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IFRS & GAAP: Reconciling Differences Between Accounting Systems and Assessing the Proposed Changes to the IFRS Constitution

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Abstract: The article begins by looking at the differences and similarities between different accounting systems, namely IFRS and GAAP. After this, the article moves on to talk about why it may be beneficial to the international investment community to have a singular account system as opposed to multiple different systems that have small, but weighty and significant differences. From here, the article discusses why convergence between the accounting systems may not be likely due to IFRS's goal of independence from influence by the United States. The article also walks through each amendment proposed to the IFRS Constitution and discusses how each of these changes will impact the convergence effort.

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I. INTRODUCTION

When evaluating a company's performance, evaluators look at many aspects of the business, including free cash flow, net assets, outstanding debt, revenue, and equity. One way to holistically evaluate a company's performance is to look at a company's financial statements and accounting books. Though this may be one of the best ways to learn about a company's financial health, it can be misleading due to differences in the accounting standards a company follows. Companies within one nation may conform to one set of accounting standards, but other companies in other nations may use other standards. Two of the most widely accepted accounting standards used in the international business community are Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS).

It is important to note that both GAAP and IFRS represent two of the most basic templates for accounting standards that countries adapt, with many countries promulgating their own versions of either accounting standard, albeit with small variations from country to country. Different variations of GAAP are used in different countries.[1] However, while each country's version of GAAP may be different, every country that uses GAAP has accounting standards which are substantially similar to one another. In spite of the nuanced differences in each of the accounting standards of each particular country, we will refer to the basic template as GAAP. Similarly, while each version of IFRS may be different, every

[1] For example, the United States uses US GAAP, India uses India GAAP, the United Kingdom UK GAAP.

country that uses IFRS has accounting standards substantially similar to one another. Because of the similarities in the accounting standards of the countries that use IFRS, we will refer to the basic template as IFRS.

The differences between IFRS and GAAP may be subtle, but distinctions between the two accounting methods can have weighty implications in evaluating the financial health of a company. This can impact internal matters such as a company's tax base as well as external substantive issues, including cross-border investment activity, investor misinformation, and cross-border transactions. Because of the potential impact of the differences between GAAP and IFRS, it could behoove the international business community to converge on a single set of accounting standards. Failing convergence, it would benefit the international business community to have companies "keep their financial records in accordance with accounting standards that are so similar that regulators and stock exchanges worldwide would accept financial statements prepared in accordance with differing accounting standards because the differences between standards would be very small."[2] While some argue that the differences between IFRS and GAAP are small and no convergence is needed, others still argue for a continued effort towards convergence because the existing differences are problematic.

The IFRS accounting standards are propagated by the IFRS Foundation, which acts in accordance with its own constitution. The IFRS Constitution undergoes changes every few years. Accordingly, the only way IFRS could be altered to further the convergence effort is through changes to its constitution. The IFRS Foundation is currently considering the implementation of changes to the IFRS Constitution that would impact the differences between IFRS and GAAP.[3] These changes to the IFRS Constitution would also effectively end any hope of efforts towards convergence between IFRS and GAAP.

While both accounting systems have similarities and differences, and while it is important for the international business community to reconcile the differences between the two systems, this paper will look at the proposed changes to the IFRS Constitution in 2016 and how those proposed changes will serve to increase the gap between these two vital accounting standards.

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[2] David S. Ruder, Charles T. Canfield & Hudson T. Hollister, *Creation of World Wide Accounting Standards: Convergence and Independence*, 25 NW. J. INT'L LAW & BUS. 513, 514 (2005).

[3] IFRS: Global Standards for the World Economy 2015 Review—Proposed Amendments to the Constitution, IFRS FOUND. (Jun. 10, 2016), http://archive.ifrs.org/About-us/IFRS-Foundation/Oversight/Trustees/Trustee-reviews-of-structure-and-effectiveness/2015-Review-of-Structure-and-Effectiveness/Pages/Proposed-amendments-to-the-Constitution.aspx.

II. IFRS & GAAP: THE DIFFERENCES

In order to understand why the changes to the IFRS Constitution will have any effect on the differences between IFRS and GAAP and why this matters, the reader must first understand the similarities and differences between IFRS and GAAP. While IFRS and GAAP are similar in many ways, the differences between the two systems can have weighty implications for the international business community. But in order to understand the differences between the two systems, we must first understand the similarities between them.

Commonalities

Both accounting systems are used by multinational corporations and other major financial entities that conduct cross-border transactions on a regular basis and often hold cross-border securities.[4] Looking at the generalities of both accounting standards, both IFRS and GAAP do not allow an entity to rectify inappropriate accounting policies by disclosing the accounting policies used by way of notes or explanatory material, which requires user organizations to properly and prominently display information pertinent to the identification of the reporting entity and other information that makes a financial statement easier to understand for the reader.[5] With regards to disclosures within a business's balance sheet, both accounting standards allow for an entity to disclose further sub-classifications of line items presented as classified in a manner appropriate to the entity's operations, either in the statement of financial position or in the notes.[6] Both accounting standards are also similar in how they allow entities to present information,[7] what they define as cash or a cash-equivalent asset,[8] how they allow companies to measure noncurrent assets classified as held for sale,[9] how they allow companies to address changes to a plan of selling an asset,[10] how they allow entities to deal with noncurrent assets to be abandoned,[11] how they allow companies to deal with a change in estimates in dealing with a change in accounting policies and correction of errors,[12] and how they allow entities to report initial recognition of PPE (property, plant, and

[4] A cross-border security is defined for the purposes of this paper as a security originating in one country and owned by a party in another country.

[5] International Accounting Standard ("IAS") 1.18; IAS 1.51.

[6] IAS 1.77.

[7] IAS 1.10A; Accounting Standards Codification ("ASC") 220-10-45-1.

[8] IAS 7.6, IAS 7.7; ASC Master Glossary, "Cash" and "Cash Equivalents".

[9] IFRS 5.15 and 5.15A; ASC 360-10-35-38 to 360-10-35-43.

[10] IFRS 5.26-.29 and 5.42; ASC 360-10-35-44 to 35-45, ASC 360-10-45-7.

