

BSA Honors Program

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*Bringing Conformity to Accounting Standards:
U.S. GAAP versus International GAAP*

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Bringing Conformity to Accounting Standards:

U.S. GAAP versus International GAAP

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Introduction

The United States is considering a change to the accounting principles that govern U.S. entities' financial reporting standards. The accounting principles the Securities and Exchange Commission [SEC] is considering adopting are known as international generally accepted accounting principles [iGAAP.] "The SEC is addressing this topic in order to find the right balance between the 'educated' professional judgment, that is acceptable, and the 'guessed' professional judgment" (Forgeas, 2008). The purpose of this thesis is to address the topic of why I believe the United States has not adopted iGAAP. I assessed the advantages and disadvantages of the United States' generally accepted accounting principles [U.S. GAAP] and International GAAP [iGAAP], and have drawn my own conclusion on why the SEC has not adopted iGAAP, and if the United States we should adopt them.

Having one set of principles may make it easier for investors to compare businesses across borders. It may also lead to higher comparability among companies because all the financial statements, such as the balance sheet and income statement, would be in the same format, and would include all of the same disclosures. Some reasons why the United States' decision on adopting iGAAP has been postponed include the principles based versus rules based idea behind the standards, taxation differences on companies, and the significant costs that may arise from preparing financial statements under iGAAP. Also, the idea of companies not willing to change, and the idea that the United States GAAP has superior standards over iGAAP leads to more hesitancy to change something that is not broken.

Becoming familiar with the two sets of standards, and their differences, is

crucial for all U.S. accountants. In a global economy, many U.S. accountants will need to learn the differences between the two systems. Adopting iGAAP will have a profound effect on the whole accounting world and every U.S. business.

History of Accounting Standards

The American Association of Public Accountants was founded in 1887 (Mendlowitz & Drew, 2012). This association focused much of its work on “issuing certificates, based on experience” (Journal of Accountancy, 2012). The American Association of Public Accountants issued its first standard in 1894. This standard regarded the balance sheet (Journal of Accountancy, 2012). In 1916, the American Association of Public Accountants changed “its name to the Institute of Public Accountants” (Journal of Accountancy, 2012). One year later, the Institute of Public Accountants changed its name to the American Institute of Accountants, and they introduced to states a written test for hopeful accountants, a test similar to the CPA examination that accountants take today (Journal of Accountancy, 2012). The American Institute of Accountants was responsible for spearheading a bulletin published by the Federal Reserve concerning the income statement. Congress created the Securities and Exchange Commission in 1934 “to prescribe ‘the methods to be followed in the preparation of [financial] reports’. The SEC [became] a strict regulator and insists on comparability, full disclosure, and transparency” (Zeff, 2005). 49 years after the American Association of Public Accountants was created, “the AIA [published] *Examinations of Financial Statements*, which [introduced] the term ‘generally accepted accounting principles’, known as GAAP” (Zeff, 2005). In 1940, “the American

Accounting Association published . . . *Introduction to Corporate Accounting Standards*, which defends and establishes historical cost valuation and the matching principles in accounting literature” (Journal of Accountancy, 2012). The American Institute of Accountants changed its name in 1957 to the American Institute of Certified Public Accountants [AICPA] (Journal of Accountancy, 2012). “The International Accounting Standards Committee [was] formed” in 1973 (Journal of Accountancy, 2012). In 2002, “FASB [Financial Accounting Standards Board] and International Accounting Standards Board agreed to remove differences between international standards and U.S. GAAP” (Journal of Accountancy, 2012). The Accounting Standards Codification became the single source of U.S. generally accepted accounting principles” in the year 2009 by the FASB ((Zeff, 2005)). This helped reduce errors between accountants when applying standards to certain transactions. It has been 126 years since the American Association of Public Accountants was formed, and although the name has been changed numerous times the idea of the group has not. Accountants strive to provide financial statements that are presented fairly and transparent. The SEC is now contemplating on adopting International Generally Accepted Accounting Principles [iGAAP], of which, “the process has been characterized by political feasibility” (Miller, 2011). If the SEC adopts iGAAP, the U.S. will conform to the standards that majority of the global business world is abiding by, and give up the rules-based system U.S. GAAP follows now.

