effects have been conducted in the context of firms' accounting standard choices. We review these studies in Section 3.

2.3. Cost-Benefit Tradeoff Related to Firms' Reporting Quality and Comparability Choices

It is important to note that, despite the tangible benefits of better and more comparable reporting and disclosure, there are also direct and indirect costs to improving corporate reporting. The direct reporting and disclosure costs come in many forms and include the preparation, certification and dissemination of accounting reports. These costs can be substantial, especially considering the opportunity costs of those involved in the process. Moreover, these costs are likely to have fixed components, making certain reports or disclosures particularly burdensome for smaller firms. Disclosures can also have indirect costs because other parties can use information provided to capital market participants (e.g., competitors, labor unions, regulators, tax authorities, etc.). For example, detailed information about line-of-business profitability can reveal proprietary information to competitors (e.g., Verrecchia, 1983; Feltham et al., 1992; Hayes and Lundholm, 1996; Leuz, 2004; Berger and Hann, 2007).

In light of these costs and the cost-benefit tradeoffs that firms face, it may not be optimal to strive for the highest-quality reporting regime. In fact, forcing firms to provide certain disclosures can have net costs to firms, especially smaller firms (e.g., Bushee and Leuz, 2005; Gomes and Gorton, 2007; Leuz et al., 2008b). Thus, regulators and standard setters need to carefully weigh the confluence of costs and benefits to firms, investors, and other parties in the economy. Moreover, it is important to recognize that the net benefits of high quality and more comparable reporting vary significantly across firms, industries, markets and countries.

3. *Role of Accounting Standards for High-Quality and Comparable Reporting*

As discussed in Section 2, higher quality and more comparable reporting and disclosure can have economy-wide benefits and positive externalities. Thus, it makes economic sense for standard setters and policymakers to assess the current reporting environment within a market or country (including private incentives and other institutional and regulatory forces) to determine if changes to the reporting environment could move reporting quality and comparability closer to their socially optimal levels (net of costs). However, it is important to ask how standard setters and policymakers can achieve these goals and, in particular, what role the accounting standards play in achieving high-quality and comparable reporting *practices*. The evidence discussed in the previous section indicates that capital markets and investors reward higher transparency and high-quality reporting. However, this evidence does not pinpoint the quality of the accounting *standards* as the primary source of these benefits. To the contrary, the evidence from academic studies suggests a limited role of standards in shaping reporting practices.

To substantiate this important point, we first draw on relevant empirical work from the international accounting literature, which highlights the role of reporting incentives and countries' institutional frameworks in shaping firms' reporting practices. Second, we draw on the notion of complementarities to illustrate that changing solely the accounting standards is likely to have limited effects and, in some cases, can even have undesirable effects. The concept of reporting incentives and the notion of complementarities form an important basis for our subsequent analyses. Finally, we review arguments on the suggested effects of IFRS reporting and discuss whether the evidence from voluntary and mandatory IFRS adoption around the world supports these arguments.

3.1. Incentives as Key Determinant of Reporting Quality and Comparability

There are a number of recent studies that challenge the premise that changing the accounting standards alone can make corporate reporting more informative or more comparable. This literature highlights the importance of firms' reporting incentives, rather than accounting standards, as key drivers of observed reporting quality (e.g., Ball et al., 2000 and 2003; Leuz et al., 2003; Ball and Shivakumar, 2005; Burgstahler et al., 2006). These studies recognize that accounting standards give firms substantial reporting discretion because the application of the standards involves considerable judgment. For example, accounting measurements rely on management's private information and involve an assessment of the future, making them subjective representations of management's information set.

Firms are given reporting discretion for a good reason (e.g., Watts and Zimmerman, 1986). On one hand, reporting discretion allows managers to use their private information to produce reports that more accurately reflect firm performance and are more informative to outside parties. On the other hand, whether managers use their reporting discretion in this way depends on their reporting incentives. Managers may also have incentives to obfuscate economic performance, achieve certain earnings targets, avoid covenant violations, underreport liabilities, or smooth earnings – to name just a few. Given managers' information advantage, even vis-à-vis the auditors and enforcement agencies, it is difficult to constrain such behavior. But the issue is not just a matter of proper enforcement of the accounting standards. While strict enforcement limits the amount of discretion that managers have, it does not eliminate it. Even in a hypothetical world with perfect enforcement,

observed reporting behavior will differ across firms as long as the accounting standards offer discretion, and there are differences in reporting incentives across firms (Leuz, 2006).[4]

In general, firms' reporting incentives are shaped by many factors, including a country's legal institutions (e.g., the rule of law), the strength of the enforcement regime (e.g., auditing), capital market forces (e.g., the need to raise outside capital), product market competition, a firm's compensation, ownership and governance structure and its operating characteristics. While the extent to which we have evidence differs across factors, recent empirical studies clearly support the importance of firms' reporting incentives for observed reporting and disclosure practices (e.g., Ball et al., 2000; Fan and Wong, 2002; Leuz et al., 2003; Haw et al., 2004; Burgstahler et al., 2006).[5] Particularly relevant for the IFRS debate are studies showing that even when firms are subject to the same accounting standards, reporting practices differ considerably across firms and countries (e.g., Ball et al., 2003; Ball and Shivakumar, 2005; Burgstahler et al., 2006; Lang et al., 2006).

Overall, this evidence implies that moving to a single set of accounting standards is not enough to produce comparability of reporting and disclosure practices, even if these standards are strictly enforced and implemented. Reporting incentives still vary systematically across firms, industries, stock exchanges, countries, and political regions. Convergence in financial reporting outcomes is unlikely unless there is convergence in other factors shaping firms' reporting incentives (e.g., Bradshaw and Miller, 2008; Joos and Wysocki, 2007). More generally, the evidence implies that the role of accounting standards is much more limited than often thought. They are just one of many factors shaping actual reporting and disclosure practices.

4 The same argument suggests that there will be differences in observed reporting practices across countries even if they all use IFRS.

5 The literature on earnings management also supports the notion of reporting incentives. See Healy and Wahlen (1999) and Dechow and Skinner (2000).

3.2. Complementarities among the Elements of Countries' Institutional Frameworks

Accounting standards are one of many important institutional elements affecting financial reporting practices in a country.[6] In well-functioning economies, these elements are likely to be complementary to each other. For instance, accounting information plays an important role in financial contracting (e.g., Watts and Zimmerman 1986). Financial claims and control rights are often defined in accounting terms: e.g., financial ratios specify when a corporate borrower is in (technical) default or how much the borrower can pay in dividends. Investors in public equity markets also use financial statements to monitor their claims, make investment decisions or exercise their rights at shareholder meetings. Thus, it is reasonable to expect that corporate reporting evolves in concert with other institutional factors to facilitate, among other things, financial transactions and contracting. Moreover, standardizing reporting, either by regulation or private standard setting, can reduce transaction costs compared to negotiating what is to be reported on a contract-by-contract basis (e.g., Ross, 1979; Ball 2001). Crafting accounting standards for the informational and contracting needs of key parties in an economy increases these transaction costs savings. The key parties in the economy are also active participants in the political process which affects mandated reporting policies and other economic regulations (see also, Section 6). Moreover, accounting standards likely reflect ownership and financing patterns in a country. Conversely, accounting standards can influence financial contracting (e.g., leases, performance-based compensation, off-balance sheet financing). Due to these interdependencies, a well-designed set of accounting standards and other elements of the institutional infrastructure should be complementary, i.e., fit and reinforce each other. The notion of complementarities implies that countries with different sets of

[6] A country's institutions include the public and private human-made organizations and conventions that shape economic behavior. These institutions include the legal system, banking system, taxation system, regulatory and enforcement agencies, industry associations, standards bodies, networks of professionals, etc.

institutional endowments are likely to select different accounting standards and that diversity in accounting standards is an expected outcome of diversity in countries' institutional infrastructures.

To illustrate this notion, consider a (stylized) financial system in which firms rely heavily on public debt or equity markets in raising capital, and corporate ownership is dispersed and largely in the hands of consumers that invest their savings directly or indirectly via mutual funds in public debt or equity markets. Thus, investors are at arm's length from firms and do not have privileged access to information. In such a system, corporate disclosure is crucial as it enables investors to monitor their financial claims and exercise their rights. We therefore expect that the reporting system focuses on outside investors ensuring that they are reasonably well informed and, hence, willing to invest in the public debt and equity markets.

In contrast, consider another stylized financial system in which firms establish close relationships with banks and other financial intermediaries, rely heavily on internal financing instead of raising capital in public equity or debt markets, and in which corporate ownership is concentrated. In this system, the key parties have privileged access to information through their relationships, and information asymmetries are resolved primarily via private channels rather than public disclosure (e.g., Ball et al., 2000). In such a system, the role of accounting is not so much to publicly disseminate information, but to facilitate relationship-based financing, for instance, by limiting the claims of outside shareholders to dividends, which protects creditors and promotes internal financing. The key point is that the two stylized financial systems are likely to have very different reporting regimes, including the accounting standards (e.g., Leuz and Wüstemann, 2004).

The notion of institutional complementarities has a number of important implications for this study. First, it implies that changes in the accounting standards cannot be considered in isolation from other elements of the institutional infrastructure. The existence of complementarities implies

that changing one element can make the system (or economy) worse off even when the element itself improves along a particular quality dimension. Thus, it is not obvious that a country should adopt a new set of accounting standards even if this set is unambiguously "better" than the existing one. Institutional fit should be part of the consideration. Another implication is that even if countries harmonize their accounting standards at a given point in time, it is questionable that this harmonization is stable over time. The new set of standards will be subject to the same institutional and market pressures that shaped the old set of standards in the first place. Thus, unless other institutional factors across countries are converging, countries starting with a common set of accounting standards are likely to drift apart over time, e.g., due to local adaptation and interpretation or even the introduction of new standards that are not desirable in all countries.

3.3. Effects of IFRS Adoption on Reporting Quality and Comparability

In this section, we discuss several hypotheses about the effects of IFRS reporting. We then review the empirical evidence on voluntary and mandatory IFRS adoption in various countries around the world and discuss the extent to which it supports the hypothesized IFRS effects. In much of the IFRS debate, the arguments are presented in general terms and not tailored to a particular country. We therefore revisit these arguments and the evidence in Section 4 and apply them to the issue of IFRS adoption in the U.S.

3.3.1. General Arguments on the Effects of IFRS Adoption

Most of the arguments in favor of IFRS adoption focus on the effects on capital markets and investors. One argument is that the adoption of IFRS improves financial reporting to outside investors. To support this argument, proponents point out that IFRS are more capital-market oriented

and, hence, more relevant to investors as well as more comprehensive, especially with respect to disclosure, than most local GAAP.[7] If the switch to IFRS does in fact improve corporate reporting and disclosure, prior analytical and empirical studies suggest that mandatory IFRS reporting should be associated with an increase in market liquidity as well as a decline in firms' costs of capital (see Section 2.1).[8]

A related argument is that IFRS reduce the amount of reporting discretion relative to many local GAAP and, in particular, compel firms towards the bottom of the quality spectrum to improve their financial reporting. Consistent with this argument, Ewert and Wagenhofer (2005) show that tightening the accounting standards can reduce the level of earnings management and improve reporting quality. However, as explained in Section 3.1, reducing the amount of reporting discretion can also make it harder for managers to convey their private information through the financial statements. Thus, the effect of changes in discretion on reporting quality is *a priori* not obvious.[9]

Another argument suggesting favorable capital-market effects is that IFRS reporting makes it less costly for investors to compare firms across markets and countries (e.g., Armstrong et al., 2008; Covrig et al., 2007). As discussed in Section 2.2, greater comparability can make financial reports more useful to investors and other stakeholders, even if the quality of corporate reporting does not improve. Moreover, using the same set of accounting standards across firms from different countries likely improves outsiders' ability to detect earnings management and accounting manipulations, as it limits the set of permissible accounting treatments, which in turn should improve firms' reporting

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7 See, e.g., Daske and Gebhardt (2006) for evidence on the perception of disclosure quality. See, e.g., Ding et al. (2007) and Bae et al. (2008) for evidence that IFRS are more comprehensive than most local GAAP.

8 This argument assumes that firms were previously mandated to report under "lower quality" standards that resulted in relatively poor reporting and disclosure outcomes. The argument is therefore less applicable to countries like the U.S. which already have high-quality accounting standards. See Section 4.

9 Note that, for the U.S., the argument often goes the other way round. That is, a switch to IFRS is seen as *increasing* accounting discretion relative to U.S. GAAP (see Section 4.5.1). See also SEC (2008).

incentives. Thus, if the switch to IFRS does in fact improve the comparability of firms' reports, it can improve market liquidity and reduce the cost of capital.

Differences in the accounting standards are also viewed as an impediment to cross-border investment (e.g., Bradshaw et al., 2004; Aggarwal et al., 2005). Thus, the global movement towards IFRS reporting may facilitate cross-border investment and the integration of capital markets (e.g., Covrig et al., 2007). Although the magnitude of this effect is unclear (e.g., Beneish and Yohn, 2008), making it easier for foreigners to invest in a country's firms should again improve the liquidity of the capital markets and enlarge firms' investor bases, which in turn improves risk-sharing and lowers the cost of capital (e.g., Merton, 1987).

However, it is also possible that IFRS adoption has only minor, if any, capital-market effects. IFRS, like any other set of accounting standards, provide firms with substantial discretion and, hence, the reporting incentives argument applies. Firms that oppose the switch to IFRS or towards more transparency are unlikely to make material changes to their reporting policies (e.g., Ball, 2006; Nobes, 2006; Christensen et al., 2007; Daske et al., 2007). This concern applies not only to recognition and valuation rules, where firms are known to have substantial discretion, but also to footnote disclosures, which firms can provide in a more or less informative manner.[10] Thus, even if the standards themselves mandate superior accounting practices and require more disclosures, it is not clear whether firms implement these requirements in ways that make the reported numbers more informative. The same argument applies for comparability.

This alternate, incentives-based view suggests that countries' institutional structures and changes therein play an important role for the capital-market effects around IFRS adoption. All else equal, countries with stricter enforcement regimes and institutional structures that provide strong reporting

[10] See, e.g., the evidence in Gallery et al. (2008) on disclosure differences around IFRS adoption in Australia.

incentives are more likely to exhibit discernable capital-market effects around the introduction of IFRS reporting, if indeed there are substantial differences between IFRS and the local GAAP. Stricter enforcement and better reporting incentives imply that firms are less likely to get away with adopting IFRS merely as a label, i.e., without materially changing their reporting practices (for related evidence, see Daske et al, 2008).[11]

3.3.2. Evidence from Voluntary IFRS Adoptions around the World

Empirical studies on the effects of IFRS reporting can be divided into two categories, depending on whether they analyze voluntary or mandatory adoptions. At present, there are only a few studies that analyze the effects around the introduction of mandatory IFRS reporting; most studies examine firms' voluntary decisions. This and the following section review the evidence in both categories.[12]

Empirical studies on the economic consequences of *voluntary* IFRS adoptions generally analyze direct capital-market effects, such as liquidity or cost of capital, or the effects on various market participants, such as the impact on analyst forecast properties or on the holdings of institutional investors. Leuz and Verrecchia (2000) examine German firms that adopt IAS or U.S. GAAP and find that those firms exhibit lower bid-ask spreads and higher turnover compared with German GAAP firms. Using implied cost of capital estimates, Cuijpers and Buijink (2005) do not find significant differences across local GAAP and IFRS firms in the European Union (EU). Daske (2006) examines voluntary IAS adoption by German firms and finds that they exhibit a higher cost of equity capital than local GAAP firms. Daske et al. (2007) show that firms with a "serious" commitment to adopting IFRS experience larger cost of capital and market liquidity benefits

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11 Conversely, one could argue that countries with better reporting practices before the introduction of IFRS should experience smaller capital-market effects. This argument, however, rests on the presumption that changing the accounting standards alone improves firms' reporting practices and ignores institutional reasons why firms in these countries have better reporting quality to begin with.

12 See also the surveys by Leuz and Wysocki (2008) and Soderstrom and Sun (2007).

compared to firms that simply adopt IFRS as a "label." Finally, Karamanou and Nishiotis (2005) show positive short-window abnormal returns around the announcement of IAS adoption.

Focusing on reporting quality, Barth et al. (2008) analyze changes in the properties of reported earnings around the voluntary adoption of IFRS and present evidence that firms' reporting quality increases. Hung and Subramanyam (2007) examine a sample of German firms that adopt IAS between 1998 and 2002. They compare accounting numbers reported under German GAAP with those under IAS for the same firm-years, and find that total assets and book values of equity are significantly higher under IAS. In addition, they document that the IAS adjustments to book value are generally value relevant, while the adjustments to net income are not.

There are also a few studies on the reaction of market participants to voluntary IFRS adoptions. Cuijpers and Buijink (2005) find an increase in analyst following around IFRS, but the effect is not robust to controls for self-selection. Ashbaugh and Pincus (2001) show that analyst forecast errors are positively related to differences in accounting standards between IFRS and various local GAAP, and that the accuracy of these forecasts improves after firms adopt IFRS. Covrig et al. (2007) document that foreign mutual fund ownership is significantly higher for IFRS adopters compared to local GAAP firms and that the difference in mutual fund holdings increases for firms in poor information environments and with low visibility, suggesting that IFRS reporting can help firms attract foreign institutional investment.