[11] IFRS 5.32(a)-(c), 5.33-5.34, 5.13; ASC 205-20-45-15, ASC 205-20-35-47 to ASC 205-20-35-48.

[12] IAS 8.34-.38; ASC 250-10-45-17.

equipment) assets and their depreciation.[13] The two accounting systems are also similar in the way they allow capitalization of borrowing costs during extended delays in construction and once the asset is ready for use.[14] They are also similar in the way they allow recognition of an intangible asset acquired in a business combination at fair value separate from goodwill if separable or if it arises from contractual or other legal rights.[15] Other similarities also exist between the two accounting systems in the areas of impairment,[16] inventories,[17] lease liabilities,[18] accounting for income tax,[19] general recognition of revenue from a contractual transaction,[20] hedge accounting,[21] and other partially-converged issues such as dealing with Earnings Per Share (EPS).[22] The differences between these two accounting standards are simple to put into words, but much harder to thoroughly and fairly articulate and comprehend.

Differences

Many accountants consider the main difference between the two accounting systems to be straightforward: GAAP is a rules-based system whereas IFRS is a principles-based system.[23] IFRS consistently strives to incorporate the concept of reasonableness,[24] while GAAP provides accountants and preparers with a much more particularized set of requirements.[25] In one of their published documents, accountants at KPMG have noted that the goal of GAAP is accordance with GAAP regulations, while the goal of IFRS is to give a fair presentation of a company's financial position.[26] The lack of guidance and emphasis on substance under

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[13] IAS 16.6; ASC 360-10-05-3. *See also* IFRS Section 2.6; ASC 360-10-35-43.

[14] IAS 23.20, IAS 23.22; ASC 835-20-25-5.

[15] IAS 38.33-.37; ASC 805-20-25-10.

[16] GRANT THORNTON, COMPARISON BETWEEN U.S. GAAP AND IFRS STANDARDS, 46 (2016).

[17] *Id.* at 50.

[18] *Id.* at 54–67.

[19] *Id.* at 71. *See also id.* at 73-74, 84.

[20] *Id.* at 85–91.

[21] IAS 39.71-.102; ASC 815-20.

[22] GRANT THORNTON, *supra* note 16, at 195–212.

[23] GEORGE J. BENSTON ET AL., WORLDWIDE FINANCIAL REPORTING 214 (2006); Remi Forgeas, *Is IFRS That Different From U.S. GAAP?*, AICPA (June 16, 2008), http://www.ifrs.com/overview/General/differences.html.

[24] Lance J. Phillips, *The Implications of IFRS on the Functioning of the Securities and Antifraud Regime in the United States*, 108 MICH. L. REV. 603, 617-18 (2010).

[25] *See, e.g.*, Bert J. Zarb, *The Quest for Transparency in Financial Reporting: Should International Financial Reporting Standards Replace U.S. GAAP?*, 76 CPA J. 30, 32 (2006) ("U.S. GAAP consists of a set of complex and detailed accounting rules that leave little room for individual judgment").

[26] KPMG, *IFRS compared to U.S. GAAP: An Overview*, 8-9 (2008),

IFRS commonly requires management to employ estimates, assumptions, and judgment calls in financial reporting.[27]

Company revenue is one of the most important financial measures used by global investors when considering a business entity's financial health. How much money a business brings in is often indicative of a company's strength in a particular market sector and a company's strength in a given geographic location. It also allows a careful observer to learn at least a little about the financial health of the particular market sector and geographic location. This not only allows an investor to be more knowledgeable about the investment target itself, but also allows an investor to contextualize information about the investment target with respect to the market sector and geographic location in which the investment target operates. The significance of this information is often reflected in a financial statement.[28] Given this crucial importance of revenue in financial statements, it is important that companies globally have a singular standard of recognizing revenue across accounting standards. In a speech in March 2016, James Schnurr, Chief Accountant for the U.S. Securities and Exchange Commission (SEC), noted one of the major differences between GAAP and IFRS which is relevant to their different treatments of revenue:

> [GAAP] comprises broad revenue recognition concepts and numerous requirements for particular industries or transactions that can result in different accounting for economically similar transactions. While for IFRS, the current revenue recognition standards require significant judgment to apply [forcing] companies often to look to US GAAP for guidance when IFRS does not have specific guidance on point.[29]

The subjectivity and flexibility inherent in an individual's judgment being applied when a company prepares its financial statements according to IFRS[30] can have significant implications in representing a company's

http://contractualcfo.com/documents/KPMG_Comparison.US.GAAP.IFRS.pdf.

[27] *See* Navin Agrawal, *The Impact of IFRS on Corporate Governance*, MINT (Oct. 2, 2008), http://www.livemint.com/2008/10/02001719/The-impact-of-IFRS-on-corporat.html?d=1.

[28] Richard Loth, *Understanding the Income Statement*, INVESTOPEDIA (Nov. 30, 2015), http://www.investopedia.com/articles/04/022504.asp (explaining that while net income may be considered the singular most important piece of information for investors, profitability relies heavily on revenue, making revenue of equal importance to profitability, if not more important than profitability).

[29] James Schnurr, Chief Accountant, Office of the Chief Accountant, Sec. Exch. Comm'n, Remarks Before the 12th Annual Life Sciences Accounting and Reporting Congress (Mar. 22, 2016).

[30] In accordance with the IFRS's goal of being able to give investors a "fair overview" of

financial information to investors, government officials, and other companies, and cause the company's financial information to vary widely. In situations that deal with a service contract that is to be performed over multiple reporting periods, IFRS allows a company to recognize all the revenue up front upon partial performance. GAAP, on the other hand, "tak[es] the idea that revenues should be matched to expenses more seriously [and] amortizes these contracts over the period of service without up-front recognition."[31]

Another difference between the accounting standards is also succinctly articulated by Schnurr:

> In addition, I am particularly troubled by the extent and nature of the adjustments to arrive at alternative financial measures of profitability, as compared to net income, and alternative measures of cash generation, as compared to the measures of liquidity or cash generation. In my view, preparers should carefully consider whether significant adjustments to profitability outside of customary measures such as EBITDA or non-recurring items or other charges to the business, such as the sale of portions of the business in order to provide the user with an understanding of how these events impact trends and future performance, are appropriate. As it relates to cash measures, I believe those measures should be reconciled to cash flow from operations.[32]

Clearly, what the different accounting standards allow preparers to factor into a company's performance varies greatly. While one accounting standard allows for preparers to account for nonrecurring transactions such as the sale of part of a business in order to impact the depiction of a business's profitability, Schnurr argues that accounting standards should focus on recurring activities, such as sales, while distinguishing these from non-recurring activities so as to be able to better contextualize the company's performance for potential investors and help with understanding the impact of nonrecurring events on a business and its future.