Conceptual Framework of U.S. GAAP

The Financial Accounting Standards Board developed the conceptual framework of U.S. GAAP. Understanding the conceptual framework for both U.S. GAAP and

iGAAP is very important. The conceptual framework is “a basis for setting accounting rules and for resolving financial reporting controversies” (Kieso, Weygandt, & Warfield, 2012). In other words, the conceptual framework provides all accountants with guidance on how to prepare the financial statements and execute transactions. A framework also aids in situations where the accountant is responsible for making a decision without guidance from rules or regulations. With the conceptual framework accountants can compare their statements against the framework, and see if investors will be able to understand the statements and make the decision whether to invest in that particular company. “A conceptual framework underlying financial accounting is important because it can lead to consistent standards and it prescribes the nature, function, and limits of financial accounting and financial statements” (Kieso, Weygandt, & Warfield, 2012). The conceptual framework has three levels as seen in Exhibit One. The first level represents the basic objective of accounting; also known as the “why?” Accountants are hired to present information that is free from error to allow investors make knowledgeable choices. Without the conceptual framework and the codification it would be hard for accountants to do so.

The second level of the conceptual framework concentrates on the qualitative characteristics and elements. “The FASB identified the Qualitative Characteristics of accounting information that distinguish better (more useful) information from inferior (less useful) information for decision-making purposes” (Kieso, Weygandt, & Warfield, 2012). There are three main qualitative characteristics located in the second level: relevance, faithful representation and enhancing qualities. The information presented in financial statements need to be relevant in order for the user to make a well-informed

decision about the information presented. Faithful representation occurs when the information presented is free from error, and nothing significant is omitted. There are four enhancing qualities: comparability, verifiability, timeliness, and understandability. These four qualities are very important to users of financial statements. Users need to be able to compare financial statements of one company to the financial statements of another company with ease. “Verifiability occurs when independent measurers, using the same methods, obtain similar results” (Kieso, Weygandt, & Warfield, 2012). Timeliness is important to financial statement users; they expect the information in a timely manner, because if it is not, they will not be able to make informed decisions about the company when they need it. These users also need to be able to understand the information that is presented to them, and its significance, and that is where the quality of understandability comes into play. The second level is responsible for tying levels one and three together.

Level three includes assumptions, principles, and constraints. This level is also referred to as the “how”, or the implementation. The basic assumptions are defined as followed by Donald E. Kieso, Jerry J. Weygandt, and Terry D. Warfield in *Intermediate Accounting*:

Economic Entity – company keeps its activity separate from its owners and other businesses.

Going Concern - company to last long enough to fulfill objectives and commitments.

Monetary Unit - money is the common denominator.

Periodicity - company can divide its economic activities into time periods.

These assumptions are believed to be true in each company. If any of these basic

assumptions are not being met, they are normally addressed in the notes section of the financial statements.

Measurement in accounting plays a large role; in U.S. GAAP the most commonly used measurements are historical cost and fair value. Another important principle, in addition to measurement, is revenue recognition. "Revenue recognition – generally occurs (1) when realized or realizable and (2) when earned" (Kieso, Weygandt, & Warfield, 2012). And expenses follow the revenues. The full disclosure principle is an important principle for accountants to follow, as well. The financial statement users are influenced by what is presented in the financial statements, notes to the financial statements and the supplementary information. If an accountant leaves out something major, the financial statement user's decision may be harmed because of the omission.

The last principle of level three is constraints. There are two restrictions: cost constraint and industry practice. The cost constraint weighs the cost advantages against the cost disadvantages of providing information to financial statement users. A cost constraint occurs when a company needs to determine if the cost associated with providing information to financial statement users will outweigh the benefit they will receive from the information they obtain. Industry practice relates to the specific practices that an industry might utilize that is different than other industries. These practices most often require some "departure from basic accounting theory" (Kieso, Weygandt, & Warfield, 2012). The presentation of financial statements is an example of this; an insurance company will have different looking financial statements than a manufacturing company. In whole, the conceptual framework aids in the decision making process of accountants and provides them with a general overview of how the

accountant should arrive at the financial statements in the United States.