In sum, the evidence on *voluntary* IFRS (or IAS) adoptions is somewhat mixed, but on balance suggests that voluntary adopters experience positive capital-market effects. However, these results have to be interpreted carefully. As firms choose whether and when to adopt IFRS, it is difficult to attribute any observed economic consequences to the accounting standards *per se*. It is possible, if not likely, that the effects are attributable at least in part to the factors that gave rise to the IFRS

adoption decision in the first place. As a result, the evidence can inform us about the potential costs and benefits of IFRS for firms with particular characteristics but cannot provide a rationale for a mandate.

3.3.3. Evidence from Mandatory IFRS Adoptions around the World

Studies on *mandatory* IFRS reporting either examine the stock market reactions to key events associated with the EU's movement towards mandatory IFRS reporting or analyze the effects around the introduction of mandatory IFRS financial statements in certain countries.[13] Studies in the first group try to infer whether the adoption of IFRS in the EU has net benefits (or costs) to firms from their stock market reactions to key events that made IFRS reporting more or less likely. The evidence from these papers is mixed. Comprix et al. (2003) examine abnormal returns of EU firms on four "core" event dates in 2000 that increased the likelihood of mandatory IFRS reporting. They find a weakly significant, but negative market reaction to the four event dates. However, firms that are audited by a Big Five auditor, located in countries that are expected to have greater improvements in reporting quality due to IFRS adoption, or subject to higher legal enforcement experience significantly positive returns on some of the event dates. Armstrong et al. (2008) examine the reactions to 16 events between 2002 and 2005 associated with the adoption of IFRS in the EU. They find a positive (negative) reaction to events that increase (decrease) the likelihood of IFRS adoption, suggesting that European investors view the introduction of IFRS as beneficial. They also document that the reaction is more positive for firms from lower quality information environments, with higher pre-adoption information asymmetry, and for firms that are domiciled in common law countries. The latter result could reflect concerns about IFRS implementation in code law countries, while the

[13] There are also studies that compare the quality and economic outcomes of IAS/IFRS reporting with those of U.S. GAAP reporting in particular market settings. We review these studies in Section 4.

former associations are consistent with investors expecting informational benefits from IFRS adoption. Christensen et al. (2007) analyze the market reactions of U.K. firms to announcements of mandatory IFRS reporting in the EU and find that the average U.K. market reaction is small, but that there is substantial heterogeneity in how markets react. Using the degree of similarity with German voluntary IFRS or U.S. GAAP adopters as a proxy for U.K. firms' willingness to adopt IFRS, they find that this proxy is positively (negatively) related to the stock price reaction around news events increasing (decreasing) the likelihood of mandatory IFRS reporting. This result is consistent with the notion that firms' reporting incentives are central to interpret observed effects around IFRS adoption (see also Daske et al., 2007).

Studies in the second group analyze the effects of mandated IFRS using data from the first few annual reports released under the new regime. Platikanova (2007) analyzes measures of liquidity and information asymmetry in four European countries. She finds heterogeneous liquidity changes for these countries, but shows that the liquidity differences across countries become smaller after the adoption of IFRS, which is consistent with comparability effects. Christensen et al. (2008) analyze whether reconciliations between IFRS and U.K. GAAP around the IFRS introduction convey new information to the markets, and find that market reactions are concentrated among early announcers and among companies for which covenant breaches are expected to be more costly. They interpret their findings as suggesting that mandatory IFRS adoption can lead to wealth transfers between shareholders and lenders due to changes in the likelihood of breaching covenants. Capkun et al. (2008) find that earnings reconciliations of EU firms in the transition year are value relevant. As with all value relevance studies, we do not know whether this result reflects that IFRS reconciliations provide new information to the markets or that they simply contain information which is also contained in prices. Horton et al. (2008) and Wang et al. (2008) examine firms' information environment surrounding the mandatory introduction of IFRS and find that analyst forecast properties

like forecast accuracy, analyst following and forecast dispersion, as well as the relative information content of earnings announcements, improve after the mandatory adoption of IFRS. However, the documented effects vary substantially by firms, industries and countries. Daske et al. (2008) examine the capital-market effects around the mandatory introduction of IFRS reporting in 26 countries using a variety of proxies. They find an increase in market liquidity after mandatory IFRS reporting between 3% and 6% relative to the level of market liquidity prior to IFRS adoption. They also show a decrease in firms' costs of capital and a corresponding increase in equity valuations (measured as Tobin's q), but only when accounting for the possibility that these effects occur prior to the official IFRS adoption date. Finally, the study indicates that these market benefits exist *only* in countries with strict enforcement regimes and in institutional environments that provide strong reporting incentives. Li (2008) confirms this finding for EU firms using an additional year of cost of capital data. Alves et al. (2008) provide evidence from short-term liquidity effects around earnings announcements, suggesting that IFRS earnings by EU firms are viewed as more informative than prior local GAAP earnings.

In interpreting the results of Daske et al. (2008), it is important to note that the aforementioned capital-market effects for mandatory (or forced) adopters are relative to local GAAP benchmark firms that are not required to adopt IFRS or have not yet switched. Firms that have already switched to IFRS voluntarily prior to the mandate are an alternative group against which one could benchmark the effects. Daske et al. (2008) document capital-market benefits for (early and late) voluntary adopters in the year of the mandated switch to IFRS. The magnitude of these benefits often exceeds the corresponding effects for mandatory adopters, indicating that, relative to voluntary adopters, mandatory adopters do *not* gain in market liquidity or market value around the IFRS mandate. As the latter group already reports under IFRS, one explanation for this result is that mandatory adopters confer positive externalities on voluntary adopters by increasing the set of comparable firms, which

in turn could lead to improved risk-sharing across a larger set of investors. Daske et al. (2008) test this explanation but obtain insignificant results, possibly due to low statistical power. Another explanation for capital-market effects of voluntary adopters around the IFRS mandate are concurrent changes in the institutional environment, e.g., with respect to enforcement, governance or auditing, which apply to all firms in the economy. As voluntary adopters likely have better reporting incentives to begin with, they are expected to be more responsive to such institutional changes, which could explain why they exhibit larger effects than mandatory adopters. This explanation questions whether the capital-market effects for mandatory adopters can be attributed solely or even primarily to the adoption of new accounting standards (or the changes in other institutional factors).

At present, there is no direct evidence that concurrent changes in the institutional environment are responsible for observed capital market outcomes. However, Daske et al. (2008) show that capital-market effects around the introduction of mandatory IFRS reporting are not evenly distributed across countries. First, in countries with weak legal regimes and reporting incentives, market liquidity and firm value remain largely unchanged around the IFRS mandate. Second, the effects around mandatory adoption are most pronounced for countries with both large local GAAP/IFRS differences and strong enforcement (or strong reporting incentives). This evidence suggests that the strength of countries' enforcement regimes and firms' reporting incentives play a major role for the documented capital-market effects, which is consistent with the arguments in Section 3.1. Viewed more broadly, the evidence is also in line with the notion of complementarities (see Section 3.2) in that the effects of IFRS adoption depend on *other elements* in countries' institutional infrastructure. Consistent with this notion, recent studies by the Big Four audit firms examining the implementation and compliance of IFRS in the first year under the new mandate conclude that, despite substantial convergence, IFRS financial statements retain a strong national identity (e.g., KPMG, 2006; Ernst & Young, 2007a).

In sum, there is some evidence of positive capital-market outcomes around the IFRS mandate in several countries. However, there is considerable heterogeneity in the effects across firms and countries. Moreover, as with the evidence from voluntary adoptions, it is not clear to what extent the documented effects can be attributed to IFRS, i.e., changes in the accounting standards per se.

4. *Costs and Benefits of IFRS Adoption in the U.S.*

In this section, we apply the economic framework presented in Sections 2 and 3 to evaluate the potential adoption of IFRS in the U.S. We start by recognizing that the U.S. economy and institutional framework are unique in several respects. Thus, even if switching to IFRS has been beneficial for some countries, it is not obvious that the same would be true for the U.S. We then ask whether the switch from U.S. GAAP to IFRS changes the quality or comparability of U.S. corporate reporting practices to gauge the potential capital-market effects from IFRS adoption in the U.S. Next, we assess the compatibility of IFRS with key elements of the U.S. institutional framework (e.g., the litigation system, taxation, etc.), and discuss the relevance of existing IFRS/U.S. GAAP accounting differences. Finally, we discuss various other macroeconomic effects, including the potential impact on the competitiveness of U.S. capital markets, service providers, trade flows and foreign direct investments.

4.1. *Specifics of the U.S. Economy and Institutional Framework*

The U.S. economy and institutional framework are unique in several important respects. First, the U.S. is by far the largest economy of the world and the size of its public equity markets exceeds those of all other countries. Based on data for the year 2007 from World Bank, the U.S. gross domestic product, market capitalization of listed companies, and total value of stocks traded are more than double the amounts for the next largest individual country. Having large and active stock markets likely affects firms' capital structure (e.g., Demirgüç-Kunt and Maksimovic, 1999) and the choice between public and private financing (e.g., Rajan and Zingales, 1995). U.S. firms typically rely heavily on publicly traded external finance, which is provided in arm's length transactions (e.g., La Porta et al., 1998). In response, U.S. firms face intense scrutiny by the capital market and its intermediaries (e.g., financial analysts, institutional investors, and the media). The market forces

likely create a strong demand for transparent reporting (e.g., Ball et al., 2000; Bushman et al., 2004; Burgstahler et al., 2006).

Consistent with the important role of organized capital markets in the U.S., a much larger fraction of U.S. households, either directly or indirectly through mutual funds, hold debt and equity securities compared to households in most other countries. These holdings by U.S. households represent a large fraction of their retirement savings. To support this financial system, there is a heavy emphasis on outside investor protection in securities regulation and also in the accounting standards (e.g., Securities Act of 1933; FASB Concepts Statement No. 1). As such, we can view current securities laws and U.S. GAAP as being primarily (but not exclusively) geared towards facilitating arm's length financing and supporting public debt and equity markets. In fact, these laws, regulations and institutions are considered major factors for the development of U.S. capital markets and the success of the U.S. economy (e.g., La Porta et al, 1998 and 2000). Moreover, in spite of a wave of U.S. accounting scandals, the bulk of the evidence in the international accounting literature suggests that the U.S. reporting system, in conjunction with other U.S. institutions, has led to high-quality financial reporting that meets the needs of outside stakeholders (e.g., Lang, 2003). Given this evidence and the role of capital markets for the U.S. economy, the potential capital-market effects of IFRS adoption, including the impact on investors, should receive special attention.

Second, the U.S. economy and its capital markets are diverse and one cannot treat all publicly traded firms as a homogenous group.[14] For instance, there are several thousand micro-cap firms in the over-the-counter markets such as the OTC Bulletin Board or the Pink Sheets that have to file U.S.

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[14] For instance, the majority of U.S. listed firms are relatively small and domestically oriented. Out of the nearly 7,000 U.S. public firms with data available in Worldscope for the year 2005, more than 50% have total assets below $200 million, and only about 25% report generating sales outside the U.S. The variation in size (measured as total assets) and degree of internationalization (measured as proportion of firms with foreign sales) for the U.S. sample is similar to the size variation and internationalization of the much larger worldwide sample comprising 22,000 non-U.S. public firms across many countries, illustrating the heterogeneity of U.S. public firms.

GAAP financial statements with the SEC (e.g., Bushee and Leuz, 2005). These firms provide financial statements that are quite different from those of large-cap multinationals. More broadly, the reporting incentives view delineated in Section 3 suggests that firms from different industries, trading venues, and with different ownership and financing structures are likely to exhibit substantial heterogeneity in their reporting practices, despite the fact that they all report under U.S. GAAP. Thus, U.S. investors are accustomed to considerable reporting differences at home. In addition, in 2007, the SEC dropped the reconciliation requirement for foreign firms that are cross-listed on U.S. exchanges and report under IFRS, effectively allowing two different accounting standards for publicly traded firms in the U.S. Moreover, U.S. investors have extensive portfolio investments abroad, suggesting that U.S. investors are able to deal with different reporting regimes.

Third, reporting outcomes under U.S. GAAP are generally considered of high quality, e.g., reflecting economic events in a timely manner, in particular when it comes to bad news events (Ball et al., 2000; Hung, 2001), and producing numbers that are transparent and less susceptible to earnings management (Lang et al., 2003; Leuz et al., 2003). Hence, the properties of U.S. accounting numbers are often used as a benchmark for other countries' accounting practices (e.g., Alford et al., 1993; Ali and Hwang, 2000). However, it is important to note that these results and the quality of U.S. reporting not only reflect the accounting standards but also other elements of the institutional framework that influence firms' reporting incentives. This is the key message from Section 3.

Fourth, the intensity of public enforcement efforts in the U.S. is unparalleled in the world, not just in terms of rules and regulation (La Porta et al., 2006), regulators' staffing levels and budgets (Jackson and Roe, 2008), but even more so in terms of actual enforcement actions and sanctions imposed (Coffee, 2007). The public enforcement system is complemented by strong private enforcement, threatening litigation and potentially substantial monetary penalties for managers, directors, and corporations that engage in reporting misdeeds. These pressures are important when

considering the reporting incentives of U.S. firms and the adoption of IFRS, which in contrast to U.S. GAAP have not evolved under similar forces.

Finally, the ultimate authority to set accounting rules and reporting requirements rests with the U.S. Congress, the SEC and, as is typical for a common law regime, the rulings set out by the courts. These legislative bodies have a longstanding tradition of intervening with financial reporting, most prominently in times of crisis (e.g., Zeff, 2003a, 2003b; Ball, 2008). Thus, the setting of accounting standards in the U.S. is not limited to one authoritative body (e.g., the FASB), but influenced by various bodies.

In sum, there are several U.S. idiosyncrasies that must be kept in mind when assessing the economic consequences of IFRS adoption, notably strong capital markets, already high reporting quality, effective public enforcement and a strong threat of private litigation.

4.2. Capital-Market Benefits of IFRS Reporting in the U.S.

Based on the arguments and evidence in Section 2, the capital-market effects of IFRS adoption in the U.S. depend crucially on whether the quality or the comparability of U.S. firms' reporting practices *change* following the switch to IFRS. We therefore discuss whether such changes in reporting quality or comparability are likely to occur and which direction they might take, applying the reporting incentives framework developed in Section 3.1 and drawing on recent empirical evidence, including studies that we have already reviewed in Sections 3.2 and 3.3.

4.2.1. Does Reporting Quality Increase with IFRS Adoption?

Much of the debate about whether the adoption of IFRS in the U.S. would change reporting outcomes focuses on the standards themselves.[15] One view is that IFRS are now of a similar quality compared with U.S. GAAP and that the remaining differences are small. Both sets of accounting standards have essentially the same underlying philosophy, a capital-market orientation, and roots based in an Anglo-Saxon common law tradition. In studies comparing the recognition, measurement and disclosure rules between IFRS and various local GAAP, the U.S. belongs to the group of countries with the fewest local GAAP-to-IFRS differences (Ding et al., 2007; Bae et al., 2008).[16] Moreover, the IASB and the FASB have engaged in numerous convergence activities actively trying to reduce the differences between IFRS and U.S. GAAP. In 2002, the two standard setting bodies issued a Memorandum of Understanding ("Norwalk Agreement") agreeing to make the two financial reporting standards more compatible and to coordinate their future work programs in order to maintain compatibility. Since then, IFRS and U.S. GAAP have converged in a number of areas, bringing the two sets of standards even closer together. In addition, proponents argue that IFRS are more principles-based and cheaper to implement than U.S. GAAP, which are often perceived as being too detailed and complex (e.g., PwC, 2007). The arguments outlined above suggest that U.S. adoption of IFRS is likely to yield similar reporting practices and reporting quality to U.S. GAAP, and might even offer long-run cost savings to firms.

An alternative view is that the adoption of IFRS would imply major reporting changes and likely lead to lower reporting quality in the U.S. This view is based on arguments that many important

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[15] See, e.g., Deloitte, 2007; Ernst & Young, 2007a, 2007b; PwC, 2007; KPMG, 2008b.

[16] Both studies rely on data for the year 2001, and therefore do not take into account the ongoing convergence initiative between the IASB and the FASB. In an earlier study, Harris and Muller (1999) reach a similar conclusion by showing that reconciliation amounts from IAS earnings and book values to U.S. GAAP numbers prepared by a sample of cross-listed firms in their Form 20-F filings are smaller than the reconciliation amounts from various other countries' national GAAP to U.S. GAAP.

differences between the two standards remain (e.g., Benston et al., 2006); that IFRS offer more discretion and less guidance and, hence, more room for earnings management; and that they are less tested and comprehensive than U.S. GAAP.[17]

Based on arguments alone, it is difficult to decide which of the two viewpoints has the upper hand. Moreover, based on the economic framework presented in Section 3, a simple debate over the "which standards are best" is likely to miss other more important factors that influence the quality and comparability of firms' reporting practices. Standards are only one of many factors determining reporting outcomes, and even if IFRS were an unambiguous improvement, it does not immediately follow that IFRS adoption is beneficial in the U.S., as the issue of institutional compatibility needs to be considered (see Sections 3.1 and 3.2). Thus, in our view, a sole focus on accounting standards is not appropriate and the standards debate is misguided.