GAAP "evolved as a system responsive to the demands of equity holders in U.S. financial markets," so it is oriented towards the income statement.[33] Accordingly, when GAAP requires an event to make an impact on the income statement, it flags the event for those wishing to valuate a company's financial health. On the other hand, IFRS favors the balance sheet due to its ties to block-holder regimes.[34] This reflects a great

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a company's financials (*see* KPMG, *supra* note 26), a thoroughly subjective responsibility.

[31] William W. Bratton & Lawrence A. Cunningham, *Treatment Differences and Political Realities in the GAAP-IFRS Debate*, 95 VA. L. REV. 989, 996 (2009).

[32] Schnurr, *supra* note 29.

[33] Bratton & Cunningham, *supra* note 31, at 996.

[34] *Id.*

influence on IFRS by its constituents, in particular bank creditors and employees.[35]

With respect to inventory accounting, GAAP is more flexible of the two accounting standards. In accounting, one must make an assumption about the order in which goods are sold. Goods are either sold in order of being produced or acquired,[36] or they are sold in reverse order of being produced or acquired.[37] In a situation where a seller is facing rising prices for his or her goods, FIFO "reflects economic reality on the balance sheet, listing inventories close to current values, while LIFO better reflects prevailing economics on the income statement with a figure for cost of goods sold reflecting current prices. GAAP permits companies to choose; IFRS, with its regime of balance sheet primacy, requires FIFO."[38]

A final difference between GAAP and IFRS is the different treatments given to the consolidation of special purpose entities by each accounting standard. A special purpose entity ("SPE") is an entity created by a company to carry out a specific purpose or transaction and is most commonly used as a method of keeping debt off a parent company's balance sheet.[39] After the Enron scandal, GAAP regulators decided to tighten the rules governing when a company must consolidate the financial statements of SPEs with its own.[40]

Statement of Financial Accounting Standards No. 140 ("FAS 140") governs the consolidation of SPEs under GAAP.[41] According to FAS 140, a business entity is required to consolidate the financials of a SPE unless all of the following conditions are met:

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[35] *See generally* Ruder, Canfield & Hollister, *supra* note 2 (positing the notion that accounting standards should be developed by a body that is independent and not beholden to any special interests since being beholden to special interests may lead to an increased risk of having many negative ramifications including falsification of financial information, misrepresentation, and investor fraud).

[36] The first in, first out (FIFO) method of inventory valuation is a cost flow assumption that the first goods purchased are also the first goods sold. In most companies, this assumption closely matches the actual flow of goods, and so is considered the most theoretically correct inventory valuation method.

[37] The last in, first out (LIFO) method of inventory valuation is a cost flow assumption that is used by many U.S. companies in moving the costs of products from inventory to the cost of goods sold. Under LIFO, the latest or more recent costs of products purchased or produced are the first costs expensed as the cost of goods sold.

[38] Bratton & Cunningham, *supra* note 31, at 997.

[39] Jalal Soroosh & Jack T. Ciesielski, *Accounting for Special Purpose Entities Revised: FASB Interpretation 46(R)*, 74 CPA J. 30, 30 (2004).

[40] *Id.* at 33 ("As the Enron crisis brought attention to the use of SPEs, FASB responded by issuing a proposed interpretation of existing accounting principles aimed at putting many off-balance-sheet entities back onto the balance sheet of the companies that created them.").

[41] FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 140: ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES (2000).

> (a) the assets transferred to the SPE have been isolated from the sponsor company, meaning they have been put beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership;
>
> (b) the SPE has the right to pledge or exchange the assets, and no condition constrains the SPE from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor; and
>
> (c) the transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the sponsor company to repurchase or redeem them before their maturity or (2) the ability to unilaterally cause the holder to return specific assets.[42]

It is important to note, however, that if the SPE is classified as a variable-interest entity ("VIE"), a parent company is always required to consolidate the financials of the SPE with its own.[43] According to FASB Interpretation No. 46(R) ("FIN 46(R)"),[44] a VIE is a SPE that meets at least one of the following additional criteria:

> (1) The equity investors lack the direct or indirect ability through voting rights or similar rights to make decisions about the entity's activities that have a significant effect on the success of the business;
>
> (2) The equity investors lack the obligation to absorb the expected losses of the entity;
>
> (3) The equity investors lack the right to receive the expected residual returns of the entity; and
>
> (4) The total equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties, including equity holders.[45]

With respect to the fourth criteria, an equity investment of less than ten percent is presumed insufficient to allow the SPE to finance its own activities; this presumption can be rebutted by proving one of three enumerated conditions.[46]

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[42] Phillips, *supra* note 24, at 623.

[43] Soroosh & Ciesielski, *supra* note 39, at 34.

[44] FIN. ACCOUNTING STANDARDS BD., FASB INTERPRETATION NO. 46: CONSOLIDATION OF VARIABLE INTEREST ENTITIES (2003).

[45] *Id.* at ¶5.

[46] The three conditions are the following: 1) "[t]he entity has demonstrated that it can finance its activities without additional subordinated financial support"; 2) "[t]he entity has

IFRS rules regarding consolidating SPEs are much less detailed than GAAP. This reflects the principles-based approach of IFRS. According to International Accounting Standard No. 27 ("IAS 27"),[47] a company must consolidate a SPE's financial information into its own financial statements if the SPE is subject to the company's "control."[48] Control is presumed if the company owns more than half of the voting power of an SPE, but can also be established if the parent company appears to obtain the benefits of the SPE's operations, the parent company retains the decision-making powers sufficient to obtain the benefits of the SPE's operations, or the parent company otherwise has the right to obtain the benefits of the SPE's operations, which in turn also exposes the parent company to the risks incident to the SPE's activities.[49] Though the one-half voting power rule is relatively straightforward, other indicators of control may be a bit more vague, which can allow a parent company's management body considerable discretion in how it classifies SPEs.