Conceptual Framework of iGAAP

The conceptual framework of iGAAP is very similar to the U.S. GAAP conceptual framework, the main difference being the terminology used in each framework. The conceptual framework of iGAAP, as seen in Exhibit Two, contains three levels, and the second level acts as a tie between levels one and three, as did level two in U.S. GAAP. “The conceptual framework (sometimes referred to as the framework) sets out the concepts that underlie the preparation of the financial statements” (Wiecek & Young, 2010). The first level of iGAAP’s conceptual framework address the “why” or goals and purposes of accounting. The objective is to “provide information: about the financial position, performance, and changes in financial position to a wide range of users in making economic decisions” (Wiecek & Young, 2010). The financial statements of international companies want to provide financial statement users the information they need to make well-informed decisions about their company.

Level two contains qualitative characteristics and elements of the financial statements. The qualitative characteristics are: understandability, relevance, reliability, and comparability. Understandability is the same as in U.S. GAAP, if the financial statement user cannot understand what is presented in the financial statements then they are of no use. “Relevant information must at least have the following characteristics: predictive value and confirmatory value” (Wiecek & Young, 2010). Predictive value occurs when the accountant uses the historic information available to him or her to “predict the company’s future profits and cash flows” (Wiecek & Young, 2010).

Whereas, confirmatory value is when the financial statement users can either confirm or disaffirm their prior expectations. Reliability of financial statements is another qualitative characteristic. Substance over form is important in regards to reliability. “Accounting should reflect the substance of a transaction. It should look beyond the legal form” (Wiecek & Young, 2010). Another idea related to reliability is prudence. Prudence is comparable to conservatism. The idea is to not overstate assets or income to make the company appear financially better. And last, but not least, is completeness. The financial statements should include all information that is deemed significant. The elements of financial statements are very important. They provide the potential investor with an overview of the company, and highlight the strengths and weaknesses of a firm. Unlike U.S. GAAP, which has ten elements, iGAAP only has five elements. The five are: assets, liabilities, equity, income, and expenses. The third, and final, level of the conceptual framework of iGAAP is the “how” section. This section is almost identical to U.S. GAAP’s; terminology plays a large role in the differences of the framework, but the ideas behind them are the same. But the similarities between U.S. GAAP and iGAAP stop at the conceptual framework.

The standards that govern the two types of systems are different; iGAAP is ruled by principles-based standards and U.S. GAAP consists of rules-based standards. This creates differences between the two systems, because more reliance of good judgment is placed on accountants under iGAAP than U.S. GAAP. And certain transactions may be recorded because an accountant following iGAAP did not follow the same procedure as an accountant following U.S. GAAP. Also, fair value measurement of assets and liabilities under the two systems poses as a problem when comparing two companies.

U.S. GAAP does not allow assets to be upward revalued, whereas iGAAP does. This can mislead financial statement users when comparing a U.S. based company with a foreign company who follows iGAAP, since the liabilities and assets aren't measured the same way. Comparability is therefore reduced. There are also taxation differences that occur under the two systems. U.S. GAAP allows an inventory valuation method known as last in, first out. With this method companies are able to reduce their income and therefore have lower income tax expense. Without this method U.S. companies would have to pay more in income taxes, which will lead to a reduced profit. This particular inventory valuation method is prohibited in iGAAP, so U.S. companies would need to prepare for this major change. This change could cost the company a lot of money. The company would not lose money only by purchasing iGAAP education for employees, but also in updating software. The accountants would need to learn a whole new system, and that would take time away from the daily business operations.

Rules-based versus Principles-based Standards

The Financial Accounting Standards Board [FASB] is the standard setting body of U.S. GAAP, and produces standards that are rules-based. "This approach attempts to anticipate all or most of the application issues and prescribes solutions" (Needles & Powers, 2011). The accountant is not given much freedom for making decisions in a rules-based system, because the FASB attempted to cover all situations that may arise, and give instructions on how to handle the transaction. "In addition, the FASB (and its predecessors) have developed rules-based standards to meet the demand of major constituents, particularly management and auditors, who want a clear answer to each and

every perceivable accounting issue” (Benston, Bromwich, & Wagenhofer, 2006). The accountant does not have the freedom to make decisions about transactions without first checking with the FASB on how the transaction should be executed. This may be very difficult for the accountant, and timely since “U.S. GAAP as codified by the FASB consists of about 17,000 pages” (Needles & Powers, 2011). Rules-based standards were created to give accountants standards to follow and in turn, they will produce financial statements that are comparable and of use to financial statement users.