Our economic framework, drawing heavily on the reporting incentives view, suggests that the U.S. adoption of IFRS is unlikely to have a major impact on reporting quality. To the extent that U.S. firms currently optimize their reporting strategies, they are expected to resist mandated changes that are not in their interest by using the flexibility inherent in the standards. The reporting incentives that were at play in the U.S. *before* the introduction of IFRS will still be at play *after* the switch. For this reason, IFRS adoption alone is unlikely to increase reporting quality and yield substantial capital-market benefits, even when IFRS are viewed as superior to U.S. GAAP (e.g., Ball, 2006; Christensen et al., 2007; Daske et al., 2007, 2008). Conversely, it is difficult to force firms to reduce their reporting quality below its optimal level. Firms can always go beyond the required disclosures and provide further explanations or reconciliations in the notes. Thus, IFRS adoption in the U.S. is unlikely to decrease reporting quality, unless we believe that U.S. GAAP and the SEC disclosure

[17] See also the views summarized in the Roadmap (SEC, 2008) and, for example, the article by Marie Leone, "Regulator Rips Into Global Accounting Plan" in CFO.com (September 10, 2008).

regime significantly exceed the optimal level of reporting quality from a firm's perspective. If the current level of reporting quality is close to what investors demand and firms must provide to support outside financing needs and existing ownership structures, firms will continue to face a strong demand for transparency and public information after the switch to IFRS. In addition, the relatively strong U.S. enforcement mechanisms will remain in force.

For the same reasons, more discretion in IFRS combined with less guidance is not necessarily bad. While it is possible that firms use discretion to manipulate earnings (or to "reset" their balance sheets when transitioning to IFRS), more discretion also allows managers to convey a firm's economic performance to outsiders in a better or less costly way.[18] Less guidance and fewer bright-line rules could imply that there is less transaction structuring to obtain a specific accounting treatment (e.g., off-balance accounting for leases or special purpose vehicles). Again, how firms use the discretion largely depends on managers' reporting incentives and, unless these incentives changes major changes in reporting quality are unlikely. Moreover, the U.S. has aimed to shore up enforcement in the wake of recent corporate scandals. For instance, the passage of the Sarbanes-Oxley Act in 2002 has tightened firms' internal controls, which should positively affect managers' reporting incentives when facing more discretion.

Consistent with the above prediction that the switch to IFRS is unlikely to have a major impact on reporting quality, there are empirical studies that specifically compare the reporting outcomes under IFRS and U.S. GAAP. First, several studies analyze the properties of reported accounting numbers in settings where firms could choose between IFRS and U.S. GAAP for financial reporting

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[18] The results in Subramanyam (1996), for example, suggest that the majority of U.S. firms use discretion in a way to make earnings more informative and not for earnings management purposes. See also discussion in SEC (2008).

purposes.[19] They find that earnings and book values differ little in terms of value relevance, timeliness or earnings management (Bartov et al., 2005; Van der Meulen et al., 2007). Correspondingly, there is little evidence that markets or investors view the outcomes differently, as evidenced by similar market liquidity and information asymmetry across IFRS and U.S. GAAP firms in settings where other institutions (e.g., enforcement) are held constant (Leuz and Verrecchia, 2000; Leuz, 2003).

A second set of studies investigates foreign firms that are exchange-listed in the U.S., prepare financial statements in accordance with IFRS, must provide reconciliations to U.S. GAAP, and are subject to SEC oversight (e.g., Pownall and Schipper, 1999). The empirical findings are mixed. Using various measures of earnings quality and value relevance, there is no clear evidence that U.S. GAAP or IFRS numbers dominate, and in many cases the earnings properties across the two standards are indistinguishable (e.g., Harris and Muller, 1999; Barth et al., 2006; Gordon et al., 2008). At the same time, reconciled U.S. GAAP numbers from Form 20-F filings seem to be subject to more earnings management, exhibit lower associations with share prices and are less timely to recognize losses than numbers prepared by U.S. firms (Lang et al., 2006). However, this result likely reflects the influence of cross-listed firms' home-country reporting incentives and institutions, or incentives stemming from the act of reconciliation itself (Leuz, 2006). Similarly, Barth et al. (2006) directly compare IFRS and U.S. GAAP earnings across a matched sample of non-U.S. and U.S. firms, and find evidence that IFRS numbers are of lower quality. Again, it is not clear that this evidence should be interpreted as suggesting that IFRS leads to lower quality financial numbers because firms outside the U.S. are generally subject to different reporting incentives and, hence, we would not expect them to exhibit the same properties as U.S. firms, even under the same set of

[19] Examples of such settings were German exchange-listed firms after the 1998 enactment of the KapAEG law, former New Market firms in Germany, or exchange-listed firms in Switzerland after the 1991 revision of the company law.

standards. Consistent with this view, Lang et al. (2003) show that firms' *local* GAAP reporting improves around U.S. cross-listings, likely reflecting a change in reporting incentives when firms become exposed to the U.S. institutional environment.

In sum, given the quality of U.S. GAAP combined with strong enforcement and market-based incentives already in place, IFRS adoption is unlikely to improve reporting quality in the U.S. any further. Thus, it would be difficult to justify the move to IFRS only on the basis of reporting quality effects and the associated capital-market benefits delineated in Section 2.1. Moreover, there are likely limits to how much market liquidity and costs of capital can improve as a result of reporting quality increases. Such constraints are more binding for countries like the U.S. where reporting quality is already high. At the same time, it is also unlikely that reporting quality substantially declines.

4.2.2. Does the Comparability of Reporting Practices Increase with IFRS Adoption?

While we expect IFRS adoption to have relatively small effects on reporting quality, it is more likely to have an impact on the cross-border comparability of U.S. reports, especially now that many other countries have moved to IFRS reporting. As explained in Section 2.2, if IFRS adoption makes financial reporting by U.S. firms more comparable to the reports of foreign firms, a number of positive capital-market effects are likely to ensue. These comparability benefits could provide a rationale for switching to IFRS.

However, there are several factors that limit the magnitude of the comparability benefits from IFRS adoption in the U.S. First, the reporting incentives view and the discretion argument apply equally, if not more, to reporting comparability. Consistent with this view, evidence from the adoption of IFRS in other countries suggests a tendency of firms to refer to their previous, local GAAP when making judgment calls and exercising discretion under IFRS (e.g., KPMG, 2006;

ICAEW, 2007; Christensen and Nikolaev, 2008). We expect U.S. firms to do the same. Thus, as discussed in detail in Section 3, IFRS adoption around the globe is unlikely to achieve true comparability in reporting practices. However, using a common set of accounting standards could make reporting more comparable in the sense that it narrows the set of permissible accounting treatments. As such, IFRS adoption can lead to some improvements in comparability, including associated cost savings for investors.

Second, the magnitude of the comparability benefits is presumably a function of the closeness of local GAAP to IFRS (e.g., Bae et al., 2008; Daske et al., 2008). If true, the benefits in the case of the U.S. are likely to be modest, since IFRS already closely resemble U.S. GAAP in many areas. More importantly, this implies that many comparability improvements for U.S. firms should have already been realized when the bulk of countries with large accounting differences between prior local GAAP and either IFRS or U.S. GAAP switched to IFRS in recent years. In essence, the switch of other countries to IFRS should have conferred positive externalities on U.S. firms.

Third, taking a network perspective, one could argue that the comparability benefits are largest for smaller countries that have idiosyncratic accounting standards and opt into a large network with a common set of accounting standards (e.g., Meeks and Swann, 2008). As the U.S. capital markets are large and offer many U.S. peers using the same set of accounting standards (i.e., U.S. GAAP), it can be argued that the comparability benefits for U.S. firms from joining the "IFRS network" would be relatively small. On the other hand, given that the global "IFRS network" has now achieved a significant scale, the benefits for U.S. firms to joining such an established network will be larger compared to joining the underdeveloped IFRS network of the 1990s. At this point, however, there is little direct evidence on the comparability benefits from IFRS reporting that would allow us to gauge the magnitude of the effects.

Taken together, we conclude that a positive impact from IFRS adoption likely arises from comparability and network effects. There are several factors that limit the magnitude of these benefits for U.S. firms and investors. But even if the benefits turn out to be modest, it should be noted that they are recurring in nature and, hence, accrue over the long-run.[20]

4.3. Costs of IFRS Adoption and Reporting Costs Savings to U.S. Firms

It follows from our previous discussions that the capital-market benefits of IFRS adoption and the effects on U.S. reporting practices are likely to be limited. Nonetheless, there could be a significant impact on the reporting infrastructure and firms' reporting processes and systems. We therefore shift our focus to the cost consequences. The largest out-of-pocket costs will likely occur during the transition phase, and not on an ongoing basis. In the long run, costs could arise indirectly from necessary changes in the institutional environment as a consequence of the switch to IFRS. Furthermore, there can be cost savings to firms that operate in multiple countries and adopt IFRS for all their operations.

4.3.1. Transition Costs

Many of the issues related to IFRS adoption are transitional in nature leading to one-time or short-term costs. Firms will have to adjust their accounting systems and processes and, as required under the Sarbanes-Oxley Act (SOX), update the documentation of internal control procedures. In the first year of publishing IFRS reports, they will also have to provide at least one year of comparative prior period financial information (IFRS 1), maybe even up to three years under existing SEC regulation. In addition, firms will need to train their employees in the preparation of IFRS financial statements as well as familiarize outside stakeholders like analysts and investors with IFRS

[20] Moreover, some of the benefits occur at the level of the individual investor and hence need to be aggregated across investors, which could result in a sizeable aggregate effect.

numbers. This includes but is not limited to hiring outside specialists and consultants due to lack of in-house knowledge and familiarity with IFRS, organizing conference calls and road shows for investors, preparing press statements explaining differences in accounting policies, and redesigning financial publications like annual and quarterly reports. It should be noted that, similar to the implementation of SOX, the transition costs for U.S. firms could translate into large additional revenues for financial reporting advisory and auditing firms. Not unexpectedly, many of these advisory firms therefore take a very positive stance regarding the potential adoption of IFRS by the U.S.

In addition, IFRS can affect state- and federal government-regulated industries like utilities, telecommunications and financial institutions that provide financial statements to their regulators. For instance, capital requirements for financial institutions are often determined on the basis of U.S. GAAP financial statements. Furthermore, a switch to IFRS requires a re-evaluation of all explicit or implicit contracts with components tied to accounting numbers.[21] A switch to IFRS can also affect managerial compensation schemes tied to reported earnings performance as well as debt covenants with explicit references to GAAP numbers.[22] Although the impact of IFRS adoption on the magnitude of reported earnings of U.S. firms is ambiguous, studies from other settings suggest that earnings volatility could rise, in particular if the switch to IFRS were to accelerate the use of mark-to-market accounting (e.g., Hung and Subramanyam, 2007; Christensen and Nicolaev, 2008; Muller et al., 2008). As a consequence, the likelihood of debt covenant violations could increase, requiring costly renegotiations between lenders and debtors (Christensen et al., 2008). Note, however, that

[21] From a mere legal perspective, the effects should in many cases be limited. If IFRS become generally accepted accounting principles in the U.S., any explicit reference to U.S. GAAP compliant numbers in contracts could extend to reports prepared in accordance to IFRS, and no change in terminology is needed.

[22] Large sample evidence in Dichev and Skinner (2002) suggests that about 40% of private corporate lending agreements in the U.S. contain at least one accounting-based covenant.

contract implications seem most prevalent in the year of the transition, and are likely to abate over time.

Overall, we expect transition costs for U.S. firms to be substantial, and to contain a fixed component, thereby weighing more heavily on smaller firms. It is difficult to put a precise estimate on the aggregate or per-firm transition costs. Based on survey data for the 2005 mandatory transition to IFRS in the European Union, it is possible to construct an estimate of the first-time preparation costs of IFRS consolidated financial statements for publicly traded firms. This evidence suggests per-firm estimates ranging from 0.31% of total sales for firms with sales below $700 million to 0.05% of total sales for larger firms (ICAEW, 2007), which amounts to an *average* one-time cost of $420,000 for small firms and $3.24 million for large firms.[23,24] Based on these estimates, the aggregate transition costs would amount to at least $8 billion for the U.S. economy as a whole.[25] In terms of the universe of affected firms, this estimate for the aggregate costs is conservative because Compustat does not cover many firms trading in the over-the-counter (OTC) markets and hence our estimate includes only exchange-listed firms. SEC-registered OTC firms will have to switch to IFRS (or at least partially adjust their reporting) and, in relative terms, the switch is likely to be even more

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[23] We obtain these numbers using data from Compustat North America in 2005. Out of 6,822 individual firms with total sales numbers available, 5,006 firms fall below the $700 million threshold, and 1,816 are above. We then compute transition costs based on average total sales for each group, i.e., $136 million × 0.31% ≈ $0.42 million (or 5,006 × $0.42 ≈ $2,110 million) for small firms, and $6,484 million × 0.05% ≈ $3.24 million (or 1,816 × $3.24 ≈ $5,890 million) for large firms, respectively.

[24] To compare these numbers to those outlined in the SEC Roadmap (SEC, 2008, p. 70848, estimated at $32 million per company eligible for early IFRS adoption over the first 3 years of IFRS reporting), we also apply our approach to the 200 U.S. firms with the largest sales numbers in 2005. Based on average total sales for this group, the first-year transition cost estimate increases to $17.98 million (i.e., $35,954 million × 0.05%). In the following years, the recurring costs of preparing IFRS financial statements are estimated on the range of 0.06% of total sales for small firms to 0.008% of total sales for very large firms (ICAEW, 2007). Hence, we add $2.88 million (i.e., $35,954 million × 0.008%) for each of the following two years, yielding a 3-year transition cost estimate of about $24 million. More generally, our computations show that the estimated costs vary considerably by firm size and hence one has to be careful with comparisons of average estimates.

[25] It should be noted that some of the transitional costs for U.S. firms translate into incremental revenues for financial reporting advisory firms. Therefore, switching to IFRS will likely result in a redistribution of wealth among parties in the economy. A potential concern for U.S. policymakers is whether a significant amount of the wealth is redistributed to non-U.S. parties including foreign financial reporting advisory firms with pre-existing expertise in IFRS implementation. We come back to this issue in Section 4.6.2.

costly for them (e.g., Bushee and Leuz, 2005; Leuz et al., 2008b). In addition, our estimate does not include financial institutions, for which total sales is either not available or nor a good activity measure. Obviously, all these estimates are only as good as the survey input data and, hence, they should be interpreted very cautiously.[26] Finally, we note that the costs are likely to increase even further if the SEC requires firms to provide, for a limited period, IFRS reports together with reconciliations to U.S. GAAP (or vice versa), as for instance Proposal B in the Roadmap (SEC, 2008).

4.3.2. Recurring Costs

Even though the one-time conversion costs are likely to be substantial, they by themselves are unlikely to justify maintaining the current U.S. GAAP regime. If there are (modest) benefits to IFRS adoption that continue to recur over the long-run and are sufficiently large, they will eventually outweigh the start-up costs (assuming a reasonable discount factor). Hence, it is also important to ask whether there are any major recurring costs from IFRS adoption, as they could substantially alter the cost-benefit tradeoff. Given that U.S. GAAP comprise a comprehensive set of rules and regulations, it is unlikely that on an ongoing basis the direct out-of-pocket costs for the preparation of IFRS reports exceed those under the current system. If anything, one might argue that the direct costs go down as a result of the lower complexity of IFRS. However, there may be recurring indirect costs arising from incompatibilities with the U.S. legal and institutional system. Such issues would not be easily fixed, as institutional changes take time and can result in substantial costs. In addition, there can be opportunity costs related to a loss of innovation in standard setting arising from the lack of

[26] Another caveat is that the transition costs of EU firms may not be representative for U.S. firms that operate in a different institutional environment, as noted in Section 4.1.

competing accounting standards in the marketplace. We explore these indirect costs in Sections 4.5 and 4.6.

4.3.3. Cost Savings Arising from a Single Global Reporting System

U.S. firms with operations around the world may realize cost savings from using a single set of standards for their financial reporting systems around the world. The foreign subsidiaries of U.S. multinationals often have to comply with the domestic reporting standards of their domicile (e.g., for statutory reporting or tax purposes). This introduces duplication of reporting systems and translation costs for U.S. multinational firms. In particular, each foreign subsidiary would either (i) maintain and track its primary accounts in compliance with U.S. GAAP (but then have to translate its reports to the domestic GAAP of its domicile), or (ii) maintain and track its primary accounts in compliance with the domestic GAAP of its domicile and then translate or reconcile these accounts to U.S. GAAP for consolidation with the U.S. parent company's accounts. As many countries have moved to IFRS reporting for consolidated accounts but not yet for statutory purposes (or the parent-only accounts), a foreign subsidiary of a U.S. multinational may have to maintain (or reconcile) *three* sets of accounts, i.e., U.S. GAAP, IFRS and domestic GAAP. In these cases, switching to IFRS reporting by the U.S. multinational could eliminate one set of accounts and hence could produce cost savings.[27] Furthermore, there is the prospect that IFRS become the global set of accounting standards for statutory and parent-only accounts as well, in which case IFRS adoption by the U.S. would enable U.S. multinationals to maintain and track a single set of accounts, eliminating duplication and leading to reporting costs savings.[28] Thus, the magnitude of the cost savings of IFRS adoption by U.S.

[27] Certain jurisdictions also allow the use of IFRS for statutory purposes. In addition, it should be noted that foreign jurisdictions typically accept U.S. GAAP for financial reporting purposes.- Thus, as an alternative, it would be possible to eliminate one set of accounts by moving the subsidiary to U.S. GAAP.