Revenue recognition from nonrecurring activities, inventory measures, and treatment of SPEs are just some of the ways that the two lead accounting standards in the world differ from one another. Because of their respective approaches, a careful reader can infer that there is room for confusion and different outcomes when taking a given company's financial information and preparing separate financial statements according to IFRS and GAAP.

III. WHY CONVERGE?

Given the differences in the accounting systems, the question of convergence turns from a positive one, a question of "what is?", to a normative one, a question of "what should be?" What should the international business community do to reconcile the differences between GAAP and IFRS so as to be able to give global investors the best and most holistic information that they need in order to make the best business decisions?

Over the past few years, the SEC has pushed hard for a convergence between the two accounting systems while others have also considered the effects of a converged accounting system or even a single accounting

at least as much equity invested as [comparable] entities that hold only similar assets of similar quality in similar amounts and operate with no additional subordinated financial support"; and 3) "[t]he amount of equity invested in the entity exceeds the . . . entity's expected losses based on reasonable quantitative evidence." *Id.* at ¶9.

47 INT'L FIN. REPORTING STANDARDS FOUND., INT'L ACCOUNTING STANDARD NO. 27: CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS (rev. 2008).

48 *Id.*

49 Phillips, *supra* note 24, at 624.

system on multinational corporations and global investment.[50] [51] The Council of the European Union has also stated how important it thinks the goal of convergence is for the sake of competitiveness of the capital markets.[52] In 1997, the SEC noted that companies wishing to raise capital in multiple countries were required to prepare multiple sets of financial statements to comply with different jurisdictional accounting requirements, increasing compliance costs and creating inefficiencies.[53] Discussions between FASB and IASB in 2002 resulted in a plan towards convergence, known as the "Norwalk Agreement."[54] The Norwalk Agreement recorded the understanding between FASB and IASB to use their best efforts to make their existing financial reporting standards fully compatible with each other as soon as practicable and to coordinate their future action to ensure compatibility would be maintained once achieved.[55] The Norwalk Agreement outlined a number of action steps that both IASB and FASB would implement as soon as practicable on matters such as revenue recognition, consolidations, and fair value measurement in order to achieve convergence.[56] As of 2009, some expected that the U.S. would begin a transition toward IFRS through small, thoroughly reviewed steps with an end-goal of complete adoption.[57] With a number of important projects expected along with a limited trial period overseen by the SEC to have been completed by 2011, FASB was expected to decide whether to adopt a mandatory switch to IFRS from GAAP accounting in 2011.[58] No such

[50] James M. Lukenda & Michael Scannella, *International Financial Reporting Standards: Hello Accounting Convergence, Goodbye, GAAP?*, 28.3 AM. BANKR. INST. J. 22, 22 (2009) ("The initial stages for this convergence began in 1988, when the SEC encouraged international efforts to develop a core set of accounting standards.").

[51] *See also* Tyler Weigel, Comment, *A New Universal Language?: An Overview of Adopting The International Financial Reporting Standards in the United States*, 80 UMKC L. REV. 1239 (2012) (considering the effects on domestic corporations if the SEC conformed to the majority of the global business community and adopted IFRS); Kyle Pine, Comment, *Lowering the Cost of Rent: How IFRS and the Convergence of Corporate Governance Standards Can Help Foreign Issuers Raise Capital in the United States and Abroad*, 30 NW. J. INT'L L. & BUS. 483, 486 (2010) ("Thus, there is an overall benefit created by the convergence in high-quality regulatory standards in that it equalizes the cost of compliance across jurisdictions while still maintaining the benefits to firms attributed to the bonding theory.").

[52] Regulation 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the Application of International Accounting Standards, 2002 O.J. (L 243) 1, 1-4.

[53] Lukenda & Scannella, *supra* note 50.

[54] FIN. ACCOUNTING STANDARDS BD., COMPLETING THE FEBRUARY 2006 MEMORANDUM OF UNDERSTANDING: A PROGRESS REPORT AND TIMETABLE FOR COMPLETION (2008), http://www.fasb.org/intl/MOU_09-11-08.pdf.

[55] Lukenda & Scannella, *supra* note 50.

[56] Completing the February 2006 Memorandum of Understanding, *supra* note 54.

[57] *See* Lukenda & Scannella, *supra* note 50.

[58] Completing the February 2006 Memorandum of Understanding, *supra* note 54.

switch occurred.

Still, FASB was committed to achieving convergence, recognizing that "securities regulators around the world have an interest in ensuring that high quality, comprehensive information is available to investors in all markets."[59] In order to provide such comprehensive information to American investors while also allowing foreign investors to better understand the financial information underlying American businesses, some urged that IFRS must be adopted in the United States even after the expected convergence date of 2011 elapsed.[60] The SEC acknowledged that "capital markets have become increasingly global, [and] U.S. investors have a corresponding increase in international investment opportunities."[61] Such a statement by SEC could be perceived as one that acknowledged a market demand for IFRS, given the fact that two-thirds of American investors owned securities of foreign companies in 2008.[62] As a more globalized world economy emerges, the demand for a truly globalized accounting standard will only increase. As former SEC Chairman Christopher Cox remarked, "[h]aving a set of globally accepted accounting standards is critical to the rapidly accelerating global integration of the world's capital markets."[63]

The SEC currently (as of 2017) recognizes the importance of a converged accounting standard, if not a singular accounting standard. In his 2016 speech, SEC Chief Accountant Schnurr discussed the new guidance that FASB issued in May 2014 and how the new guidance was intended to "improve existing revenue requirements by eliminating industry-specific guidance, provide a more robust framework for addressing revenue issues, and require additional disclosures to users of financial statements."[64] Schnurr clarified his comment regarding the robust framework for addressing revenue issues. Under the new revenue guidance, "variable pricing terms, such as performance bonuses, milestone payments, and

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[59] SEC. EXCH. COMM'N, SEC Concept Release No. 33-7801, 34-42430, 65 Fed. Reg. 8,897 (Feb. 16, 2000), http://www.sec.gov/rules/concept/34-42430.htm.