Principles-based standards issued by the International Accounting Standards Board [IASB] form iGAAP. These “standards are less prescriptive and rely on broad statements of objectives and principles to be followed” (Needles & Powers, 2011). This produces more reliance on the accountant in making the right decision. There aren’t as many rules to follow as U.S. GAAP, but the accountant is still expected to make the best decision. As seen in Exhibit Three, there is more detailed guidance under the rules-based system. This means Meaning that there aren’t many instances where the accountant will be forced to make a decision about a transaction, because a rule has already been produced for him or her in the U.S. GAAP codification. Unlike iGAAP, where there is more reliance placed on professional judgment, “Judgments are often dependent on the person’s culture and prior experience . . . Thus, judgments often differ from person to person, company to company, and industry to industry (Needles & Powers, 2011). And with this in mind, the U.S. is trying to avoid these differences and offer the financial statement users with financial statements that are comparable and free from error.

“There are concerns in the U.S. that principle-based standards would allow for a wider spectrum of interpretation and legal confrontations” (Foster, 2012). The United

States wants avoid all possible fraud schemes, and believes that adopting a principles-based standard system would make it easier for fraud to occur since there isn't as much implementation guidance as the rules-based standards. "Greater reliance is placed on the preparer's judgment to align the financial reporting with the conceptual framework" (Needles & Powers, 2011). "Other critics of rules-based standards have pointed out that rules can become useless and, worse yet, dysfunctional when the economic environment changes or as managers create innovative transactions around them" (Benston, Bromwich, & Wagenhofer, 2006). The thought that another episode similar to ENRON may occur is another reason why the U.S. wants to steer away from standards that give the accountant more authority over the decisions made.

Fair Value Measurement

"ASC [FASB] Glossary defines fair value as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'" (Grant Thornton, LLP, 2006). The IASB defines fair value as "the amount for which an asset could be exchanged, or a liability settled between knowledgeable, willing parties in an arm's length transaction" (Wiecek & Young, 2010). Most fair value measurements come from "quoted prices in an active market" (Needles & Powers, 2011). This gives the accountant a number that would be similar from company to company because the item's value is being determined by the market, and not by the company itself. If there is not an active market for the item, the accountant is then responsible for using a valuation technique to give the item a reasonable value. Fair value measurement is the most common type of measurement in

iGAAP. Under iGAAP the investor is presented the inventory in fair value, which means how much the inventory is worth today. With U.S. GAAP one option of disclosing information on inventory is called historical cost. With historical cost the dollar amount of inventory on the balance sheet is not reported at the market cost, and therefore does not give a fair representation of how much it is actually worth. “The use of fair value accounting in the U.S. has accelerated in recent years as a means of enhancing financial statement quality, transparency and relevance” (Abahoonie & Barbut, 2009). In order to keep the quality of financial statements high, accountants may need to revalue assets whose value has increased or decreased in the market, thus giving the financial statement users a better idea of the company’s financial well-being. One item worth noting in regards to fair value measurement is revaluation of an asset. “Revaluation recognizes a change in the fair value of an asset after its initial acquisition” (Needles & Powers, 2011). Revaluation of property, plant, and equipment [PPE] is a major difference between U.S. GAAP and iGAAP. Belverd E. Needles, Jr. and Marian Powers explain the differences of revaluation between U.S. GAAP and iGAAP in *International Financial Reporting Standards: An Introduction*:

U.S. GAAP do not allow upward revaluation [in property, plant, and equipment]. IFRS [iGAAP], on the other hand, permit downward and upward revaluation for tangible and identifiable intangible long-term assets . . . Under U.S. GAAP, PPE must be carried at historical cost less accumulated depreciation. By contrast, IFRS [iGAAP] allow PPE to be valued at historical cost or at fair value if readily measurable less accumulated depreciation.

The differences between the fair value of buildings and land, and their historical cost could be quite significant. The fair values of PPE will rely on the judgments of estimators. An erroneous judgment could lead financial statement users to make decisions from incorrect information. The fair value may be too high, which would increase the amount of assets the company has, and wrongly increase the amount of total assets. This may lead financial statement users into thinking that the company is financially healthier than they actually are.