[28] IFRS reporting for statutory and parent-only accounts is still heavily debated around the world and, hence, this prospect may be far in the future. One might therefore argue that these cost savings should not be given much weight

multinationals depends among other things on the *future* use of IFRS for statutory reporting around the world (as well as the *future* acceptance of U.S. GAAP in foreign jurisdictions). Aside from the cost savings, a switch to IFRS by a U.S. multinational likely also improves within-firm reporting comparability across its subsidiaries to the extent that translated or reconciled U.S. GAAP numbers prepared by the subsidiaries for the parent are not of the same quality as primary accounts in IFRS.

There are two additional points related to the possible costs savings from a single global reporting system that are worth emphasizing. First, purely domestic U.S. companies are unlikely to realize any international reporting costs savings from using IFRS compared to U.S. GAAP. Thus, the costs and benefits from IFRS are not evenly distributed – an issue that we discuss in the next section. Second, foreign multinationals that use IFRS will also realize incremental savings if the U.S. adopts IFRS because their (publicly-listed) U.S. subsidiaries will no longer have to create duplicate financial reports that comply with U.S. GAAP. Therefore, the adoption of IFRS by the U.S. can decrease the costs to foreign multinationals from either establishing or purchasing a U.S. subsidiary.

4.4. Which Firms Are Likely to Have Larger Net Benefits (or Costs) from IFRS Adoption?

Empirical studies show that the costs and benefits of IFRS adoption are distributed heterogeneously among firms (e.g., Daske et al., 2007, 2008). In this section, we discuss which U.S. firms are likely to benefit the most (or have the smallest net costs). We start with existing evidence on the determinants of voluntary IFRS adoption around the world to predict which U.S. firms would likely incur larger net benefits (or smaller net costs) from adopting IFRS. The underlying assumption

in the decision of whether the U.S. adopts IFRS. The counterargument is that IFRS adoption by the U.S. could substantially increase the chances of IFRS becoming the global set of standards for all kinds of reporting.

is that firms voluntarily switch to IFRS only if, in expectation, the benefits exceed the costs.[29] Prior research reveals that voluntary IFRS adopters are larger, more likely to have international cross-listings, more extensively rely on outside funding, have geographically dispersed operations, more diffuse ownership, and are more likely domiciled in countries with low-quality local reporting (e.g., Dumontier and Raffournier, 1998; Ashbaugh, 2001; Leuz, 2003; Cuijpers and Buijink, 2005; Christensen et al., 2007). Many of these determinants are derived from contexts in which adopting IFRS could improve reporting quality (relative to local GAAP reporting), which is not necessarily the case for the U.S. For instance, the argument that firms switch to IFRS to reduce information asymmetries and hence improve their ability to satisfy their current and future financing needs does not really apply to U.S. firms and U.S. GAAP. The majority of U.S. firms can satisfy their financing needs by tapping into the domestic capital market. It follows that the primary beneficiaries of IFRS adoption should be U.S. multinational firms (as well as U.S. investors who want to diversify their portfolios abroad and would no longer need to invest in understanding both U.S. GAAP and IFRS), consistent with the notion of comparability benefits.

We broadly define "multinationals" as firms with foreign subsidiaries or operations, firms that derive a significant portion of their sales abroad, firms considering international expansion, firms with foreign suppliers or customers, and firms with a more international investor base. As discussed in Section 4.3.3, for these firms, benefits could come in the form of avoiding costly dual reporting when foreign authorities allow or require IFRS financial statements for statutory reporting purposes. However, most countries have not yet moved to IFRS for statutory reporting. The latter is typically based on the so-called individual (or parent-only) accounts under local GAAP, rather than based on

[29] It should be noted that the overall proportion of voluntary IFRS adopters is small, averaging only about 6% of the total Worldscope population between 1988 and 2004 (see Daske et al., 2007, Appendix A). This suggests that the large majority of international firms did not expect to incur net benefits from voluntarily adopting non-local GAAP.

IFRS consolidated accounts (e.g., Nobes, 2008, for a classification of European countries that still require national GAAP for unconsolidated accounts). Benefits could also arise from the removal of formal or informal trade barriers that prevent foreign firms, investors, governments and other parties from transacting with non-IFRS compliant U.S. firms, or at least make it more costly to do so.[30] In a similar vein, U.S. firms with cross-listings abroad, seeking to attract foreign investors or obtain foreign finance might not have to prepare a separate set of financial statements.[31]

Another group of potential beneficiaries from IFRS adoption are large firms and those with Big Four auditors. Since switching to IFRS likely involves a fixed-cost component, larger firms will be at an advantage. Big Four audit firms are already experienced in implementing and auditing IFRS reports and can rely on an international network of professionals for special issues. This gives them a comparative advantage over local, non-affiliated auditors. On the other end of the size spectrum, smaller U.S. firms could also benefit from the adoption of IFRS. IFRS are often touted as being less complex than U.S. GAAP. Lower complexity means lower risk of errors and, on average, lower audit costs.[32]

4.5. Compatibility of IFRS with U.S. Regulatory System, Legal Environment, and Economy

In this section, we discuss issues related to the compatibility of IFRS with the U.S. institutional environment and infrastructure. There is a growing body of evidence that a country's institutions,

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30 Note that we can turn the "trade barriers" argument on its head and use it from a protectionist's perspective *against* IFRS adoption by the U.S. In particular, any formal or informal requirement of U.S. GAAP reporting imposes additional non-tariff costs impeding foreign firms from entering the U.S. and conducting business with U.S. clients, suppliers, investors or creditors.

31 The scope of the cross-listing argument is limited to requirements explicitly precluding U.S. GAAP reporting. On many international exchanges U.S. firms are already allowed to report in accordance with U.S. GAAP (e.g., London, Hong Kong, Frankfurt). In addition, as stated by the European Commission in 2008, U.S. GAAP meets the criteria of equivalence to IFRS, effectively granting U.S. issuers the right to be listed in EU markets without costly reconciliation (reference: IP/08/619).

32 However, as discussed in more detail in Section 4.5.1, it is not clear whether IFRS will remain as simple and principles-based when adapted to the U.S. environment, or whether the lower complexity is just a byproduct of its relatively young age.

including its financial reporting regime, are important determinants of aggregate economic outcomes.[33] Furthermore, as discussed in Section 3.2, the fit among the elements of a country's institutional framework is likely important for the performance of a country's financial and economic system. As a result, a switch to IFRS by the U.S. could lead to unwanted consequences for the U.S. economy if there are incompatibilities with other elements of the institutional framework, even when IFRS are deemed to be high quality and perform well in other countries.

An imperfect institutional fit between IFRS and current U.S. institutions can also be a source of both transitional and future recurring costs to the economy. That is, even if IFRS and U.S. institutions are in principle compatible, certain U.S. institutions may need to be adjusted or adapted so as to fine-tune them to the introduction of IFRS. As there are many institutions that use or rely on firms' reported accounting numbers, including the audit profession, regulators, enforcement agencies, the legal system, tax laws, and private contracts, adjustment costs can be non-trivial. At the same time, possible adjustments to current U.S. institutions could lead to greater efficiencies and improvements of the system overall. Given the complexity of the interactions, the institutional effects and adjustments arising from IFRS adoption are difficult to ascertain and quantify.

4.5.1. Accounting Discretion and the U.S. Litigation System

It is often argued that the major difference between IFRS and U.S. GAAP is that the former are more principles-based compared to U.S. GAAP, which are often described as more rules-based. The exact meaning of this distinction is not well defined and is often unclear. Moreover, in our view, it potentially distracts from more fundamental economic arguments on the impact of accounting standards. Similar to IFRS, U.S. GAAP are also based on certain principles (see, e.g., the FASB's

[33] See surveys by Shleifer and Vishny (1997) and La Porta et al (2000).

conceptual framework). Moreover, Ball (2008) argues that, contrary to popular belief, the U.S. accounting system can be viewed as principles-based at the court level. He points to the 1969 criminal case of the *U.S. vs. Simon* in which the U.S. Supreme Court essentially adopted a principles-based view of accounting.[34] Thus, the evolution of U.S. GAAP to a more rules-based set of standards could just be a result of age, and the demand for greater specificity and guidance gradually grew, as the original standards were stress tested and further developed.

Nonetheless, there is little disagreement that current IFRS are less specific and provide less application guidance than U.S. GAAP (e.g., SEC, 2008). As result, a key difference between the two sets of standards is the amount of discretion that firms and managers have. As discussed in Section 4, more discretion in the accounting standards is not necessarily bad. It can enable managers to convey private information to the markets in a less costly fashion. On the other hand, discretion can allow managers to pursue ulterior reporting motives. As countries' institutional frameworks play a major role in shaping managers' reporting incentives and the use of discretion (see Section 3.1), it is important to ask whether the amount of reporting discretion in IFRS poses a problem for the U.S. litigation system, which is rather unique around the world (see Section 4.1).

As a result of less specific standards and guidance, managers must exercise more judgment in interpreting IFRS, which could increase the incidence of legal challenges of managers' (good-faith) professional judgments.[35] On one hand, a switch to IFRS could lead managers to make initially "less aggressive" accounting choices given that the new parameters of U.S. litigation under IFRS have yet to be established. The uncertainty about litigation outcomes could even induce managers to make

[34] This view has been reaffirmed in recent court cases (e.g., WorldCom as outlined in Ball, 2008). This point notwithstanding firms and auditors often demand specific guidance from the SEC or the FASB in an effort to reduce (perceived) litigation risks.

[35] Similar to the litigation risk argument, managers' professional judgments are also more likely to be challenged by regulators, in particular the SEC (e.g., KPMG, 2008b).

overly conservative accounting choices. Furthermore, managers may undertake conservative operating, financing, and investing decisions if they lead to accounting treatments under IFRS that managers perceive as minimizing litigation risk. On the other hand, it is conceivable that the transition from U.S. GAAP to IFRS leads to initially "more aggressive" accounting choices and more earnings management because IFRS give managers greater latitude in interpreting and implementing the standards. However, U.S. firms' reporting incentives are shaped by many institutional factors and these factors that are not expected to change around the introduction of IFRS. Therefore, it seems unlikely that greater reporting discretion under IFRS alone would lead, on average, to more earnings management across U.S. firms, but it can do so in cases where managers have poor reporting (or even hiding) incentives to begin with.[36] Thus, SEC enforcement and firms' internal controls could become more important as a result of IFRS adoption.

If there is a switch to IFRS, we expect the U.S. litigation system and accounting practices to transition to a new equilibrium. Consistent with this expectation, current accounting practices and GAAP generally reflect the present features of the U.S. litigation system (e.g., Basu, 1997; Ball et al., 2000). Similarly, the amount of guidance in U.S. GAAP is often viewed as a response to the litigation system. Thus, for a transition period, IFRS adoption is likely to impose some costs on the parties involved. For instance, audit firms and financial reporting regulators (i.e., the FASB and the SEC) may need some time to handle the ambiguities of IFRS and to develop new expertise. Moreover, the pressures from the U.S. litigation system will shape the application and enforcement of IFRS in the U.S., and likely create demands for additional implementation guidance. One such example is the "forward-looking" risk estimates that firms are required to provide under IFRS. Since

[36] Even if earnings management were to increase as a result of more discretion under IFRS, a potentially countervailing effect is the occurrence of less transaction structuring and less real earnings management (Ewert and Wagenhofer, 2005).

U.S. GAAP do not require these estimates, their disclosure under IFRS could increase the exposure to private litigation by investors. In sum, our prediction is that, if IFRS are exposed to the U.S. institutional environment, there will be substantial pressures on the standard setters and U.S. regulators to provide more guidance, details and rules.

4.5.2. Accounting Differences between U.S. GAAP and IFRS

Before discussing the effects and particular areas of differences between IFRS and U.S. GAAP, it must be stressed that the two sets of standards have many things in common and that they are considerably more similar due to the (formal and informal) convergence efforts of both standard setters over the years. But in spite of the commonalities, several major differences between the two sets of standards remain when it comes to particular transactions. Differences arise in how specific items are recognized, measured, presented on the financial statements, and what disclosures are needed. The Big Four audit firms provide updated lists of the differences between the two standards, listing many differences.[37] For example, according to PwC (2008), FIN 48 (Income Taxes) and FAS 123R (Share-based Payments) alone account for several of the key differences between U.S. GAAP and IFRS. In addition, U.S. GAAP have an overlay of specific guidance for firms.

In an attempt to quantify the magnitude and direction of the accounting differences between the two sets of standards, Plumlee and Plumlee (2008) analyze a sample of 100 firms randomly selected from foreign private issuers that filed a 20-F with the SEC during 2006 and employed IFRS. Their analysis indicates only a few categories of large reconciling items. Those areas are pensions and post-retirement benefits, share-based compensation, revaluations of property, plant and equipment, impairment losses on goodwill and intangibles, and deferred taxes. While the net income differences

[37] See the summary of accounting differences between IFRS and U.S. GAAP by Deloitte (2008), Ernst & Young (2008), KPMG (2008a) and PwC (2008). We have already discussed one major difference, i.e., the amount of discretion that the two sets of standards offer in Section 4.5.1.

between IFRS and U.S. GAAP (netting across all the reconciling items for a firm) are on average small and relatively concentrated (for more than half of the firms the differences fall within +/- 15% of IFRS net income), there exist extreme cases with major differences ranging from -206% to +253% of IFRS net income. For stockholders' equity, the net difference is on average 10% (median = 2.7%) with a similar distribution as the net income difference. Similarly, Gordon et al. (2008) examine 20-F reconciliation amounts for cross-listed firms in the U.S. that use IFRS as their home-country GAAP, and find that the five categories with the biggest differences are business combinations, compensation, taxes, intangibles and the classification of debt.

In terms of direction, Plumlee and Plumlee (2008) find that 75% of the foreign private issuers report IFRS net income in excess of U.S. GAAP net income.[38] For stockholders' equity, the directional effect is less clear-cut: only 43% of the firms report IFRS values exceeding stockholders' equity under U.S. GAAP. Conditional on being positive or negative, the average difference in stockholders' equity is substantial (i.e., +35.1% and -23.7%, respectively), and differs by firm size and industry.

Thus, the effects of a switch from U.S. GAAP to IFRS on key metrics, such as net income, EPS or stockholders' equity, are difficult to predict for any particular firm. Moreover, while 20-F reconciliations provide useful descriptive evidence on the magnitude and direction of the differences between IFRS and U.S. GAAP, the findings are unlikely to generalize to the population of U.S. firms and, hence, should be interpreted cautiously. Foreign firms with cross-listings in the U.S. are not representative for the average U.S. firm. Cross-listed firms are typically large multinationals (e.g., Lang et al., 2003). Moreover, cross-listed firms may have incentives to reduce or even minimize reconciliations (e.g., Leuz, 2006).

[38] Gordon et al. (2008) also find that, on average, net income under IFRS exceeds net income under U.S. GAAP.

However, as discussed in Section 3.1, the importance of accounting standards for the quality of reported accounting numbers is often over-estimated and the debate on IFRS adoption in the U.S. often incorrectly focuses on narrow issues about differences in the standards. Instead, it is important to highlight the reporting incentives argument. For instance, if a firm is forced to switch from U.S. GAAP to IFRS but does not want to change the valuation of a particular asset, managers can try to use reporting discretion to achieve the same valuation under IFRS. If this is not possible (e.g., because the asset cannot be recognized under IFRS), managers can attempt to compensate for the recognition or valuation difference in this particular asset by using reporting discretion in other assets. Finally, managers can always provide additional information, e.g., in the form of a reconciliation schedule in the footnotes. While such additional disclosures are costly, they limit the extent to which accounting differences matter for reporting quality.

Even if accounting differences between IFRS and U.S. GAAP are unlikely to have a major reporting quality effect (see also Section 4.2), they can impede comparability and impose costs on financial statement users. They can also have mechanical effects on contractual provisions and, hence, require contractual adjustments. Finally, accounting differences could influence real operating, investing and financing activities. For instance, firms may structure transactions differently once they no longer obtain the preferred accounting treatment.

For this reason, we provide several examples of key accounting differences between U.S. GAAP and IFRS, and discuss their potential impact on firms' real decisions. It should be noted that these differences are likely to decline over time as the IASB-FASB convergence project continues. Thus, the relevant differences in accounting standards are not the ones based on current IFRS and U.S. GAAP, but those in place at the proposed transition date.

First, a heavily debated issue is the use of fair values in IFRS and U.S. GAAP (e.g., Watts, 2003a**,** 2003b; Benston et al., 2006; Barth, 2008). One question in this regard is whether IFRS will accelerate the trend towards fair-value accounting given that IFRS make more use of mark-to-market approaches, and contain multiple instances in which the use of fair values is optional (e.g., IAS 16, IAS 40). While fair-value accounting is in many ways conceptually appealing, it is often difficult to implement (e.g., Ball, 2006), and could be incompatible with the current legal, institutional, and political environment in the U.S. As the use of fair-value estimates is often viewed as increasing the amount of discretion given to managers (e.g., Watts, 2003a, 2003b), the fair-value debate is closely related to the issue of reporting discretion, which we have already discussed in Section 4.5.1. Moreover, it is not obvious that the switch to IFRS indeed leads to more fair-value use. Consistent with this argument, Christensen and Nikolaev (2008) show that around the mandatory adoption of IFRS many U.K. firms abandoned fair values in favor of historical costs, while only a few German firms used the newly granted discretion and switched from historical costs to fair values as a basis for their valuation.