[60] Weigel, *supra* note 51.

[61] Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers, Exchange Act Release No. 33-8982, 73 Fed. Reg. 70,817 (proposed Nov. 21, 2008), http://www.sec.gov/rules/proposed/2008/33-8982.pdf.

[62] Press Release, Sec. Exch. Comm'n, SEC Proposes Roadmap Toward Global Accounting Standards to Help Investors Compare Financial Information More Easily (Aug. 27, 2008), http://www.sec.gov/news/press/2008/2008-184.htm ("The increasing integration of the world's capital markets, which has resulted in two-thirds of U.S. investors owning securities issued by foreign companies that report their financial information using IFRS, has made the establishment of a single set of high quality accounting standards a matter of growing importance.").

[63] James S. Turley, *Mind the GAAP*, WALL ST. J., Nov. 9, 2007, at A18.

[64] Schnurr, *supra* note 29.

guarantees, will need to be re-evaluated as the timing of revenue recognition and content of disclosures could differ as compared to current U.S. GAAP" and that the core principle of the new revenue recognition standard was to be that "companies will recognize revenue to depict the transfer of promised goods to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for goods." Private businesses tend to use the cash basis method for simplicity's sake because the SEC does not require such businesses to strictly adhere to GAAP accounting standards.[65] Accordingly, this movement towards a blanket approach to an accrual basis of accounting depicts an effort towards convergence by FASB.

IV. INDEPENDENCE

Independence is a key concern when considering either convergence or adopting IFRS. An effective accounting standard ought to be independent of outside commercial and government influence, allowing it to maintain integrity and high quality.[66] This does not mean however, that the entity creating the accounting standards does not consult any other entity to help form the creating entity's opinion. In fact, the creating entity "must engage in [such consultation] seeking the views of the affected parties, including businesses, so that the standards they create will not have unintended consequences."[67]

In adopting IFRS for the United States, or even moving towards the IFRS standard by way of convergence, regulators such as the SEC and FASB must make sure that the accounting standard the regulators are adopting or converging towards maintains its independence. While independence is the goal to strive for, an accounting standard should also reflect the ideals and goals inherent to the accounting standard of the constituents it serves. In understanding the issue of IASB's independence, it is important to recall what was said earlier—that IFRS is a principles-based accounting standard with a focus on a company's balance sheet whereas GAAP is a rules-based accounting standard with a focus on a company's income statement.[68]

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[65] Sean Ross, *Why Does GAAP Require Accrual Basis Rather Than Cash Accounting?*, INVESTOPEDIA (Jan. 13, 2015), http://www.investopedia.com/ask/answers/011315/why-does-gaap-require-accrual-basis-rather-cash-accounting.asp.

[66] *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984) ("The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.").

[67] Ruder, Canfield & Hollister, *supra* note 2, at 517.

[68] Bratton & Cunningham, *supra* note 31, at 996.

Creating FASB

FASB was created thirty-five years ago as a result of the American Institute of Certified Public Accountants ("AICPA") taking the lead[69] to create a responsive standard-setting entity without ceding territory to a federal agency.[70] In the process, AICPA also allowed input from organizations and individuals representing management and the financial sector.[71] Because the relevant federal agencies were thought to be dominated by progressive, anti-corporate types, the private sector had a strong incentive to keep the federal government out of the industry's self-regulation.[72]

The goal was to maintain public legitimacy, making it important for FASB to maintain independence and remain above political pressure[73] while still maintaining a sense of responsiveness to its constituents.[74] Thus, FASB became a board selected by an independent foundation, with the foundation being populated with constituents and a monitoring advisory body, which was also populated with constituents.[75] IASB has become a similarly structured body with a larger size and wider geographic distribution.[76]

FASB's, and by extension IASB's, governance model lends itself to a "middle way" that subjects itself to numerous political objections from both the right and the left: conservative public choice commentators denounce the industry regulating body calling it a rent-seeking scam[77] while

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[69] Ronald King & Gregory Waymire, *Accounting Standard-Setting Institutions and the Governance of Incomplete Contracts*, 9 J. ACCT. AUDITING & FIN. 579, 585-86 (1994).

[70] The federal securities laws directed the SEC to prescribe the form and content of financial statements. *See generally* Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77, 77s (2012)).

[71] ROBERT VAN RIPER, SETTING STANDARDS FOR FINANCIAL REPORTING: FASB AND THE STRUGGLE FOR CONTROL OF A CRITICAL PROCESS 8-9 (1994); Mohamed Elmuttassim Hussein & J. Edward Ketz, *Accounting Standards-Setting in the U.S.: An Analysis of Power and Social Exchange*, 10 J. ACCT. & PUB. POL'Y 59, 76 (1991).

[72] VAN RIPER, *supra* note 71, at 9.

[73] VAN RIPER, *supra* note 71, at 9.

[74] *See* ROBERT CHATOV, CORPORATE FINANCIAL REPORTING: PUBLIC OR PRIVATE CONTROL? 232-39 (1975).

[75] VAN RIPER, *supra* note 71, at 13-18.

[76] Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards, 72 Fed. Reg. 45,600, 45,605 (proposed Aug. 14, 2007); *see also Who We Are and What We Do: The IFRS Foundation and the International Accounting Standards Board*, IFRS FOUND., *http://www.ifrs.org/-/media/feature/about-us/who-we-are/who-we-are-english.pdf* (last visited Aug. 31, 2017).