If the measurement technique is changed, taxes for companies in the United States may also become unfavorable. This would upset many investors and may cause them to invest elsewhere. Also, the companies may be taxed more, and in turn reduce their profit. It is also important to note that changing the measurement technique could also be costly to the company.

Taxation Differences

An area of major concern for U.S. companies is taxation, and the effect that iGAAP may have on their tax expense account. Companies do not want to have to pay more income tax than they already do. One specific account, inventory, could have a large impact on the amount of tax expense a company may cumulate as a result of the adoption of iGAAP. This is because of the methods of costing inventories. The inventory account under both U.S. GAAP and iGAAP are both handled in the same manner. "IAS 2 [iGAAP], *Inventories*, and ASC Topic 330 [U.S. GAAP], *Inventory*, both generally require that inventories initially are recorded at cost and subsequently are tested for impairment by reference to a market-based value" (Securities and Exchange

Commission Staff, 2011). But, the costing methods for the two standards are significantly different. Under “U.S GAAP LIFO is an acceptable method. But, under iGAAP LIFO is prohibited” (Ernst & Young, 2009). LIFO stands for Last In, First Out and is “a method of accounting for the cost of inventory” (Needles & Powers, 2011). With more than one-third of U.S. companies utilizing the LIFO method of inventory costing it does benefit the companies that use the LIFO method in a significant way (Needles & Powers, 2011). Companies may choose to use LIFO “because in periods of rising prices, it produces a lower taxable income” (Needles & Powers, 2011). This has been especially important to companies in the recent years because of the economic recession. Companies have focused more on reducing costs, and their inventory valuation method may have changed to LIFO because of the tax benefit it produces. A lower taxable income means less money paid out than needed, in turn leaving the company with a higher retained earnings amount.

If the SEC adopted iGAAP, “U.S. companies that would be stripped of LIFO would experience a tax impact ‘somewhere north of \$50 billion’” (Whitehouse, 2012). This would significantly impact the companies, and could cause major problems in the business world. Not only would the companies have a larger income tax expense under a different inventory valuation method, but also the cost of changing from LIFO to another method would be significant. “The transition to IFRS [iGAAP] will have an enormous impact on the calculation and reporting of income taxes for U.S. companies that are currently reporting under [U.S.] GAAP” (McGowan & Wertheimer, 2009). These rising costs will add up quickly. Some smaller companies may not be able to handle the pressure, and in the worse case scenario may be forced to shut down operations. This

creates a downward spiral effect. The company loses money from shutting down operations, and its investors are also losing money because they will not get their share of the profits, and in turn will sell of their shares quickly. It is also important to note that changing the measurement technique could also be costly to the company, not only money-wise but also in regards to time. If the company needs to revalue their assets it could also disrupt the operations of the business making the business run less efficiently.

Adoption Costs

FASB has been working with IASB in creating codifications that will create a smooth transition if the SEC were to adopt iGAAP. Although, no one knows for sure when it will happen, the FASB is trying to prepare to the best of their abilities. The change will not occur overnight and will not only take time, but also money. “If a change is more gradual, the smaller companies can learn from the larger companies so the cost of implementation could be decreased” (Whitehouse, 2011). Education would be one of the larger costs of adopting iGAAP. It will be a bigger challenge for companies that do not have any experience with international financial standards than for companies that are familiar with the differences. It will also be a larger financial burden to the smaller companies, because many of them do not have much room for additional costs in their budget. The American Institute of Public Accountants explains the costs of adopting iGAAP as follows:

While the initial cost to identify and quantify the differences between U.S. GAAP and IFRS, staff training and implementing IT support could be significant, the conversion also could result in an ultimate reduction of

costs for capital and financial reporting related to operations. In its proposed roadmap to move all U.S. publicly traded companies to the global standards issued in November 2008, the Securities and Exchange Commission estimated that the largest U.S. registrants that adopt IFRS early would incur about \$32 million per company in additional costs for their first IFRS-prepared annual reports, and that the average U.S. company would incur costs of between 0.125% to 0.13% of revenue.