Second, in the area of revenue recognition, U.S. GAAP comprise very specific guidance provided by the FASB and the SEC. These detailed standards include industry-specific provisions. In contrast, IFRS only have two primary revenue standards plus a few interpretations on revenue recognition that intended capture all revenue transactions. These principles apply without additional details or specific provisions for particular industries. For example, in the software industry, U.S. GAAP set out very specific rules and higher thresholds for recognizing revenue than IFRS. These rules have affected the business and selling strategies of U.S. software companies, which in turn implies that the adoption of IFRS could bring strategy adjustments for these firms (e.g., PwC, 2008).

Third, share-based payments are another area of significant differences. IFRS allow firms to accelerate the expense recognition of certain stock options with "graded vesting" (e.g., Ernst &

Young, 2008). Consequently, some firms could restructure their compensation arrangements and contracts in response to IFRS adoption, providing another example where accounting differences could lead to changes in contracting and managers' real operating decisions.

Fourth, the area of financial liabilities and equity gives rise to differences that could affect how a firm chooses to raise capital. Certain financial instruments that are classified as equity under U.S. GAAP have to be re-classified as debt under IFRS. The re-classification of these instruments will affect reported net assets as well as debt to equity ratios (De Jong et al., 2006). Furthermore, calculated interest expenses will sometimes increase under IFRS (and, in turn, decrease reported net income) because the distributions no longer qualify as payouts to equity holders. These changes can affect firms' borrowing activities, debt covenants, ratings, and other contracts.

Finally, consolidations are another area of differences between U.S. GAAP and IFRS. Under IFRS, the decision to consolidate is based on the principle of whether the company effectively has control, i.e., the power and ability to dictate operating and financial policies of another entity. On the other hand, U.S. GAAP provide many rules and exceptions that allow firms to avoid consolidation and to place items "off balance sheet". Therefore, IFRS adoption likely increases the number of entities that have to be consolidated (e.g., Deloitte, 2008), potentially affecting firms' acquisition and investment strategies. Furthermore, the change in consolidation treatment can alter financial ratios, which could necessitate mechanical adjustments to accounting-based contracts.

4.5.3. IFRS Reporting and U.S. Disclosure Requirements

Current FASB standards and additional SEC filing rules require far more disclosure than is observed in many countries. To the extent that these disclosures exceed what is required under IFRS, they do not create an incompatibility. That is, IFRS do not preclude additional disclosures. To the contrary, the underlying principles of IFRS encourage disclosures that help paint a "true and fair"

picture of firms' transactions, their performance and financial health. However, a switch to IFRS poses the question of whether to maintain explicit SEC disclosure requirements that are outside or go beyond those in IFRS.

As Hail and Leuz (2006) demonstrate, strict disclosure requirements that are well enforced are associated with a lower cost of capital for firms that operate within these requirements. However, they also show that the cost of capital reduction is larger in countries with less integrated capital markets. As the U.S. market is one of the best integrated capital markets in the world and as U.S. GAAP and IFRS already have demanding disclosure requirements, the cost of capital benefits from *additional* disclosure requirements in the U.S. are likely to be muted. Moreover, disclosure requirements are costly to firms and, hence, the usual cost-benefit tradeoff applies (see also Section 2.3). In this sense, the switch to IFRS provides an opportunity to review whether the current U.S. disclosure requirements provide net benefits to U.S. firms and investors.

A more subtle issue is that disclosure requirements can change managers' reporting incentives and thereby indirectly influence the recognition and valuation of transactions in firms' financial statements.[39] As such, additional disclosure requirements could be counterproductive with respect to the goal of comparability. A counter argument is that additional disclosure requirements could be used to bolster the quality of IFRS reporting in the U.S., if they are expanded in those areas in which particular IFRS are a concern or viewed as insufficient. Furthermore, more stringent and specific disclosure requirements could provide a way for the U.S. to distinguish its reporting environment from other countries and allow the kind of leadership it had in developing accounting standards in the past. The strictness of U.S. reporting requirements and enforcement has attracted many foreign firms to the U.S. capital markets (e.g., Doidge et al., 2004; Karolyi, 2006; Hail and Leuz, 2009). Thus, the

[39] For example, there is growing evidence that earnings management and good disclosure are negatively related (e.g., Leuz et al., 2003; Burgstahler et al., 2006).

SEC disclosure overlay provides benefits and opportunities for the U.S. but it also has costs with respect to comparability, which need to be traded off against each other (see also Section 4.6.1).

4.5.4. IFRS Reporting and the Link to Taxation

The effect of IFRS on U.S. firms' corporate taxes and on U.S. tax policy is an important area of debate. Academic research has highlighted the potential interactions between a country's tax reporting system and its financial reporting system. For example, Guenther and Young (2000) and Haw et al. (2004) suggest that a strong tax enforcement system within a country is associated with higher-quality reported accounting numbers. On the other hand, it is unclear whether tax enforcement leads to better financial reporting outcomes, or whether other (correlated) institutional factors provide incentives to increase reporting quality that also lead to greater observed tax compliance (Wysocki, 2004). Clearly, there are a number of strong institutions in the U.S. outside the tax system, such as the well functioning legal system, the auditing infrastructure or the audit firm oversight by the PCAOB, that likely foster tax compliance.

Even though we view high-quality financial reporting and tax compliance as correlated outcomes, it is conceivable that the relatively strict tax enforcement system in the U.S. provides incentives towards a higher-quality implementation of IFRS.

Aside from incentive effects, a change to IFRS can also affect certain tax calculations related to financial statement numbers. As discussed in Section 4.5.2, income under IFRS differs from U.S. GAAP income in the areas of revenue recognition, leases, asset impairments, classification and measurement of financial instruments, hedging activities, and stock-based compensation. Many of these items give rise to timing differences with regard to their treatment under the Tax Code and, hence, will have an impact on the magnitude and time-series pattern of deferred taxes reported in the IFRS financial statements.

Another difference arises in the area of uncertain tax positions. The IASB has explicitly stated that it will not use the FASB's requirements on uncertain tax positions in FIN 48 (e.g., PwC, 2008). This raises the question of whether the U.S. is willing to give up its position and adopt current IFRS provisions (i.e., IAS 12 on Income Taxes), whether the U.S. uses its weight to change IFRS to include elements of current FIN 48, or whether it chooses a carve-out for IAS 12 and supplants it with FIN 48. At the very least, the case of FIN 48 provides an interesting example of impediments to the ongoing convergence between IFRS and U.S. GAAP.

Finally, there are IFRS-U.S. GAAP differences that affect the amount of taxes that firms pay and, hence, have cash-flow consequences. One potentially important issue arises from the fact that IFRS do not allow LIFO accounting. In contrast, U.S. tax law allows LIFO valuation but only if it is also used for financial reporting. Presumably, a switch to IFRS would lead to a higher tax burden for firms that previously used LIFO valuation, unless the tax system is adjusted. There are also international tax impacts including, but not limited to fair value measurement, cash repatriations and cash distributions through affiliates (e.g., PwC, 2008). In addition, there could be differences in state and local tax positions (e.g., PwC, 2008).

The Internal Revenue Service (IRS) is likely aware of the tax-revenue implications of a possible switch to IFRS, and it is expected that tax rules will be adjusted to compensate for any potential revenue losses. The reverse is less clear, especially in times when overall revenues are declining. However, for the LIFO issue, there are several relatively simple solutions. First, the IRS could drop the requirement that LIFO is also used for financial reporting purposes. As such financial reporting prerequisites are rare in the U.S. tax system, it is unlikely that dropping the LIFO conformity rule

imposes major costs on other elements of the tax system.[40] Second, the IRS could provide tax credits or tax breaks to firms that currently benefit from LIFO accounting but would incur higher taxes after being forced to use IFRS. Thus, there are some transition costs for both the IRS and firms, as they must adjust their tax planning strategies and tax reporting systems to the new rules. Moreover, if there are real tax implications from IFRS adoption, they likely affect firms in an uneven manner as their present tax burden not only reflects a firm's financial and operating structure, but also management's incentives to minimize tax payments under the current Tax Code. Therefore, a shift in the incentives structure is likely to affect management's tax planning strategies.

4.6. Other Macroeconomic Effects

In this section, we consider other macroeconomic effects from IFRS adoption in the U.S. While changes to a country's reporting system in conjunction with changes to other institutions could have broad effects on economic outcomes, IFRS adoption by the U.S. is unlikely to have a major macroeconomic impact, such as GDP growth effects, because U.S. GAAP are already high-quality reporting standards and the U.S. already has strong institutions. If there are any macroeconomic effects of IFRS adoption, they are likely to arise in three areas: (i) the re-distribution of wealth between different types of firms (e.g., internationally-oriented vs. purely domestic firms), (ii) the re-distribution of wealth between different service providers (e.g., Big Four vs. smaller audit firms), and (iii) comparability and competitive effects arising from the use of a single worldwide set of accounting standards.[41] As we have already discussed the potential wealth redistributions among

[40] However, dropping the conformity rule will likely lead to more firms switching to LIFO for tax purposes, resulting in revenue losses.

[41] In addition, one might contemplate re-distributional effects in the labor markets. Some argue that IFRS adoption would lead to higher reported earnings, which in turn could boost wage demands from employees and labor unions (Wu and Zhang, 2008). However, such differences could be explained in a reconciliation schedule, and hence it is uncertain, if not unlikely, that the wage demands would have much weight.

firms in Section 4.4, we focus on the effects of IFRS adoption on the competitiveness of U.S. capital markets, trade flows and foreign direct investments, service providers, and the educational system.

4.6.1. International Competitiveness of U.S. Capital Markets

Based on evidence from the cross-listing literature, it is not clear that U.S. capital markets were hurt in the past by strict U.S. regulation or U.S. GAAP reporting requirements (e.g., Ammer et al., 2005; Doidge et al., 2008; Piotroski and Srinivasan, 2008). To the contrary, the bonding literature suggests that firms choose to cross-list in the U.S. because of its strict regulations and not in spite of them (e.g., Reese and Weisbach, 2002; Doidge, 2004; Doidge et al., 2004; Hail and Leuz, 2009). That is, the valuation and cost of capital benefits from U.S. cross-listings seem large enough to outweigh the costs of reporting under U.S. GAAP or preparing 20-F reconciliations, particularly for firms from countries with weak institutions and underdeveloped capital markets.

Based on this evidence, U.S. GAAP reporting requirements do not appear to be a competitive disadvantage. Conversely, it is not clear either that moving to IFRS would make U.S. capital markets more attractive to foreign firms.[42] The SEC has recently decided to allow foreign firms cross-listing in the U.S. to report under IFRS without a 20-F reconciliation, essentially granting them a choice between U.S. GAAP and IFRS. This move raises the question of whether, based on fairness or competition arguments, U.S. registrants should be given the same option. Even though giving a choice to U.S. registrants does not involve the exactly same tradeoffs for the SEC as giving it to foreign issuers, it involves similar issues. For instance, if foreign countries were to require the use of IFRS reporting but not accept U.S. GAAP, U.S. companies that trade or operate in these countries (or

[42] It should be noted that much of the evidence on the "attractiveness" of U.S. capital markets (including U.S. GAAP reporting requirements) was gathered in the years preceding widespread adoption of IFRS in Europe and other parts of the world. Also, IFRS adoption might make U.S. markets more attractive to international investors that are not familiar with U.S. GAAP. We have discussed this effect in Section 4.2.2. Effects on foreign direct investments and trade flows are considered in Section 4.6.3.

would like to do so) would be forced to use IFRS in addition to U.S. GAAP.[43] Furthermore, international subsidiaries of U.S. firms may have to report under IFRS for statutory purposes. In this regard, it is important to recall that most countries so far require IFRS only for the consolidated financial statements of publicly traded firms but not for their parent-only accounts or for statutory purposes. Thus, at present, many international (non-publicly traded) subsidiaries of U.S. firms still have to report under local GAAP, which necessitates some form of restatement or reconciliation regardless of whether the U.S. moves to IFRS or not. In the long run, however, IFRS reporting requirements of international subsidiaries of U.S. firms are likely to become a bigger issue as many countries are considering an IFRS mandate for private firms and for statutory reporting purposes. Thus, it follows that if the U.S. maintains the current U.S. GAAP reporting requirement, more and more U.S. multinational firms will either have to reconcile IFRS reports from foreign subsidiaries to U.S. GAAP for consolidation purposes, or have to provide a reconciliation from the subsidiaries' U.S. GAAP reports to IFRS for statutory purposes.

If, on the other hand, the U.S. adopts IFRS, we expect that regulatory competition will shift to other elements of the reporting system, such as the enforcement of IFRS within a jurisdiction (including penalties and investor remedies for non-compliance) or additional disclosure requirements. The cross-listing literature suggests that, historically, many foreign firms have chosen to list in the U.S. precisely for the bonding benefits arising from the relatively strict U.S. disclosure and enforcement regime. Accordingly, these elements should be viewed as "assets" in the regulatory competition with other countries. Similarly, one possible strategy for the U.S. would be to become a leader for IFRS implementation and enforcement. However, this strategy likely creates a "U.S.

43 At present, we are not aware of a country that requires IFRS but does not accept U.S. GAAP for financial reporting purposes, but it is possible that countries could introduce such rules in the future (e.g., for political reasons).

version" of IFRS and, hence, introduces incompatibilities with the reporting practices of foreign firms (see also Section 6).

4.6.2. Effects on Service Providers

The infrastructure supporting U.S. corporate financial reporting is significant. It includes financial and information intermediaries such as accountants, auditors, consultants, financial analysts, investment bankers, and transaction-advisory service providers. For example, in 2006 there were almost 300,000 accountants and auditors employed directly by U.S. accounting firms, tax preparation firms, bookkeeping and payroll services firms, law firms and consulting firms.[44] Direct and indirect employment by other financial and information intermediaries is also significant with a large concentration in the New York City area.

Much of this support infrastructure has developed around the current U.S. GAAP reporting paradigm. Drawing upon homegrown U.S. GAAP expertise, the U.S. has become an exporter of high-end services. This expertise has been in demand by foreign cross-listed firms and foreign firms engaged in cross-border transactions. Moreover, U.S. accounting, auditing, consulting, banking, and transaction-advisory firms have been highly successful in exporting their services around the world. Arguably, U.S. adoption of IFRS makes the U.S. less unique and the resulting financial reporting system will have many features in common with other countries including the EU. The adoption of IFRS could therefore have negative competitive and employment implications for U.S. service providers. However, there are also countervailing effects that need to be considered.

First, even without IFRS adoption by the U.S., foreign firms are unlikely to demand as much U.S. GAAP expertise in the future. IFRS are now widely accepted around the world and demand

[44] See the Bureau of Labor Statistic "Occupational Outlook Handbook" for the professions of Accountants and Auditors (http://www.bls.gov/oco/ocos001.htm).

therefore has shifted to IFRS-related services. Thus, if the U.S. service providers are perceived as lacking IFRS-specific capabilities, they will lose business to foreign competitors. Conversely, if the U.S. maintains a version of U.S. GAAP that is substantially different than IFRS, then domestic service providers would continue to have a "home field" advantage relating to U.S. GAAP services. In addition, U.S. GAAP capabilities are likely to remain in close proximity to their U.S. client base, reducing the risk of extensive off-shoring of services. Foreign financial intermediaries would also be at a competitive disadvantage in a U.S. GAAP regime. Thus, in this scenario, we expect U.S. service providers to essentially hold on to their domestic market share at the expense of building capabilities to capture worldwide growth in IFRS-related services.

Second, the accounting and auditing industry is likely to generate additional business from a transition to IFRS, and could be seen as primary beneficiary of such a decision. In particular, large multinational auditors appear better positioned than small domestic auditors, which lack the IFRS expertise and the international network to capitalize on IFRS services. That said, smaller auditors could specialize in U.S. GAAP services to firms that are not subject to IFRS reporting requirements (e.g., private firms) or firms that stick to U.S. GAAP in the event the SEC makes IFRS adoption optional.

4.6.3. Effects on Trade Flows and Foreign Direct Investment

International trade and capital flows are affected by firms and investors weighing the portfolio of institutional costs and benefits offered by various jurisdictions when planning where to operate, invest or raise capital. The costs and benefits of a country's accounting system are among the factors likely to be considered by firms and investors. Thus, we discuss whether the adoption of IFRS in the U.S. has predictable effects on trade flows, portfolio investment or foreign direct investments (FDI).

In terms of international trade flows, using the same accounting language might facilitate trade of real goods between suppliers and customers. Márquez-Ramos (2008) provides evidence consistent with the notion that the accounting harmonization process in Europe has reduced information costs and unfamiliarity between countries and, therefore, is one way of encouraging international trade and FDI. However, these effects primarily apply to transitional economies that are moving away from lower quality domestic GAAP to IFRS. In the case of the U.S., these "language" effects on trade are likely to be small because both IFRS and U.S. GAAP are of high quality and already widely used and understood around the world.

In the area of cross-border capital flows, the home-bias literature suggests that familiarity with the accounting standards matters for portfolio holdings. Specifically, the adoption of high-quality standards (including IFRS) is associated with higher foreign mutual fund and institutional investor holdings, consistent with less home bias and a more efficient cross-border capital allocation (Bradshaw et al., 2004; Aggarwal et al., 2005; Covrig et al., 2007). In addition, Cumming and Johan (2007) provide weak evidence that the adoption of IFRS in Europe have facilitated cross-border private equity investments. However, as Beneish and Yohn (2008) point out, it is difficult to sort out whether these findings are mainly due to familiarity with a particular accounting system or due to better information being produced by the new accounting system. Again, given the high quality of U.S. reports, the effects on cross-border capital flows from IFRS adoption are likely to be small.