[77] According to conservative criticism, FASB should have operated as a private standard setter subject to free competition instead of serving as a conduit to federal regulation while also mandating rents to auditing firms. *See* Ross L. Watts & Jerold L. Zimmerman, *The Demand for and Supply of Accounting Theories: The Market for Excuses*, 54 ACCT. REV.

progressive pluralists criticize it claiming that the standard-setting entity should be an agency directly responsible to a larger, overseeing legislative body.[78] Applying this already heavily-criticized model of governance to IASB arguably makes things worse, because it removes a political subject matter to a distant venue in which U.S. domestic concerns occupy, at best, a secondary place on the agenda.[79] Perhaps this is why efforts to adopt IFRS instead of GAAP have failed repeatedly. Convergence also requires some degree of synchronization of goals so as to make both accounting standards seamlessly compatible with each other without complete repudiation and rejection by constituents of either accounting standard. To see whether IASB's composition would allow IFRS to move in this direction, we must look at IASB's composition.[80]

The Committees

The IFRS Foundation is divided into the IFRS Monitoring Board and the IFRS Advisory Council with the Monitoring Board taking a more outward-facing role in the organization's operations. The IFRS Advisory Council is comprised of the IFRS Foundation Trustees, the International Accounting Standards Board, and the IFRS Interpretations Committee. IASB is comprised of eight formal advisory bodies: Accounting Standards Advisory Forum, Capital Markets Advisory Committee, Consultative Groups, Emerging Economies Group, Global Preparers Forum, SME Implementation Group, IFRS Transition Resource Group for Impairment of Financial Instruments (ITG), and Transition Resource Group for Revenue Recognition (TRG).[81]

273, 275-81 (1979). Applying this oft-criticized FASB governance model to a global platform does not solve for this issue, but rather, simply takes the problem to a global level with the IASB governance model serving as a conduit to multiple national regulation agencies exacerbating the problem. Bratton & Cunningham, *supra* note 31, at 1000.

[78] Bratton & Cunningham, *supra* note 31, at 1000. Liberals believe that standard-setting is a high stakes game in which the setter has no alternative but to balance interests, a political role. Accordingly, the standard-setter's legitimacy depends on political responsiveness. FASB could not provide this responsiveness at inception because it depended on contributions from the preparers and auditors, groups with high stakes in all of its outcomes. *Id*.

[79] Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers, *supra* note 61, at 70,846-84 7 (recognizing that substitution of IFRS for GAAP implies diminished influence for American interests).

[80] The focus is on whether IFRS could move towards convergence because if IFRS cannot move towards convergence, any convergence effort would essentially amount to GAAP unilaterally shifting towards replicating IFRS. *See* Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers, *supra* note 61, at 846-47 (discussing why IFRS would not be feasible in the United States).

[81] *IFRS Consultative Bodies*, IFRS FOUND., http://www.ifrs.org/about-us/consultative-

Of the eight advisory bodies, "Consultative Groups" breaks down into eight subgroups, each with a particular focus. When viewed as a whole, the remaining seven are dominated by European membership, leaving little room for an American presence, much less a North American one. To contextualize, of the eight advisory bodies, there are only two advisory bodies where the American contingency is not outweighed by its European counterpart. One of these two groups is the Emerging Economies Group. Of the fourteen members in this group, there are no Europeans. The group had one U.S. citizen who served as Chairman of the group, who recently died. The position has remained empty since November 14, 2016. Perhaps it is fitting that this group is not dominated by either European or American presence as the purpose of the group, as the name suggests, is to serve the interests of emerging economies, and neither the United States nor the major European players qualify as "emerging" economies.

The only other formal advisory body where a European presence does not outweigh an American presence is the Transition Resource Group for Revenue Recognition, where there are twelve Americans and only ten Europeans. This group is comprised of twenty-seven individuals, providing the American contingency a slight plurality advantage. Recall that we previously discussed the fact that the SEC and GAAP have taken steps towards convergence with IFRS on the matter of revenue recognition. This is important to note because it may be indicative of what the United States needs in order for its voice to be heard by a formal IASB advisory body so as to be able to turn the dream of convergence into a reality.

Setting aside the Emerging Economies Group and the Transition Resource Group for Revenue Recognition leaves six advisory bodies. The Accounting Standards Advisory Forum is comprised of twelve individuals, three of which are European and three of which are from the Americas. Note that this encompasses North and South America, leaving some of the world's largest economies and the largest emerging economies to fight over three seats on the advisory body, which serves the purpose of achieving IASB's "goal of developing globally accepted high-quality accounting standards."[82] Of the 210 members on the remaining advisory committees and consultative groups, seventy-five are European while twenty-eight are American. The disparity between nationalities of the individuals that make up IASB across the groups and committees is rather indicative of the struggle that the United States currently faces in order to encourage IFRS towards convergence. Moving forward, it is important to remember that this struggle is only for the status quo and does not account for the changes that

bodies/ (last visited Aug. 31, 2017).

[82] *About the Accounting Standards Advisory Forum*, IFRS FOUND., http://www.ifrs.org/groups/accounting-standards-advisory-forum/#about (last visited Aug. 25, 2017).

are currently being proposed to the IFRS Constitution.

V. CHANGES IN THE IFRS CONSTITUTION

While we have outlined the logistical and hierarchical structure of IASB, the entire entity is actually governed by a constitution that was originally published in its original form by the Board of the former International Accounting Standards Committee (IASC) in March 2000 and by the IASB members at a meeting in Edinburgh on May 24, 2000.[83] Trustees were nominated by a Nominating Committee on May 22, 2000 and assumed their office on May 24, 2000, as a result of the approval of the Constitution.[84] These Trustees formed the IFRS Foundation on February 6, 2001.[85] In order for the IFRS accounting standard to remain flexible, dynamic, and responsive to its subscribers' needs, the Trustees have been amending the Constitution since its original enactment. The Constitution requires the Trustees to review the Constitution every five years.[86] The first mandatory constitution review was commenced by the Trustees in November 2003 and was concluded in 2005.[87]

Currently, the IFRS Foundation has proposed new amendments to the IFRS Constitution, by which IASB would abide. Far from convergence, these changes will serve to increase the divergence between IFRS and GAAP as accounting standards by decreasing the North American contingency, thereby decreasing the group of American representatives within IASB. But simply eliminating American influence on IFRS by banning Americans from IASB would be too blunt and bold of a political statement. Instead, by enacting amendments to the IFRS Constitution that would allow the IFRS Foundation to effectively squeeze out American representatives, the IFRS Foundation will be foreclosing any meaningful chance for convergence between IFRS and GAAP. The proposed changes are likely to widen the gap between the two accounting systems.