Many companies may need to reevaluate their budgets in order to adopt iGAAP effectively and efficiently. The project will be costly and it will take time, but once implemented the financial statement users will be able to compare companies across foreign borders with ease

Conclusion

I believe the Securities and Exchange Commission has not adopted iGAAP because they are not certain that the transition will be smooth. The FASB has created standards that are similar to iGAAP to ease the process, but it is not a guarantee that it will be easy. There will be challenges, and companies are most likely going to be frustrated with the change of accounting principles, and I believe the SEC wants to avoid being the cause of the problem. I also believe that SEC worries that switching from rules-based to principles-based standards will create more potential for fraud, or the possibility of comparability being reduced. The adoption costs are going to be detrimental to smaller U.S. based companies. Not only will the adoption costs hurt companies financially, but educating employees will take time away from the daily business operations. Also,

methods will change, inventory valuation as an example. This is another area where the SEC is making companies pay more in income taxes, and no company wants to pay more in taxes. I think the SEC backed themselves into a corner by contemplating the possibility of adopting, and now the IASB is expecting them to do so.

I do believe that adoption of iGAAP is inevitable. With the world trending towards a more global business structure financial statement users will need financial statements that are comparable across foreign borders. "Ultimately, a standard-setting body has to do its best to meet the needs of society as a whole when it promulgates a standard that sacrifices one of those qualities for the other; and it must also be aware constantly of the calculus of costs and benefits" (Financial Accounting Standards Board, 1980). It will not be an overnight process, FASB and IASB will need to work together in order to create standards that meet in the middle, so U.S. companies do not give up all of the advantages that U.S. GAAP offers them and international companies will need to be given the same treatment in regards to iGAAP.

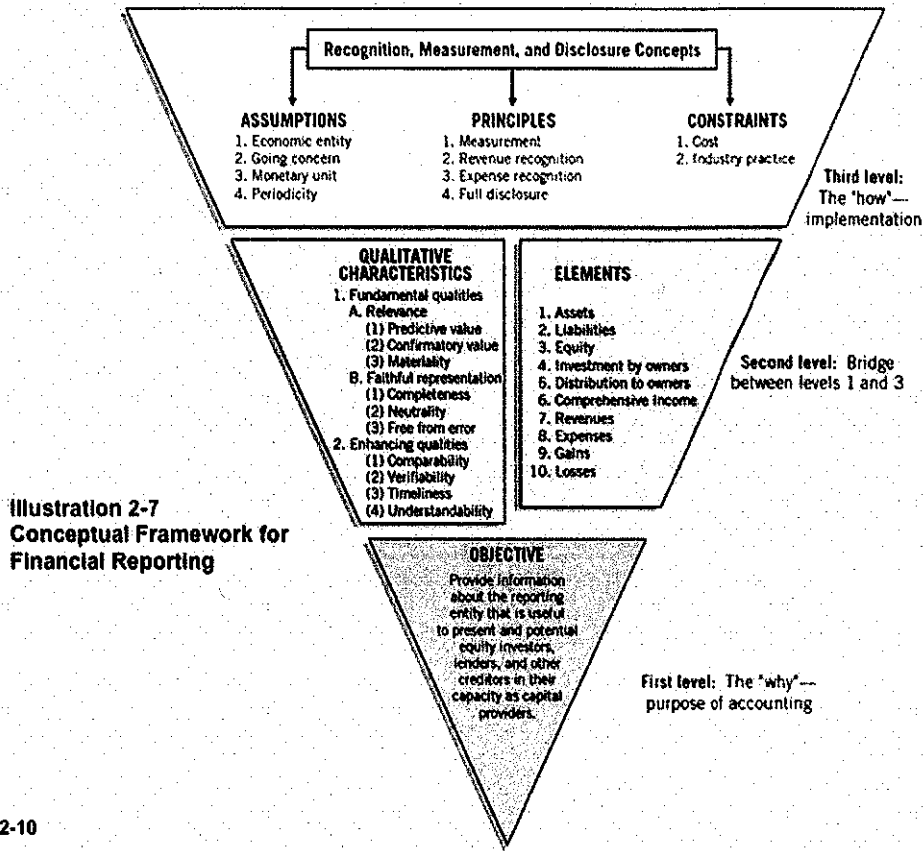
Financial statement users of U.S. companies will not notice significant changes in the information that they receive from financial statements. "U.S. adoption of IFRS will not cause major changes in U.S. financial reporting results, at least overall" (Smith, 2011). There will still be assets, liabilities, revenues and expenses but the route the accountant took to produce the numbers may be different. Financial statement users may be provided with numbers that are more relevant than before. The idea of fair value measurement comes to play here, especially in inventory. If an item is priced at historical cost it does not reflect how much the item may be worth today in the market. Therefore the cost of inventory would be lower, and the assets would be undervalued.