In the area of FDI (including multinational mergers and acquisitions), there are issues related to both direct reporting costs and information processing costs arising from different financial reporting systems across jurisdictions. For example, it is possible that U.S. firms are more apt to set up foreign operations (rather than investing in the U.S.) or to acquire foreign firms if they are no longer required to reconcile from IFRS for statutory reporting to U.S. GAAP for consolidation purposes. In other

words, the direct reporting costs of foreign operations are likely to be lower if the U.S. switches to IFRS *and* foreign jurisdictions increasingly move to IFRS for statutory reporting purposes.

The converse question is whether foreign firms are more likely to set up U.S. operations (or acquire U.S. firms) if there exists an IFRS infrastructure in the U.S. The answer to this question depends on whether U.S. subsidiaries of foreign firms have (statutory) reporting requirements tied to U.S. GAAP. Contrary to many countries around the world, the U.S. does not have general statutory reporting requirements. However, presently, there exist many federal and state regulatory rules for private companies referencing U.S. GAAP or "generally accepted accounting principles." At this point, it is unclear if U.S. GAAP would continue as a distinct set of standards even after the adoption of IFRS (e.g., for private firms) or whether IFRS would simply turn into "generally accepted accounting principles" in the U.S. Regardless of this issue, foreign acquirers currently have to operate two sets of accounts when purchasing a *publicly traded* U.S. company. In these cases, it is conceivable that U.S. adoption of IFRS would promote FDI in the U.S.

4.6.4. Education System

A major issue surrounding the adoption of IFRS is whether it is possible to bring the accounting profession, analysts, educators and other parties up to speed in a sufficiently timely manner so as to have a smooth transition to IFRS (e.g., Barth, 2008; SEC, 2008). To the extent that there are "educational" gaps, they would speak in favor of delaying IFRS adoption in the U.S. However, as many other countries have experienced a relatively smooth transition of the education system to IFRS, the same should be possible in the U.S., although the relatively large size of the U.S economy and the diversity of its markets present particular challenges.

Furthermore, the major accounting firms have already started an IFRS awareness campaign among major constituencies and education providers.[45] This campaign suggests that many auditing and consulting firms are being proactive in their preparation for a potential IFRS adoption by the U.S., irrespective of the view that these activities could also be self-serving.

Finally, the IFRS educational and training concerns apply mainly to preparers and the accounting profession and less to capital-market participants. The latter group is already exposed to IFRS through foreign companies and will become increasingly familiar with IFRS financial statements as time passes. For example, academic studies on 20-F reconciliations (see Section 3) and studies of mandatory IFRS adoption (e.g., Daske et al., 2008) suggest that investors can and already do cope with differences in the accounting standards.

45 The Big Four accounting firms have released a number of reports indicating that IFRS education is lagging behind (e.g., Ernst & Young, 2007b; KPMG, 2008b; KPMG/AAA, 2008). They warn that U.S. investors and issuers are not yet sufficiently knowledgeable with IFRS, and that, at present, college curriculums, textbooks and other instructional materials do not adequately train students and other interested parties in IFRS capabilities.

5. *Standard Setting and Political Ramifications of IFRS Adoption in the U.S.*

Up to this point, we have not directly considered the process by which IFRS and U.S. GAAP are established and how they develop. In this section, we consider issues related to the economics of the standard setting process and ask whether a single set of global accounting standards is a desirable as well as a feasible economic outcome. As the adoption of IFRS is not just an economic but also a political issue, we further lay out the potential political, legal and institutional ramifications of adopting (or not adopting) IFRS in the U.S. This includes discussions of the future role of U.S. authorities (namely, Congress, the SEC and the FASB) in setting generally accepted accounting principles and how the governance structure of the IASB may affect the future evolution of international accounting standards.

5.1. *Competition Among Standards and Standard Setters*

A key role of accounting standards is to reduce the economy-wide transactions costs of communicating information among various stakeholders, allowing them to make more efficient real decisions and undertake transactions within, outside and between firms. At the same time, accounting standards impose regulatory and compliance costs, and could increase the barriers to entry into public capital markets. The academic literature discusses some of the tradeoffs of accounting and disclosure regulation (see survey by Leuz and Wysocki, 2008).[46] Much of the literature, however, focuses on whether or not to regulate and how to regulate, but there is less work on development of standards and the regulatory process.

[46] See also the debate about the Sarbanes-Oxley Act of 2002 and related work (e.g., Rezaee and Jain, 2006; Leuz, 2007; Li et al., 2007; Zhang, 2007; Leuz et al., 2008b).

An important issue for this report is whether having a single set of accounting standards around the world is desirable and would benefit firms, investors, and other stakeholders. As we discussed in earlier sections of this report, moving to a single set of accounting standards can create some cost savings and comparability benefits. However, there are also concerns related to the standard setting process. One particular concern about the adoption of IFRS in the U.S. is that such a move would largely eliminate the existing competition between IFRS and U.S. GAAP, essentially granting monopoly status to IFRS.

The literature on the economics of accounting standards views monopolies as problematic for a number of reasons (e.g., Ball, 1995; Dye and Sunder, 2001; Sunder, 2002, 2008; Benston et al., 2006; Meeks and Swann, 2008; Stulz, 2008). A monopoly standard setter has few incentives to react quickly to changes in the market place, to innovate, or to implement the best possible accounting standards for investors. The monopoly can impede experimentation with alternative accounting treatments, lead to an overinvestment in existing and new accounting standards without a proven track record, and prevent specialization of standards geared towards a particular subset of firms. Lacking an observable price mechanism to inform the markets and clearly defined criteria of social choice, monopolistic standard setters also become prone to pressure from political lobbying.

Moreover, empirical evidence from firms opting out of their local disclosure rules by cross-listing in the U.S. (e.g., Doidge et al., 2004; Hail and Leuz, 2009), from firms voluntarily replacing domestic GAAP by IFRS or U.S. GAAP (e.g., Leuz and Verrecchia, 2000; Daske et al., 2007) and from comparisons of mandatory disclosure regimes across countries (e.g., Hail and Leuz, 2006) shows that regulatory differences affect firms' and investors' decisions, that firms attempt to take advantage of these differences, and that there appear to be benefits from competition among regimes. While opting out of a given regulatory regime is costly and is difficult for many firms, the mere existence of an alternative reporting regime provides incentives for an incumbent standard setting

body to pay attention to stakeholders' needs. Thus, a functioning market mechanism mitigates incentive problems and increases the responsiveness of standard setters, thereby fostering the development of future standards and regulatory innovation.

If the U.S. adopts IFRS, lack of competition among standard setters could lead to pressures on the IASB from its members and stakeholders to justify both its existence and the costs of maintaining its operations. These pressures could yield an overproduction of standards by either revising existing standards or developing new IFRS. Alternatively, the IASB could try to expand its influence by venturing into new markets. The current project of IFRS for small and medium-sized private entities could be seen as a step in this direction. Lacking an objective market mechanism, the evaluation of such ventures is often arbitrary. Moreover, experience from other supranational institutions like the World Bank, the International Monetary Fund or the United Nations suggest that a single global standard setter will face mounting political pressure as consensus must be reached across a wide range of political regimes and interests, likely affecting the issuance and evolution of accounting standards (e.g., Werle, 2001; Charnovitz, 2005).

A related concern about a single set of global accounting standards is that the standard setting process involves a compromise among a large and very diverse set of constituents across the world. Different countries have different goals with respect to financial reporting regulation. While current IFRS are arguably focused on the needs of "outside investor" economies such as the U.K., Australia or the U.S., the majority of the economies around the world still relies heavily on close relationships among a large set of stakeholders and is less focused on outside capital markets. A potential risk for the U.S. and countries with similar "outside investor" models is that the IASB could be influenced to modify IFRS to meet the demands of "inside stakeholder" economies. As a result, future IFRS may be less suited for "outside investor" economies such as the U.S. and may fail to meet the needs of companies and investors that rely heavily on arm's-length transactions.

Competition among standard setters or accounting standards can take on various forms and occur at various levels (e.g., Benston et al., 2006). Currently, we face a situation of competition between regional monopolies, namely U.S. GAAP in the U.S. versus IFRS for large parts of the world. One could make the argument that IFRS have evolved into a set of high-quality standards and closely resemble U.S. GAAP precisely because there already was a major competitor in the market place. On the other hand, it seems unlikely that competitive forces from foreign standards (e.g., German GAAP or U.K. GAAP) were the primary drivers behind the long history of innovative accounting solutions in U.S. GAAP.[47] For the most part, it is very difficult and costly for firms to opt out of their home-country reporting requirements.[48] Thus, at the country or regional level, competition among standards does not take place unless countries are in the process of adopting a different set of standards, or at least willing to consider such a move (e.g., Hope et al., 2006). That said, the existence of multiple standard setters could nevertheless provide some discipline to the standard setting process.

Alternatively, competition among standards can take place at the exchange level. Individual exchanges can compete with each other by setting their own listing requirements. For instance, non-U.S., non-U.K. firms can choose to cross-list on NASDAQ, NYSE, the London Stock Exchange's Main Market, or its Alternative Investment Market, each with different admission criteria, reporting rules and oversight consequences (e.g., Piotroski and Srinivasan, 2008). The choice of listing venue likely conveys information to the markets and allows firms to cater to specific investor clienteles. However, as pointed out before, firms generally have to satisfy home-country reporting requirements

[47] A more likely explanation is the U.S. institutional framework that created a demand for high-quality reporting. We come back to this point at the end of this section. See also the discussion of institutional complementarities in Section 3.2.

[48] Cross-listing often involves opting into a set of foreign reporting requirements, but at the same time firms remain subject to their home-country accounting standards. To completely opt out, firms essentially have to incorporate in other countries.

unless they incorporate abroad or choose the foreign exchange as their primary listing venue. Thus, generally, firms can voluntarily opt into stricter regimes but cannot easily escape to weaker regimes, which limits the competition among accounting standards at the exchange level.

As a third possibility, competition among standards and the choice of accounting standards can take place at the firm level. In this case, firms are able to select among a pre-specified set of accounting standards the ones that best fit their needs, i.e., offer the highest net benefits (lowest net costs). It is at this level where the arguments in favor of competition discussed earlier most likely apply.[49] They are much less convincing if competition takes place among regional monopolies that are supported by the regional governments. But with a few exceptions like Germany and Switzerland during the 1990s, we have not seen this type of competition among standards within a single economy and therefore do not have much empirical evidence on its consequences.[50]

Furthermore, we should note that allowing for competition between different providers of accounting standards, regardless of the level at which the competition takes place, is not without problems. Some of the arguments against competition among accounting standards include the fear of a “race to the bottom” leading regulators to loosen existing rules, the view that accounting standards give rise to a natural monopoly due to comparability benefits and network externalities, as well as concerns about the absence of a real market for accounting standards and the non-profit status of the standard setting bodies (e.g., Dye and Sunder, 2001; Sunder, 2002; Benston et al., 2006).

Another limitation of the competition argument and the long-run co-existence of U.S. GAAP and IFRS is that U.S. GAAP could become an ineffective competitor relative to the increasingly dominant IFRS (see also Sections 6.1 and 6.7). At present, foreign countries seem to be “voting for

[49] One way to achieve such competition in the U.S. would be to allow a choice between IFRS and U.S. GAAP for U.S. firms. See Sections 6.2 and 6.3 for more discussion.

[50] See, e.g., Leuz (2003) for a study of Germany’s New Market in which U.S. GAAP and IAS were competing.

IFRS with their feet." This suggests that either current U.S. GAAP standards, while well suited for U.S. firms and the U.S. environment, do not meet the needs of companies in other jurisdictions, or countries do not feel their current and future needs being adequately represented in the U.S. standard setting process. The declining relative market share could turn U.S. GAAP into a non-credible alternative for multinational firms operating around the world. It is also possible that the convergence process between the FASB and the IASB has brought the two standards already too close together and, as a result, the choice to adopt either U.S. GAAP or IFRS by other countries is primarily a political decision driven by considerations such as the amount of influence on the standard setting process.

Finally, from a more pragmatic standpoint and setting the issue of desirability aside, we can ask whether having a single set of globally accepted accounting standards is indeed the likely outcome. Based on our discussion in Section 3, we expect incentives and institutional factors to remain a driving force of reporting practices in the years to come. Hence, adopting IFRS on a worldwide scale will hardly eliminate all national, industry and firm-level forces and incentives that influence firms' financial reporting practices. Local capital markets, enforcement institutions and economic forces are simply too strong and diverse, making a uniform implementation of IFRS around the globe highly unlikely (e.g., Ball, 2006; Nobes, 2006; Daske et al., 2007 and 2008). Moreover, globally adopting IFRS likely shifts regulatory competition from the creation of accounting standards to the interpretation, implementation and enforcement of existing IFRS in local markets. These forces could lead to regional versions of IFRS or different de-facto standards. For instance, financial crises, new business practices or innovations in the capital markets can require changes or new interpretations of extant IFRS, which in turn might lead certain countries to opt out or adopt their own version of IFRS. The carve-out of specific sections in IAS 39 (Financial Instruments) during the endorsement process of IFRS by the European Commission in 2004 and 2005 is just one example of

such a nationalized version of IFRS, which sets an important precedent (e.g., Armstrong et al., 2008). The recent financial crisis presented the IASB with the threat of another EU carve-out (Tweedie, 2008).

Pressures from the capital markets and new business practices can also help explain why U.S. GAAP, notably a *local monopoly* for listed U.S. firms, have evolved into a high-quality set of accounting standards. As discussed in Section 4.2.1, the needs of investors and other participants in U.S. capital markets are an important driving force of U.S. accounting standards and practices. That is, the same market and institutional forces that shape managers' reporting incentives are likely to be the primary drivers for reporting innovations and the development of standards, rather than regulatory competition among standards from different countries or regions. These forces would remain in place and continue to exert pressures on standard setting if the U.S. decides to adopt IFRS.

5.2. Political Ramifications of IFRS Adoption in the U.S.

A potential political benefit for the U.S. from IFRS adoption is that it signals an additional willingness on the part of U.S. policymakers to cooperate with other major countries on important global issues. However, there are also political risks for the U.S., which we discuss below.

Under the current system, U.S. Congress has delegated oversight over public security offerings and the security markets to the SEC, which in turn has delegated the development of accounting standards to the FASB. The SEC supervises this process, effectively retains veto power with respect to the use of standards by U.S. firms, provides implementation guidance and monitors the conformity of the financial reporting practices by publicly listed firms with the standards. In addition, the SEC issues additional disclosure requirements for publicly traded firms that are registered with the SEC.

A switch to IFRS reporting in the U.S. would certainly affect the complex interplay of these institutions as well as create an additional player with a formal standard setting role. IFRS are set by

the IASB, which acts as an independent supranational standard-setting body appointed and overseen only by the Trustees of the IASC Foundation.[51] Although the IASB has pledged to cooperate with national standard setters to achieve convergence in accounting around the world, there is little left for individual rule-making bodies in a given country, at least as far as the standards themselves are concerned, except perhaps to act as local agents or constituents of the IASB.[52] In theory and without further stipulations, this would also apply to the U.S. Congress and the SEC and, hence, transfer the authority to set standards in the areas of accounting measurement, recognition and disclosure to the IASB. Such a delegation of standard-setting power to the IASB, by its very nature, poses numerous political challenges, beyond the economic aspects that we have discussed so far.

Legislative bodies like the U.S. Congress have an innate resistance to give up power to a foreign authority or standard setting body. One of the major concerns from a U.S. perspective is that foreign governments and interest groups exercise an undue influence on the IASB and, consequently, the formulation of IFRS. For instance, it is not clear that other countries have the same goals as the U.S. when it comes to defining the role of accounting, or when they opted for IFRS to replace their domestic accounting standards in the first place (e.g., Hope et al., 2006). As discussed in Section 4.1, the U.S. economy has several unique features and the U.S. reporting system has evolved in concert with these features. For instance, current U.S. GAAP tend to be very investor-oriented and capital-market-oriented. In contrast, many foreign countries are less reliant on public equity and debt markets and, hence, foreign governments may push for accounting standards that focus more on

[51] Many viewed the lack of oversight by a securities regulator like the SEC as a flaw in the IASB governance structure (e.g., Tweedie, 2008). In response to this perception, the Trustees of the IASB approved in January 2009 the creation of a Monitoring Group, which comprises leaders from the SEC, the Japanese Financial Services Agency, the European Commission, and the International Organization of Securities Commissions (IOSCO).

[52] Note that in many countries the mandate of IFRS reporting applies only to consolidated financial statements of publicly listed firms. Statutory (or parent-only) accounts as well as financial reporting by private firms are explicitly excluded, and therefore countries might still retain a national accounting standards regulator.

protecting employees or creditors' interests. They could also put less weight on public or private enforcement mechanisms that impose IFRS on firms in their countries.

Presumably due to similar concerns with respect to their economies, several countries and regional entities, most prominently the EU, have put in place an endorsement mechanism for future amendments of existing IFRS or the creation of new IFRS.[53] This mechanism not only grants them a veto right, but also levers their influence in negotiating changes to IFRS (e.g., Benston et al., 2006; Chand and Cummings, 2008), as has been highlighted by the events related to the recent financial market crisis. It is unlikely that U.S. Congress will forgo the option to implement similar endorsement and veto mechanisms, especially in light of the fact that other countries already retain such rights.[54] While such endorsement mechanisms are a safeguard against undue foreign influence, they tend to complicate and slow down the development and implementation of new IFRS. Moreover, if the U.S. adds or opts out of certain IFRS provisions as part of an endorsement process, this could bring us back to regional or national sets of standards (e.g., NAFTA-version vs. EU-version of IFRS). Such a regionalization of IFRS goes against the stated goals of creating a global set of accounting standards that facilitates cross-border comparability around the world.