Amendments

As currently composed, the IASB Trustees are appointed from a talented pool with a restriction on the geographic location of where the Trustees may come from. Six of the Trustees are appointed from the Asia/Oceania region, six from Europe, six from North America, one from Africa, one from South America, and two Trustees can be appointed from

[83] *IFRS Foundation Constitution*, IFRS FOUND., at 4 (Dec. 1, 2016), http://www.ifrs.org/-/media/feature/about-us/legal-and-governance/constitution-docs/ifrs-foundation-constitution.pdf.

[84] *Id.*

[85] *Id.* at 4.

[86] *Id.*

[87] *Id.*

"any area, subject to maintaining overall geographical balance."[88] One of the proposed changes would decrease American presence on IASB by changing the geographic breakdown of where the Trustees may currently come from by decreasing the six Trustee seats designated for North America, one seat for South America, and two at-large seats to six Trustee seats designated for "the Americas" and three at-large seats. The three at-large seats can be filled at discretion. While it is uncertain as to who would have the discretionary power to fill the at-large seats, this power could reside with the entirety of the Board or with the Chair. In either situation, it makes sense for these seats to be filled with individuals who favor IFRS, its independence from American influence, and a principles-based approach to accounting where what is fair is more important than providing complete information to investors. This shifts the composition of the Board to be more Eurocentric, causing Americans to have less say on IASB Board of Trustees. While other outcomes are possible, this shift in the geographic breakdown would most likely translate to fewer voices that can advocate for convergence.

Another proposed change to the IFRS Foundation Constitution is with regard to a Trustee's professional background. Section 7 of the Constitution currently states that "[n]ormally, two of the Trustees shall be senior partners of prominent international accounting firms."[89] The proposed changes seek to eliminate the quoted provision, which serves as a soft requirement to serving as a Trustee. This would effectively lower the qualifications for two of the Trustee positions. To get a better understanding of why this amendment matters, we must look at prominent international accounting firms and the geographic location of their proverbial brain center. Of the "Big Four"[90] accounting firms, PricewaterhouseCoopers (PwC) and Deloitte are headquartered in the U.S. Meanwhile, the Ernst & Young ("EY") Global Chairman and CEO is located in Washington D.C., while KPMG's International Chairman is seated in New York and both are headquartered elsewhere.[91] PwC and Deloitte still have large European offices, while KMPG and EY are headquartered in Europe, IFRS's geopolitical territory. Of the next five most prominent international accounting firms, Baker Tilly, BDO, Grant Thornton, Mazars, and RSM, Grant Thornton is headquartered in Chicago. The rest are headquartered in Europe. While IASB already had a large pool of qualified candidates from which to select potential Trustees, eliminating the soft requirement of two

[88] *Proposed Amendments to the IFRS Foundation Constitution*, IFRS FOUND., at 7 (Jun. 2016), http://www.ifrs.org/-/media/project/2015-trustees-review/exposure-draft/published -documents/ed-proposed-amendments-to-constitution.pdf.

[89] *Id.* at 10.

[90] KPMG, PwC, Deloitte, and Ernst & Young.

[91] Presumably, a business's proverbial brain and muscle is housed in its headquarters.

senior partners significantly increases the size of this candidate pool.

While some may argue that this amendment can lead to more senior partners serving as Trustees, this end-goal could have been achieved without the proposed amendment. Alternatively, the proposed amendment could have simply abolished the number of trustees that would normally be senior partners at prominent international accounting firms. While anyone who offers a reason as to why this amendment is being proposed would likely be speculating, one reason may be a desire to increase the amount of candidates who may be slightly less qualified than the individuals they would be replacing, but may be more susceptible to European influence.

The amendments discussed above are relevant to the Trustees. Some may say that geographical distribution is less important at the Trustee level as it pertains to convergence efforts. After all, the actual accounting standard is set by IASB.[92] While this may be accurate, proposed amendments to the IFRS Constitution do not leave IASB untouched. One proposed amendment serves to reduce North American presence on IASB, as well.[93] This amendment would once again merge seats designated for North Americans and seats designated for South Americans and have this reduced number of seats be designated to "the Americas," while also reducing the number of discretionary at large positions.[94] Sixteen members currently comprise IASB, with four seats each designated to the Asia/Oceania region, Europe, and North America, one seat designated to Africa, one to South America, and another two reserved for at-large members again, subject to maintaining overall geographical balance.[95] Similar to the effect the proposed amendment will have on the geographical distribution of the Trustees if enacted, this proposed amendment would consolidate Board seats designated for North America and South America while also reducing the number of at-large appointments possible to just one.

Because there are more international economic players than just the United States in North America, U.S. presence on the IASB was already diluted. Consolidating the North American and South American Board seats serves to doubly dilute U.S. presence on the IASB. While some may argue that the IASB can opt to appoint a U.S. national to the at-large position, the opposite is also true—IASB can also fill the at-large position with someone who does not favor convergence. As currently composed, the IASB's two at-large positions are filled: one by a European Chairman and one by a

[92] *About the International Accounting Standards Board*, IFRS FOUND., http://www.ifrs.org/groups/international-accounting-standards-board/#about (last visited Aug. 25, 2017).

[93] *Proposed Amendments to the IFRS Foundation Constitution*, *supra* note 88, at 15-18.

[94] *Id.*

[95] *Id.* at 18.

Canadian Vice-Chair, showing a clear willingness to fill the potential at-large seats with individuals from countries that subscribe to IFRS and not GAAP. The proposed amendment would serve to shift the Board's composition to be more Eurocentric, leaving fewer voices advocating for convergence.

Another proposed amendment deals with the length of the renewable term. Currently, a Board member serves for a term of five years with a renewable three-year term. The proposed change reduces the renewable term to a possibility while also adjusting the term length from a guaranteed three years to a term that could span anywhere from three to five years, subject to procedures to be developed by a Eurocentric Board of Trustees.[96] This proposed amendment effectively allows the Trustees the ability to elongate the renewable term period of European members to five years while being able to keep the renewable term period of U.S. members at three years. This encourages continuity of European board members, allowing them the best possible opportunity to see projects through to completion. It also keeps the matter of convergence away by effectively enacting a potentially staggered Board. Enacting a system that potentially allows term lengths for some Board members, including pro-convergence Board members, to be limited to three years while allowing term lengths for other Board members, potentially including anti-convergence Board members, to run for a length of eight years encourages non-convergence between IFRS and GAAP, if not divergence.

