



**SHADOW
FINANCIAL
REGULATORY
COMMITTEE**

COMMITTEE MEMBERS

GEORGE G. KAUFMAN
Co-Chair
Loyola University Chicago

RICHARD J. HERRING
Co-Chair
University of Pennsylvania

RAY BALL
University of Chicago

MARSHALL E. BLUME
University of Pennsylvania

CHARLES W. CALOMIRIS
Columbia University

KENNETH W. DAM
University of Chicago Law School

ROBERT A. EISENBEIS
Cumberland Advisors

EDWARD J. KANE
Boston College

CHRISTIAN LEUZ
University of Chicago

ROBERT E. LITAN
Brookings Institution and
Kauffman Foundation

KENNETH E. SCOTT
Stanford Law School

CHESTER SPATT
Carnegie Mellon University

PETER J. WALLISON
American Enterprise Institute

An independent committee
sponsored by the
American Enterprise Institute

<http://www.aei.org>

Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

Statement No. 273

For Information Contact:

Ray Ball
773.834.5941

Christian Leuz
773.834.1996

Statement of the Shadow Financial Regulatory Committee on
Regulation of Financial Reporting

May 4, 2009

Two accounting issues continue to surface in the public policy debate. One, fair value measurements under FAS 157, has received undue attention. The other, U.S. adoption of International Financial Reporting Standards (IFRS), has been sidelined by the financial crisis, but deserves more attention. Both issues illustrate the perils of political interference in financial reporting and in the process of professional standard setting.

On November 16, 2008, the SEC released a “roadmap” for the possible transition from U.S. Generally Accepted Accounting Principles (GAAP) to IFRS. The roadmap outlines a process that would culminate in giving up GAAP by 2014 and requiring U.S. issuers to report under the same standards as close to 100 countries around the globe.

This is an historical decision with respect to U.S. accounting standards. Despite its importance, the issue has been relegated to the back burner. One concern is that firms’ costs of IFRS adoption can be large. Another concern is that the International Accounting Standards Board (IASB), which issues IFRS, will be influenced by politics in other countries. Although both of these concerns are real and important, there are also serious risks in delaying the decision. First, the U.S. would suffer a loss of international credibility given the expectations created by the SEC roadmap. Second, the U.S. would risk losing its seat at the IFRS table, including the SEC’s prominent role in the newly created IASB’s Monitoring Board as well as FASB’s special relationship with the IASB in the accounting standards convergence process.

From an economic point of view, the decision on mandating IFRS for all publicly traded firms involves a tradeoff among recurring, albeit modest, comparability benefits for investors, recurring future cost savings that will largely accrue to multinational companies, and one-time transition costs borne by all firms and the U.S. economy as a whole.¹ Depending on how one weighs the future benefits against the current costs and how one weighs the benefits for multinationals against the transition costs for all firms, especially smaller ones, one can either support or oppose mandatory IFRS adoption.

One way to ease the economic tradeoff would be to let individual U.S. companies decide whether and when to adopt IFRS. This would put the cost-benefit tradeoff to a market test. Allowing choice would not have dramatic comparability consequences among U.S. firms. There are already considerable differences among U.S. firms' accounting practices despite the fact that all report under U.S. GAAP. Simply following the same set of standards does not bring homogeneity in reporting practices. Besides, the relevant peer group for many U.S. multinationals often includes foreign multinationals reporting under IFRS.

Allowing choice between IFRS and U.S. GAAP would also mitigate the international fallout from U.S. inaction and ensure continuation of the IFRS-U.S. GAAP convergence process. The Committee therefore urges the SEC to give serious and expeditious consideration to allowing choice. The choice would lie ultimately with a firm's management and audit committee. While not irrevocable, a firm's move to IFRS should not be easily reversible. Given the current degree of convergence between the two standards, the Committee would not be surprised if many companies would be able (and want) to certify compliance with both IFRS and U.S. GAAP.

FAS 157 has been viewed by banks and politicians as contributing to the severity of the financial crisis. In the March hearings before the House Financial Services Committee, lawmakers instructed the FASB that they wanted a quick easing of the rules as they perceived FAS 157 as contributing to the current financial crisis. The FASB subsequently issued a Staff Position (FSB 157-4) providing additional guidance on fair value measurements. However, this guidance has failed to satisfy congressional critics. Political pressure on standard setters is not unique to the U.S. The EU has repeatedly threatened the IASB with a carve-out of fair value accounting rules or even with ignoring IFRS completely and setting its own rules. Ironically, this interference of the EU with IFRS has been used a major argument against IFRS adoption in the U.S. In the past, the U.S. Congress and the SEC have been wise in deferring standard setting to the FASB.

In the Committee's view, FAS 157 is a red herring. As pointed out in an earlier Shadow Statement (No. 266, December 8, 2008), FAS 157 merely defines fair value and establishes a framework for its measurement. Even if FAS 157 was suspended, fair value accounting would continue and financial institutions still would be required to make fair value assessments. Thus, suspending FAS 157 would likely make matters worse as firms would lose important guidance for measuring fair values, which likely increases uncertainty and possibly increases the conservatism of firms' auditors. In the Committee's

¹ See independent research report to the U.S. FASB on "Global Accounting Convergence and the Potential Adoption of IFRS by the United States: An Analysis of Economic and Policy Factors" by Luzi Hail, Christian Leuz and Peter Wysocki (2009), <http://ssrn.com/abstract=1357331>.

view, it is a mistake to fix weak bank balance sheets by changing the measurement rules. It is akin to addressing an overweight problem by recalibrating the scale rather than dieting.

The Committee wants to call the attention to three other accounting issues, loan and goodwill impairments and off-balance sheet transactions. First, estimates of expected loan losses of U.S. banks vary widely, but are generally well in excess of banks' existing loan loss provisions and even banks' respective fair value disclosures (in accordance with FAS 107). Second, analysts have raised concerns that many bank balance sheets still record substantial goodwill arising from mergers and acquisitions made during the boom, despite subsequent recent operating losses and share price declines in the banking sector.² These disparities have not been adequately explained. Third, the ability of banks to carry substantial liabilities off their balance sheets during the boom period arguably deserves more attention than the continued refinements of fair value measurement.

These three accounting issues are already on the FASB's agenda, but the Committee is concerned that they—like the IFRS decision—will be crowded out by further and excessive political interference targeting FAS 157.

² See, e.g., Disclosure Insight, Comment letter on proposed staff position under FASB Statement No. 157, Fair Value Measurements, March 25, 2009.