In the past, the IASB's membership and organizational form generated IFRS that were and are largely consistent with the market needs of "outside investor" economies such as the U.S. In addition, the inherent competition between the IASB and the FASB, as well as the dialogue between these two bodies as part of the convergence project, acted to discipline the process for setting current IFRS. However, a significant risk for the U.S. is that the dynamics of the IASB may change in the

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53 For instance, in Australia, accounting standards are part of the law and the parliament has delegated the task of rule making to the Australian Accounting Standards Board (AASB). Retaining reference to Australian Accounting Standards in the law together with retaining the function of the AASB act as safeguards to preserve the legislator's veto rights, while at the same time the Australian accounting standards are essentially equivalent to IFRS.

54 In the past, the U.S. and other large countries have exercised the right to opt out of certain rulings of international governing bodies like the United Nations, the World Trade Organization or the International Atomic Energy Agency.

future as its constituencies change and the future IASB membership includes greater representation of "inside stakeholder" economies.[55] This could result in a future incarnation of IFRS that is incompatible with U.S. institutions and may not meet the needs of U.S. investors and companies. Therefore, the U.S. must consider not only the current version of IFRS and the current structure of the IASB, but also how IFRS and the IASB will evolve in the future.

This evolution is likely to be influenced, among other things, by the growing importance of emerging markets like China, India and other developing nations. With the growing relative capitalization of these emerging markets, it is expected that investors and companies in these markets will command a greater say in future debates about firms' disclosure choices and accounting standards. That being said, it is also expected that investors' needs in those markets will more closely resemble the needs of U.S. investors, leading to a convergence of the systems. Regardless, capital markets in the U.S. will continue to claim a sizable share of and influence on world capital markets for years to come.

An additional concern is that foreign regulators provide interpretations of IFRS and implementation guidance. Therefore, U.S. firms and authorities would have to monitor the actions of multiple regulators and governing bodies around the world. Moreover, based on the experiences of other jurisdictions with the implementation of IFRS (e.g., KPMG, 2006; ICAEW, 2007; PwC/Ipsos MORI, 2007), U.S. firms are expected to rely on extant SEC and FASB guidance in cases where IFRS have gaps or are too vague, which could lead to fragmented international accounting practices. Thus, even if all countries adopt a single set of accounting standards, there will be strong forces

[55] One could argue that a refusal by the U.S. to adopt IFRS will accentuate this problem or trend. However, the sheer size of the U.S. economy, potential network benefits for non-U.S. firms, and the importance of the U.S. in the IASB's quest for truly global accounting standards could serve as mitigating factors, ensuring that the interests of U.S. investors are still considered even if the U.S. decides against IFRS adoption at this point (but keeps open the possibility to do so in the future).

toward local adaptation of IFRS and differences in the de-facto standards. It is important to note that these forces not only exist with respect to IFRS implementation at the firm level (as discussed in Sections 3, 4.2 and 4.3), but also at the country level with respect to local regulators and governing bodies.

From the preceding discussion, it is clear that the future roles of the SEC and the FASB need to be redefined if the U.S. adopts IFRS.[56] Aside from their involvement in the development of future standards, it is expected that both bodies would continue to weigh in on the implementation of IFRS (e.g., in the form of SEC Staff Accounting Bulletins or via the FASB's Emerging Issues Task Force). In addition, the SEC will play a role in the governance structure of the IASB as part of the newly approved Monitoring Group.

Moreover, SEC and FASB guidance could serve as instruments to require tighter disclosure standards for U.S. firms (e.g., in the areas of management compensation, board independence, etc.). Unlike specific recognition or valuation requirements, adding disclosure requirements on top of IFRS does not hurt comparability (at least not directly). They are rather a way to customize IFRS reporting to the U.S. environment, and enable the U.S. to lead the way in terms of corporate transparency, and to build on its competitive advantages. However, such supplementary disclosure requirements likely change firms' reporting incentives and, hence, indirectly affect firms' reporting practices, which in turn can hamper the comparability of U.S. financial reports. Thus, in thinking about additional

[56] In addition, there exist areas where current legislation in the U.S. may be inconsistent with IFRS or with delegating standard setting power to the IASB. For instance, under Section 108 of the Sarbanes-Oxley Act, the SEC retains the authority to establish accounting principles or standards for purposes of enforcement of U.S. securities laws and, unless the law is changed, the IASB would have to accept SEC oversight. Because many SEC rulings are specific to U.S. GAAP and have no IFRS counterparts, the SEC, in its roadmap, has started to identify areas which require changes in an IFRS regime and has proposed initial amendments to existing rules and forms (SEC, 2008). However, additional amendments and new guidelines will likely be necessary.

disclosure requirements, the key tradeoff is assuring an appropriate reporting quality in the U.S. versus achieving comparability of U.S. reports with the rest of the world.

If the goal is to follow this competitive strategy without sacrificing some of the comparability benefits discussed in Section 2, both the SEC and the FASB need to evaluate their interactions with the IASB and aim for more influence and cooperation. Close cooperation between the IASB and the FASB has intensified since 2002 with the signing of the Memorandum of Understanding. A switch to IFRS can potentially strengthen the U.S. influence. However, other countries could resist a high level of SEC or FASB involvement, and some already argue that the level of cooperation has become too intense (e.g., Chand and Cummings, 2008).[57] Aside from bolstering the capital-market and investor-orientation of IFRS, a strong U.S. influence could in the long run move IFRS closer to a system of standards that is similar in nature to current U.S. GAAP, i.e., a system where specific rules gradually supplant the more generic principles of existing IFRS.

Another widely recognized concern about the IASB is whether its present funding structure is appropriate (e.g., SEC, 2008). At the moment, private corporations instead of government entities provide the majority of funding on a voluntary basis. While switching to a more permanent source of funding can address certain resource constraints, there are also other issues to consider such as political influence, lobbying and holdup problems. On one hand, to maintain its independence, the IASB might consider expanding its own capacity and capabilities as currently it outsources much of its research to national standard setting boards. On the other hand, the IASB could retain its relatively lean organization and put the expertise of national standard setting bodies to use by delegating specific tasks to local authorities like the FASB and only assuming a coordination role. However, such a strategy would likely slow down the standard setting process and make it harder for

[57] Currently, three out of the 13 members of the IASB and five out of the 22 trustees of the IASC foundation have a U.S. background.

the IASB to resist the influence of local interest groups. As the future governance structure of the IASB is currently in flux, it is difficult to render opinions on the likely outcomes. However, lessons can be learned from the organizational and governance choices and resulting successes and failures of other international governing bodies such as the UN, World Bank, or OECD, as well as the current governance structure of the FASB. It seems that economic and political independence is an important guiding principle in institutionalizing a standard setting body that is responsive to the needs of investors and capital markets. Equally important is the role of an effective securities regulator that monitors the development and implementation of the standards, thereby providing strong incentives for transparent and truthful reporting.

Finally, a switch to IFRS by the U.S. also faces substantial political challenges within the U.S. The lobbying view of regulation suggests that various stakeholders will weigh in on the process depending on their benefits and costs from either maintaining the status quo or adopting IFRS. Therefore, various stakeholders have incentives to lobby for a particular agenda because the decision to adopt or forgo IFRS will have re-distributional effects across these stakeholders. For example, large multinational firms are likely to lobby in favor of IFRS adoption given the potential cost savings and comparability benefits from using a uniform set of standards throughout their global operations. International auditing and advisory firms are also likely to support IFRS adoption given their prior experience with IFRS in other countries and the significant revenues that a switch to IFRS will generate during the transition period. On the other hand, smaller local auditors or domestically-oriented U.S. firms may lobby against IFRS adoption. As such, the lobbying activities will provide useful information about the costs and benefits of various constituents, and undoubtedly influence the U.S. Congress in its decision on the future direction of U.S. financial reporting.

6. *Possible Future Scenarios for U.S. Accounting Standards*

In this section, we outline several possible scenarios for the evolution of financial reporting standards in the U.S. We discuss how the various economic and policy factors identified in this report will likely play out in each of the scenarios and highlight the interactions and tradeoffs between them. Towards this goal, the scenarios are intentionally stylized. It should also be noted that they are neither exhaustive nor mutually exclusive. Furthermore, our discussion should not be seen as advocating specific scenarios or actions.

As we outline the scenarios, we highlight: (i) possible outcomes for financial reporting quality and comparability, (ii) the role of incentives in determining financial reporting outcomes, (iii) how complementary institutions influence reporting outcomes and whether a scenario is compatible with existing U.S. institutions, (iv) potential transitional and long term costs of a scenario, and (v) policy and macroeconomic implications associated with a scenario.

The scenarios we discuss are: (1) maintain U.S. GAAP with acceptance of IFRS for foreign firms, (2) maintain U.S. GAAP with a new IASB-FASB agreement to accelerate convergence between IFRS and U.S. GAAP, (3) choice between IFRS and U.S. GAAP, but require reconciliation, (4) unrestricted choice between IFRS and U.S. GAAP, (5) "U.S. IFRS" – require IFRS for all firms plus an SEC/FASB overlay that provides guidance, additional disclosure requirements, and, in some cases, supplemental standards, (6) flexible timetable to fully adopt IFRS, and (7) International U.S. GAAP (I-GAAP) – a competing set of international standards (drawing on the foundation of U.S. GAAP) designed to meet the needs of the U.S. and other countries. Scenarios (1) through (6) can be viewed as an ordering from minimal to more extensive IFRS adoption. Scenario (7) is "outside the box", and suggests a more proactive U.S. strategy to influence the direction of regional and international financial reporting, disclosure and enforcement standards.

6.1. Maintain U.S. GAAP

This scenario maintains the requirement that U.S. firms file financial reports compliant with U.S. GAAP (which, at the present time, are different from IFRS). It is nevertheless dynamic because, consistent with past trends, both U.S. GAAP and IFRS will evolve and change in the future.[58]

We perceive the following issues and outcomes under the scenario where U.S. public companies continue to file reports under U.S. GAAP. First, the comparability of U.S. financial reports will likely *increase* internationally because more countries plan to adopt IFRS and differences between IFRS and U.S. GAAP are smaller than differences between U.S. GAAP and other countries' domestic GAAP. However, there will be residual differences among IFRS and U.S. GAAP and, hence, some comparability issues at the standard level remain. These differences in the standards likely impose some costs on both U.S. and foreign investors wishing to compare U.S. and foreign firms. Given the sheer size of the U.S. capital markets and the large number of U.S. firms, it is likely that foreign investors will, at least in the short and medium term, continue to maintain bilingual capabilities between IFRS and U.S. GAAP in this scenario. Conversely, growing IFRS adoption around the world suggests that U.S. investors must also develop and improve such bilingual capabilities. In addition, we expect institutional differences to persist across countries. These differences will continue to affect both firms' reporting incentives and reporting outcomes. Thus, even among IFRS countries, financial reports will not become fully comparable, requiring U.S. (and foreign) investors to understand the heterogeneity among institutions and reporting practices around the world.

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58 The recent financial crisis provides a good example of how accounting standards are affected by changes in capital market conditions and the political landscape.

Second, we expect the direct capital-market effects of maintaining U.S. GAAP (relative to a switch to IFRS) to be minimal. The reasons, established in Section 3, are that a switch to high-quality reporting standards has measurable effects *only* in countries where IFRS are a major improvement over the local standards and *only* if complementary institutions, like enforcement, change at the same time or at least support the introduction of IFRS. However, both of these conditions seem not to apply to the U.S. Current U.S. financial reporting is already of high quality, and we do not foresee a major change to U.S. enforcement institutions, which are among the strongest in the world, following a potential switch to IFRS.

Third and closely related to the above point, we do also not foresee major changes to the reporting incentives of domestic firms and foreign private issuers in the U.S. As highlighted in Section 3.1, incentives play an important role for financial reporting practices, arguably even more so than stated accounting standards. Hence, unless incentives fundamentally change, high-quality financial reporting in the U.S. persists regardless of IFRS adoption by the U.S. and accounting trends abroad. Similarly, the mere adoption of IFRS by other countries does not imply immediate improvements in the quality and comparability of foreign firms' financial reports.

Fourth, in the short to medium term, this scenario does not introduce major (incremental) adjustment costs. As discussed in Sections 3.2 and 4.5, the interplay between U.S. GAAP and other legal, regulatory, enforcement and private sector institutions in the U.S. have jointly evolved over time, creating a relatively efficient system of complementary checks and balances for financial reporting and other elements of the U.S. institutional framework. This system is expected to continue to operate relatively efficiently if U.S. GAAP continues to be used over the short to medium term.

Fifth, in the long run, the "maintain U.S. GAAP" scenario forgoes potential cost savings for some firms and (modest) comparability benefits for all U.S. firms (and investors) from moving to

IFRS. That is, for a select group of U.S. firms, costs are likely to be higher compared with an IFRS adoption scenario. This group comprises multinational firms that want or have to use IFRS for their foreign operations (see Section 4.4). A potential remedy is to allow an exemption for U.S. multinationals that (i) wish to report under IFRS, and (ii) have significant foreign operations.

Sixth, the macroeconomic outcomes of the "maintain U.S. GAAP" scenario are likely to be mixed. In the services area, financial and information intermediaries (auditors, analysts, etc.) have to maintain U.S. GAAP capabilities, presumably in close proximity to their U.S. client base, thereby reducing the risk of extensive off-shoring (see Section 4.6). Foreign financial intermediaries, on the other hand, would be at a competitive disadvantage. At the same time, U.S.-based service providers could suffer internationally because they lack specific or sufficient IFRS expertise. Thus, maintaining U.S. GAAP can be viewed as a non-tariff trade barrier between U.S. and foreign markets. In the education realm, U.S. GAAP capabilities keep their priority, but there would also be a demand for expanded IFRS offerings in the curriculum to meet the needs of international markets.

Seventh, maintaining U.S. GAAP allows U.S. legislators (i.e., Congress and the SEC) to retain unrestricted control over domestic financial reporting, and likely increases their bargaining power in future negotiations with the IASB. In addition, the maintaining U.S. GAAP could be seen as a way to promote competition between standard setting bodies.[59] However, as discussed in Section 5.1, competition among regional monopolies of accounting standards is likely limited. In addition, (i) foreign countries seem to be "voting for IFRS with their feet" suggesting that the current form of U.S. GAAP and the U.S. standard setting process do not meet the needs of other countries; and (ii)

[59] Alternatively, maintaining U.S. GAAP could be viewed as a way to maintain the convergence process between IFRS and U.S. GAAP, which arguably has been a force in the development of accounting standards as well. We discuss this aspect in Section 6.2.

the declining market share of U.S. GAAP could turn them into a marginal competitor in the international domain.

Finally, foreign countries are likely to perceive the U.S. as non-cooperative in a multilateral effort to harmonize accounting standards if it retains U.S. GAAP, which has political ramifications, potentially beyond accounting. However, it should be noted that maintaining U.S. GAAP in the near term does not rule out the pursuit of other scenarios in the future, and this scenario can therefore be viewed as a "deferral" option.

6.2. Maintain U.S. GAAP with Continued Convergence between IFRS and U.S. GAAP

This scenario also maintains the requirement that U.S. firms file financial reports compliant with U.S. GAAP but adds the element of accelerated convergence between IFRS and U.S. GAAP. In the short run, the first six issues from the pure "Maintain U.S. GAAP" scenario will likely also to apply to this scenario. However, many of the issues dissipate as U.S. GAAP and IFRS eventually converge. The key difference between this scenario and the earlier scenario is that U.S. authorities renew their commitment to the "convergence project" with the IASB in 2011. Additionally, the following issues become relevant.

First, in the near term, the SEC and FASB maintain their influence on U.S. financial reporting, possibly increasing their bargaining power in negotiations with the IASB relative to being simply one of many constituents of the IASB (see Section 5). In this scenario, some competition between the two sets of standards remains. However, it is likely to be considerably weaker due to the existence of a formal convergence process. Moreover, the beneficial effects of competing standards diminish as the remaining material differences between IFRS and U.S. GAAP disappear as part of the convergence project (see Section 6.1). Aside from competition, the convergence process itself can be a source for improvements in financial reporting standards, as it has been in the past. But again, this

force and the influence of the U.S. on future standards is likely to weaken over time, as the remaining differences between U.S. GAAP and IFRS become smaller.[60]

Second, this scenario can be viewed as a phased adoption of IFRS with substantial U.S. input on the eventual form of IFRS. As U.S. GAAP are slowly modified to converge with IFRS, U.S. stakeholders have sufficient time to adapt to the changes. This approach is likely less costly (in present value terms) and creates less extreme disruptions for firms, investors and the reporting infrastructure, reducing the aggregate transition costs (see Section 4.3). For instance, contractual agreements tied to accounting numbers do not have to be re-written immediately because U.S. GAAP gradually change over time. On the other hand, the benefits of reporting comparability will also be realized more slowly and there will be continuous changes due to the convergence process (beyond the normal rate of change in the accounting standards).

Third, this scenario gives rise to a number of implementation issues including (i) the extension of and changes to the Memorandum of Understanding between the FASB and the IASB, (ii) the resolution of disagreements between the two standard setting bodies on the convergence of more contentious standards, and (iii) the timeframe for the complete convergence of IFRS and U.S. GAAP.