Proposal Nine seeks to alter the voting requirements by decreasing the number of minimum votes required while simultaneously increasing the percentage of votes required to publish a Standard or an Interpretation. Currently, a measure must be approved by nine members when the Board is comprised of fewer than sixteen members and by ten members when Board is comprised of exactly sixteen members. This equates to an affirmative vote by at least sixty percent of the Board when there are fourteen or fifteen members on the Board or approximately sixty-three percent when a Board is fully occupied. If it passes, the amendment would require any measure, Standard or Interpretation, to be approved by eight Board members if the Board is comprised of fewer than thirteen individuals and nine Board members if there are thirteen or fourteen members on the Board. This equates to approximately sixty-seven percent of the Board or more when there are fewer than thirteen Board members or sixty-nine percent when there are fourteen members on the Board. While this decreases the number of votes required, every measure being considered must be approved by a proportion of Board members closer to unanimity than would be required without this amendment being enacted.

Barring a sudden and sharp shift in ideologies, this amendment would

[96] *Proposed Amendments to the IFRS Foundation Constitution*, *supra* note 88, at 19-20.

render controversial measures including convergence essentially doomed to fail if Board members vote according to "party lines." The current Constitution requires the North American voting bloc of four votes to secure the South American vote, African vote, and the Asian/Oceanic voting bloc, depending on whether the at-large seats are filled and availability of the at-large vote, assuming that the European bloc would categorically vote against any convergence measure. If the proposed amendment is enacted, it would require the diluted U.S. voting bloc to first secure the votes of other Board members from the Americas and then to secure at least the entirety of the Asian/Oceanic voting bloc of four votes and the at-large vote when the at-large seat is filled. If the at-large seat is occupied by an individual who is partial to IFRS's principle-based approach to accounting standards, no convergence measure led by a diluted U.S. voting bloc will be passed, assuming votes are cast according to party lines. Accordingly, this amendment would provide Europeans and other individuals with preferences for independence from U.S. influence and for IFRS's principle-based approach to accounting standards an added incentive to fill the at-large position with a like-minded individual. With the at-large position filled and its vote secured, the European bloc would only need four votes from any Board members in order to pass Standards or Interpretations. Such a heavily-tilted Board safeguards European interests of independence from U.S. influence on the IASB and keeps IFRS principle-based, as opposed to steadily shifting towards becoming a rules-based standard.

The final proposed amendment to be discussed is one that impacts the frequency with which the Advisory Council would meet.[97] The Advisory Council is the formal advisory body to the IASB and the Trustees and essentially serves as a representative group of the IFRS Foundation's constituents.[98] Members of the Advisory Council are appointed by the Trustees.[99] Currently, the Advisory Council meets at least three times a year. If the proposed change is enacted, the Advisory Council would meet at least twice a year.[100] Some may argue that this makes no difference because only the wording has changed and has no effect on the Advisory Council's actions. If this argument is accurate, it raises the question as to why change the wording at all if the effect has remained the same. The reality, however, is that this amendment may well affect the Advisory Council's actions by allowing it to meet less frequently on an annual basis by eliminating one meeting every year. This is because having two

[97] *Proposed Amendments to the IFRS Foundation Constitution*, *supra* note 88, at 22.

[98] *About the IFRS Advisory Council*, IFRS FOUND., http://www.ifrs.org/groups/ifrs-advisory-council/ (last visited Aug. 25, 2017).

[99] *Id.*

[100] *Proposed Amendments to the IFRS Foundation Constitution*, *supra* note 88, at 22.

meetings every year still satisfies the requirement of "at least" two meetings per year. Because the Advisory Council currently meets three times every year, this amendment could allow the Advisory Council to meet less frequently.

This amendment allows the IFRS Foundation to be less dynamic and less responsive to its constituents' needs. Because the Advisory Council is essentially a representative body of the IFRS Foundation's constituents that advises the Board of Trustees and the IASB as to what constituents want and need from the IFRS Foundation as well as how IFRS can be amended, decreasing the number of times this group meets can be dangerous to IFRS's goal of being a responsive and dynamic accounting standard that robustly address its customers' needs. If enacted, this amendment also makes any U.S.-led effort to change IFRS, including convergence efforts, more difficult to achieve by decreasing the number of times the Council is required to meet and therefore hear concerns and arguments from individuals actively pushing for convergence. Because there are fewer opportunities to hear arguments in favor of convergence, the Council may focus less on convergence and consider other matters that may be more pressing to IFRS users around the world. This would help minimize U.S. influence on IFRS, negatively impacting the effectiveness of convergence efforts, and allow IFRS to remain a principle-based accounting standard and not shift towards becoming a rules-based accounting standard.

VI. CONCLUSION

All of the proposed amendments discussed in this Note have analyzed the impact they would have on U.S. influence in general and the United States' influence on the IASB and the efforts advocating for convergence between IFRS and GAAP. The logical conclusion of the analysis above is straightforward: because European business leaders value their independence from U.S. business leaders and government officials, convergence is unlikely to occur. Because the IASB and the IFRS Foundation desire independence from U.S. influence and a decreased U.S. presence on the IASB, the proposed changes to the IFRS Constitution serve to effectuate rules that would enforce exactly this result. Accordingly, convergence efforts between IFRS and GAAP are likely to fail, while the gap between the two leading accounting standards in the world may widen.

Because the IFRS Foundation and the IASB want to decrease U.S. influence on the IASB so as to maintain their independence from U.S. interests, the changes being proposed to the IFRS Constitution will cause the U.S. contingent to have a lesser presence that is twice diluted, with less voting power than before, for potentially shorter-term periods, and fewer opportunities to enact change in a given year. As the impact of these amendments to the Constitution trickles down to the daily operations of the IASB, these changes will likely lead to less power with the contingency from the United States, shifting the balance of power in favor of the European contingency. By ensuring its independence, the IASB can continue to cater to its interests by enacting changes to IFRS that advance the interest of principle-based accounting as opposed to a rules-based accounting system where the goal is to provide international investors the information necessary to make the best investment decisions.