In my own opinion, I do not think that the U.S. should adopt iGAAP. The taxation of inventory is of major concern to me. With LIFO being prohibited under iGAAP this will cost U.S. companies a lot of money in income taxes. With the economy already in a recession I do not think that our small companies could survive the change and the country would experience an even higher unemployment rate.

The costs associated with the change may be detrimental to the smaller U.S. companies. Many of them will need to adjust their budgets to make money available for the purchase of new systems and education for their employees. It will cause all companies to spend a little extra time learning the new programs, but it will improve comparability between businesses and may even offer financial statement users better information to make well-informed decisions.

Also, moving towards a principles-based system is of unease. Personally, I am a rules-based kind of person. I like having a specific set of guidelines to follow, and I think that having a rules-based system would eliminate human error during the accounting process. As stated above, people tend to do things because of their culture and history. If an accountant is taught a transaction incorrectly, he or she may continue to do so, without having knowledge of it their error, because he or she is not an accountant of the rules-based system. With more reliance on the accountant to do the right thing, I believe it opens the door to more fraudulent transactions occurring. To me, the costs outweigh the benefits when it comes to adopting iGAAP in the United States.

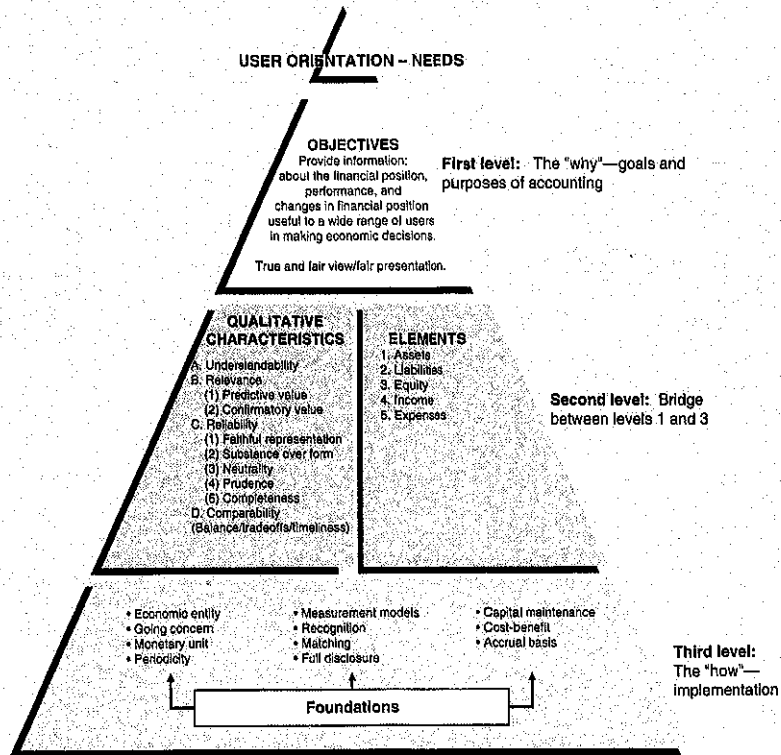
Exhibit One – U.S. GAAP Conceptual Framework



(Kieso, Weygandt, & Warfield, 2012)

Exhibit Two – iGAAP Conceptual Framework

*Illustration 1-2
The Conceptual Framework*



(Wiecek & Young, 2010, p. 5)

Exhibit Three – Comparison of Rules-Based Standards and Principles-Based Standards

Exhibit 3-1: Comparison of Rules-Based Standards and Principles-Based Standards

Attribute	Rules-Based Standards	Principles-Based Standards
Conceptual framework	Less reliance	More reliance
Professional judgment	Less reliance	More reliance
Level of detailed guidance	More	Less
Amount of industry specific guidance	Extensive	Little

(Needles & Powers, 2011, p. 35)

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