6.3. Allow Choice between IFRS and U.S. GAAP, but Require Reconciliation

Historically, the SEC has required foreign private issuers to either file financial statements in accordance with U.S. GAAP or file their domestic GAAP reports together with 20-F reconciliations. In this scenario, we outline potential issues arising from allowing U.S. firms the *choice* between U.S. GAAP and IFRS with the *supplemental requirement* that firms opting for IFRS must provide reconciliations to U.S. GAAP.

60 Of course, standard setters could still aim to improve the accounting standards over time, but these improvements would be no longer driven by convergence per se.

The academic literature on the relevance of 20-F reconciliations for investors has produced mixed results (see Section 4.2). Thus, it is a priori not obvious whether reconciling from IFRS to U.S. GAAP improves investors' insights into U.S. firms' operations. However, the "optional IFRS plus reconciliation" scenario enhances the comparability of financial statements along two dimensions: (i) all U.S. firms have "comparable" U.S. GAAP statements, and (ii) the subset of U.S. firms that file primary reports under IFRS also has "comparable" statements with international firms reporting under IFRS. Yet, as pointed out before, the comparability applies only to the accounting standards themselves (see Section 3.1). Reporting incentives are likely to differ substantially not only across IFRS and U.S. GAAP firms, but also within each group. As a result, we do not expect reporting outcomes to be fully comparable, even for firms providing reconciled numbers, and the extent to which there are comparability benefits for firms and investors is difficult to predict.

Another argument in favor of reconciliation is that it disciplines the implementation of IFRS by mitigating incentives to use the discretion inherent in IFRS in an opportunistic fashion. The counter argument, however, is that firms could have incentives to minimize the reconciliation amounts they have to disclose, which in turn can reduce the quality of both IFRS and the reconciled U.S. GAAP numbers (Leuz, 2006). In a similar vein, it is precisely those firms that have to be "forced" to disclose more information via a reconciliation for which the reporting incentives are weak and, hence, the quality and informational value of the reconciliations are presumably low.

An argument in favor of reconciliation is that it educates investors about the differences between IFRS and U.S. GAAP and, hence, facilitates the long-run transition to an IFRS regime. Moreover, under this scenario all firms maintain some U.S. GAAP capabilities. If, at a future date, the SEC decides to reverse course and no longer permits IFRS for U.S. firms, there should be relatively few obstacles to reverting back to a U.S. GAAP regime.

It is important to also consider the costs of a reconciliation requirement. Firms face the tradeoff to choose the set of standards that delivers the highest net benefits, but, in case they choose IFRS, have to bear the costs of reconciliations. These costs are non-trivial, especially if reconciliation requires changes deep down in a firm's accounting system. In light of the SEC's recent ruling to waive the 20-F reconciliation requirements for foreign registrants reporting under IFRS, it is not obvious that the benefits of a reconciliation requirement outweigh the costs for domestic registrants.[61] There likely are firms for which reconciliations have net benefits, but those firms can voluntarily provide them to help investors understand the transition to IFRS. Given the additional cost burden, we expect only a select group of firms to exercise the option to use IFRS for their primary financial statements if reconciliation to U.S. GAAP is a prerequisite for IFRS adoption.

Finally, this scenario can be viewed as a transitional option leading to either unrestricted choice between U.S. GAAP and IFRS (Section 6.4) or mandated full adoption of IFRS (Section 6.5). It should be noted that there is also the converse path: allow both IFRS and U.S. GAAP, but require reconciliation to IFRS for U.S. GAAP filers. This option may be a reasonable alternative to full adoption of IFRS if (i) the U.S. intends to adopt IFRS in the long run, and (ii) many firms find that reconciliations to IFRS are not as costly as a full mandated adoption of IFRS.

6.4. Allow Unrestricted Choice between IFRS and U.S. GAAP

In general, the "unrestricted choice" scenario provides greater flexibility to U.S. firms and allows for firm-level competition between IFRS and U.S. GAAP within the U.S economy, which is likely to be far more effective than competition among regional monopolies. In addition to the issues that we have already discussed in Section 6.3, the following arguments apply.

[61] It should be noted that the situations are not exactly the same because U.S. firms already produce U.S. GAAP reports. Unlike foreign firms that intend to cross-list in the U.S., they do not have to build U.S. GAAP reporting capabilities from scratch and they always retain the option to revert to U.S. GAAP reporting.

The academic literature on voluntary disclosure (Section 2) argues that firms trade off the benefits and costs in making their financial reporting choices. On one hand, firms can make “low quality” reporting choices, but they ultimately bear the costs of these decisions, e.g., in the form of higher costs of capital or lower valuations. On the other hand, firms can strive for high quality reporting, but this choice comes with extra preparation and auditing costs and the revelation of sensitive information to outside parties and competitors. The evidence from academic studies suggests that firms carefully weigh these costs and benefits and, hence, allowing firms a choice of standards can be individually beneficial. However, doing so introduces non-comparability at the standard level in the sense that U.S. GAAP and IFRS reports co-exist among U.S. firms. But it is not clear that these negative comparability effects are large relative to the heterogeneity that exists among U.S. GAAP reports of U.S. firms, as suggested by the reporting incentives argument.

Moreover, it is important to ask about firms’ relevant peer group. If investors really want to compare a domestically-oriented U.S. firm to a multinational U.S. firm, then a switch of the international firm to IFRS reduces comparability. On the other hand, if the international firm is compared with its global peers, then the loss in comparability to purely domestic U.S. firms should not be an issue. While the reality probably lies somewhere in the middle, this example serves to highlight the tradeoff. Furthermore, it should be noted that potential inconsistencies among U.S. firms are mitigated by the fact that *all* U.S. firms continue to face U.S. legal and other institutions, that these factors have a major influence on firms’ reporting practices and, as such, serve as a force towards comparability among U.S. firms, regardless of the standards they follow.

The next issue is whether an economy with two sets of standards bears higher aggregate transaction and social costs than an economy with just one standard. For instance, under this scenario, the auditing industry must invest in dual auditing capabilities, potentially leading to overlap and inefficiencies. To mitigate these issues, the auditing industry is likely to segment itself into

large, multinational auditors specializing in IFRS and small, domestic auditors focusing on U.S. GAAP.[62] Investors also need to be able to understand the two sets of standards. In the U.S., however, investors are already exposed to differing accounting practices, e.g., by foreign firms cross-listed on a U.S. exchange or by private U.S. firms. Finally, the educational system needs to develop a comprehensive curriculum covering both IFRS and U.S. GAAP. Regardless, these bilingual capabilities are likely to exist considering that the rest of the world is moving toward IFRS.

As many of the benefits from moving to a single set of accounting standards come in the form of externalities and network effects, they require a sufficient number of participants and increase in network size (see Sections 2.2 and 4.2). With two standards co-existing in the U.S., some of these network benefits could disappear or become substantially smaller. However, this reduction in network benefits likely affects firms reporting under U.S. GAAP more than IFRS filers, as the latter benefit from joining the growing network of international firms using IFRS.

The "unrestricted choice" scenario enables competition in its purest form (see Section 5.1). Thus, it provides standard setters with a market-based mechanism to assess their accounting provisions. It can also be viewed as an intermediate stage leading to full IFRS adoption for all U.S. firms. If enough firms switch to IFRS, then maintaining two sets of accounting standards eventually becomes socially too expensive.

6.5. Adopt "U.S.-specific IFRS"

U.S. GAAP include but are not limited to the FASB's statements of financial accounting standards (SFAS), SEC guidance on the interpretation of these standards, and U.S. legal precedents that influence current and future accounting practices. Arguably, these extra-FASB elements of U.S.

62 Note that this could create additional non-comparability with regard to firms' *audited* financial statements.

GAAP are the result of the forces of the U.S. institutional environment, e.g., the demand created by the capital markets. It is expected that these institutional forces will continue to exist after the adoption of IFRS, leading to a “U.S.-specific IFRS” scenario. In this scenario, IFRS provide the foundations for U.S. accounting standards, but they are complemented by a SEC/FASB overlay of IFRS interpretations and implementation guidance, which may sometimes based on current U.S. GAAP concepts. In addition, there can be supplemental disclosure requirements and standards that augment IFRS.

An advantage of this scenario is that it moves U.S. firms closer to IFRS-compliant foreign filers in the U.S. and other international firms reporting under IFRS. However, the comparability is hurt by the additional SEC/FASB overlay because local adaptations and interpretations of IFRS are generally viewed as a step back in the global convergence process. But again, based on the incentives arguments outlined in section 3.1, it is important to recognize that other factors aside from the accounting standards are major determinants of financial reporting practices. As result, there will likely be heterogeneity in reporting practices regardless of local adaptations of IFRS, and even under “pure IFRS” adoption. Moreover, “U.S.-specific IFRS” is likely to result in a better fit with the U.S. institutional environment. This benefit mitigates and could even outweigh the potential drawbacks from a loss in comparability.

Recognizing that U.S. legal, regulatory, enforcement and private-sector institutions have evolved over time to create a well-functioning system, the “U.S.-specific IFRS” scenario could be viewed as compromise that draws on some of the features of IFRS but also maintains additional elements of U.S. GAAP that have a proven track record. That is, this scenario attempts to reduce institutional incompatibilities and, from a fit perspective, could be more workable in the U.S. than a set of “pure” IFRS (see also Section 4.5).

A U.S.-specific version of IFRS also induces some degree of competition and discipline into the standard setting process because the SEC and the FASB maintain the option to augment IFRS with "better" standards and disclosure requirements. The competition and discipline not only benefit U.S. firms and investors, but can also work the other way round as the IASB and foreign stock market regulators may wish to adopt the SEC/FASB supplemental accounting standards and disclosure rules. It may also strengthen the U.S. position in future considerations by the IASB regarding additions to or amendments of extant IFRS. Furthermore, we expect "U.S.-specific IFRS" to be more politically palatable given domestic concerns about ceding complete control over U.S. financial reporting to a foreign authority.

With respect to macroeconomic outcomes, the "U.S.-specific IFRS" scenario likely increases the competitive pressures on U.S. financial intermediaries (auditors, analysts, etc), given that the U.S. will, in large parts, adhere to IFRS standards and foreign service providers could be equally well equipped to render IFRS-related advisory services. On the other hand, U.S.-based service providers are in the medium term no longer at a disadvantage in international markets because of the IFRS capabilities they develop for their U.S. clients. In the area of education, IFRS training has to be complemented by knowledge of the additional standards applicable to U.S firms.

In terms of cost consequences, the "U.S.-specific IFRS" scenario should be less costly during the transition phase and in the long run than unconditional IFRS adoption to the extent that many of the elements of current U.S. GAAP and SEC disclosure requirements are carried over. A related issue is whether the SEC would require foreign private issuers in the U.S. to meet the same supplemental standards and disclosure rules as U.S. firms.

6.6. Set Conditional Timetable to Fully Adopt IFRS

If one views full adoption of IFRS by the U.S. as inevitable, then the only remaining issues relate to the implementation strategy and the adoption timetable. The SEC's "Roadmap" towards IFRS reporting by U.S. issuers (SEC, 2008) proposes a relatively rigid schedule, i.e., only a limited number of firms are allowed to adopt IFRS early and, once the SEC's decision in favor of IFRS is made, the transition dates for particular groups of firms are fixed. As an alternative, we consider a more flexible and conditional transition to IFRS. In this scenario, the decision and the timing of full IFRS adoption are endogenous.

We start with the observation that different firms face different costs and benefits of switching to IFRS (see Section 4.4). Clearly, certain U.S. firms would prefer to switch quickly to IFRS while others would rather delay IFRS adoption hoping that the transition costs decline. Hence, U.S. policymakers could consider a two-stage process of IFRS adoption. In the first stage (e.g., lasting up to 10 years), firms could voluntarily choose to switch to IFRS or keep reporting in accordance with U.S. GAAP. In the second stage, firms not yet reporting under IFRS would be required to switch, but only if certain pre-set conditions are met. Thus, the trigger for full adoption is endogenous in the sense that it depends on firms' decisions regarding IFRS adoption in the first stage. The key aspect of this transition model is that the move to IFRS is conditional on the (voluntary) adoption patterns of U.S. firms and, hence, a market outcome before the remainder of the firms is forced to adopt IFRS. It allows setting the timetable based on the observed adoption patterns. The underlying assumption is that the adoption patterns provide insights and further information on firms' cost-benefit tradeoffs and, hence, reveal the preferences of U.S. firms for IFRS adoption.

The two-stage approach has the potential to create positive cascade effects. Allowing low-cost-of-IFRS firms to adopt early can convey positive externalities on other firms that have not yet

switched. For instance, auditors learn how to smoothly transition to IFRS, which reduces the transition costs for firms that adopt IFRS at a later date.

On the other hand, the phased-in transition model could introduce uncertainties for firms, investors, and other stakeholders because the final decision and the timing of the mandated switch to IFRS are not fixed, but depend on firms' behavior.[63] To mitigate this uncertainty, policymakers could specify the terms of such a "flexible switch to IFRS" scenario by (i) allowing a certain group of large firms (e.g., S&P 500 firms) to choose between GAAP and IFRS in a pre-set timeframe (e.g., within three fiscal years), and (ii) setting a threshold that, if achieved, automatically triggers the next stage (e.g., if more than 50% of the large firms choose to adopt IFRS, then require adoption for the remaining large firms, else repeat stage one), which in essence allows firms and market participants to form and revise expectations about the likelihood of IFRS adoption.

Finally, we note that the initial set of firms that are given a choice of IFRS adoption should be chosen sufficiently large because the possible network benefits of a single set of standards arise only when a large fraction of firms adopt the new set of standards (see Section 4.2.2). Thus, the current SEC proposal that only makes a small number of firms eligible for early IFRS adoption could be self-defeating because the economies of scales and network effects will not be evident for such a small group.

6.7. Create International U.S. GAAP (I-GAAP)

The prior scenarios present various combinations of IFRS and U.S. GAAP. To conclude, we attempt to widen the accounting standards debate and offer another scenario that proposes a more

[63] In fact, there is also the possibility that IFRS may never become mandatory for all firms in the U.S., raising the issue of what "early IFRS adopters" are required to provide in the future. Even if they were allowed to continue to report under IFRS, this outcome may impose future costs on "early IFRS adopters" because they would be outliers in a U.S. market where the majority of other firms presumably still use U.S. GAAP.

proactive U.S. strategy to influence the direction of global financial reporting. In this scenario, the U.S. would help create a newly revised set of accounting standards, "International U.S GAAP" (I-GAAP), which can be adopted by other countries and, as such, competes with IFRS. We realize that there are few large countries left that have not committed to IFRS and that it would be difficult and costly for IFRS countries to switch to a yet another new set of accounting standards in the near term. However, we discuss the "I-GAAP" scenario primarily as a thought experiment to illustrate an interesting range of issues with IFRS and global accounting convergence.

First, a "one-size fits all" and truly global set of IFRS may (in the long-run) not meet the capital-market needs of the U.S. and other "outside investor" economies with similar capital markets and institutions (see Sections 4.1 and Section 5.2). Therefore, the U.S. could take the lead to develop a competing set of standards to meet the specific requirements of capital market-oriented economies. As U.S. GAAP would serve as basis for I-GAAP, they would have many features that are proven to be compatible with "outside investor" economies and compatible with U.S.-style institutions.

Second, in the past, many international companies voluntarily prepared their financial statements in accordance with U.S. GAAP. Thus, these companies viewed U.S. GAAP as a viable alternative to IFRS. However, foreign governments and regulators were reluctant to officially adopt U.S. GAAP as they have little direct influence and there is no formal representation on the FASB. In contrast, the IASB allows national regulators and constituencies to have a say in the formulation of IFRS (see Section 5.2). An "I-GAAP" scenario could address this problem by (i) avoiding the perception or reality of being a set of "U.S.-only" standards, (ii) creating accounting standards in consultation with other I-GAAP member countries, and (iii) opening up a reformulated FASB (an "I-FASB") to include representatives from other member countries.

Third, a critique of IFRS is that any country can adopt this set of high-quality standards regardless of their ability to properly implement and enforce them. As a consequence, the standards lose their ability to signal a country's quality of financial reporting (Ball, 2006). I-GAAP could overcome this problem and achieve credible high-quality reporting by admitting only countries that meet certain strict requirements with respect to the implementation, enforcement and auditing of financial reporting.

Fourth, the IASB includes representation from stakeholders around the world. A concern about the IASB is that, over time as other countries grow in importance, the influence of the U.S. and hence its say on the form of future IFRS would diminish (see Section 5.2). In contrast, I-GAAP and the I-FASB could be comprised of countries that have similar policy goals to those of the U.S.

Fifth, if the U.S. retains U.S. GAAP, it may become isolated from other countries in its accounting practices. Under the "I-GAAP" scenario, a broader set of countries could use the same set of accounting standards as the U.S., increasing potential network benefits. Moreover, because I-GAAP member countries also commit to certain implementation, enforcement and auditing requirements, the comparability of reporting practices among I-GAAP firms is further reinforced.

Finally, there are a number of potential limitations of the "I-GAAP" scenario. It can impede global convergence to a single set of accounting standards. Moreover, it might (i) encourage localized accounting cartels, (ii) reinforce regionalized financial markets, (iii) increase trade and investment barriers between regions, and (iv) could be perceived as giving the U.S. undue influence relative to other member countries. Nonetheless, we believe that the pros and cons of this scenario highlight important issues regarding the future of global accounting convergence.

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