KEY POINTS
- On 27 August 2008 the Securities and Exchange Commission ('SEC') proposed an important first step to encourage certain US issuers to use International Reporting Financial Standards ('IFRS') as early as 2009, before possibly mandating universal adoption beginning in 2014.
- A transition for US companies from rules-based accounting to IFRS will be challenging because IFRS emphasises broad principles and the substance of transactions, and requires professional judgment to be used more frequently and extensively than under US Generally Accepted Accounting Principles ('GAAP').
- Advance planning is the best way for US companies to prepare for implementing IFRS.

Feature

Authors Eva K Jermakowicz and Barry J Epstein

Joining the world: US companies adopting IFRS

In a landmark vote on 27 August 2008, the Securities and Exchange Commission paved the way for certain US issuers to start converting to International Financial Reporting Standards ('IFRS') in 2009 before possibly becoming mandatory in 2014. A transition for US companies from the current rules-based approach to the somewhat more concept-based approach of IFRS will be a fundamental challenge. Advance planning is the best way for US companies to ensure that they will be ready to operate in the new environment. These firms will have to handle hurdles such as an increased volume and complexity of financial disclosure, possible consequential impacts on pension and share-based plans, and various non-accounting operational changes.

SEC ROADMAP TO IFRS ADOPTION

For over three decades now the International Accounting Standards Board ('IASB'), and its predecessor, the International Accounting Standards Committee ('IASC'), have pursued the development of IFRS. As a result of these efforts, more than 100 countries, including the nations comprising the European Union, European Economic Area, and Australia already employ IFRS. Several other major industrial nations, such as Canada, have announced or are on the verge of adoption. To date, no US-based companies have reported under IFRS, and the only exposure given to those standards has been via US filings by foreign private issuers, which have included mandatory reconciliations to US Generally Accepted Accounting Principles ('GAAP').

On 15 November 2007 the Securities and Exchange Commission ('SEC') eliminated the requirement for foreign registrants to reconcile their financial statements to US GAAP, if the financial statements fully adhere to IFRS as published by the IASB. The SEC thus acknowledged that IFRS has the potential to become the global set of high-quality reporting standards, and that investors, issuers and markets would benefit from the improved comparability of financial reporting across national borders.

On 27 August 2008, the SEC proposed a roadmap that could lead to mandatory IFRS adoption by US issuers beginning by 2014. In addition to a timeline, this sets forth several milestones for US issuers that, if achieved, could lead to all US public companies using IFRS in their SEC filings, superseding US GAAP.

To achieve these goals, the SEC set criteria for US issuers to utilise to determine if they would qualify to apply IFRS in their SEC filings to be made on or after 15 December 2009. If a US issuer can satisfy both of the following criteria, the issuer would then request and obtain a 'letter of no objection' from the SEC's Division of Corporate Finance:

- Globally, the US issuer is among 20 largest public companies in its industry; and
- IFRS is used globally as the basis for financial reporting more often than any other basis of accounting by the 20 largest public companies in that industry, as measured by market capitalisation.

The SEC estimated that around 110 US companies in 34 different industries would satisfy and be eligible under the criteria for early IFRS adoption. Early users, however, will still be required by the SEC to provide US GAAP-based information, using one of two alternatives:

- A one-time reconciliation from US GAAP to IFRS that covers one year – the transition year – provided as a note to the audited financial statements in accordance with IFRS 1, *First-time Adoption of International Financial Reporting Standards*; or
- An unaudited reconciliation from IFRS to US GAAP, on an ongoing basis, for the three years of IFRS financial statements included in the Form 10-K.

US issuers that meet the criteria and elect for early use of IFRS must present three years of audited financial statements in the first year of IFRS reporting, instead of the two years' comparative statements required under IFRS 1. Thus, a company reporting on a calendar-year basis that adopts IFRS in 2009, for example, would have to provide audited financial statements for the years ending 31 December 2007, 2008, and 2009, in its Form 10-K filed with the SEC in 2010.

Several milestones must be achieved before universal IFRS adoption becomes mandatory in the US. These include: improvements to accounting standards; enhanced accountability by, and funding of, the International Accounting Standards Committee Foundation; improved ability to use interactive data for IFRS reporting; IFRS education and training in the US for investors, auditors and others; the experience from limited early use of IFRS; the timing of future rulemaking by the Commission; and considerations relating to whether the mandatory use of IFRS should be staged or sequenced among groups of companies based on their market capitalisations.

The SEC, in a proposed rule published on 14 November 2008 (Release 33-8982), has formalised its so-called roadmap for the potential universal adoption of IFRS by US issuers of securities. As expected, this sets forth a number of milestones that, if met, would lead to mandatory implementation of IFRS beginning, for the largest registrants, in 2014, with extension to the smallest public companies

by 2016. US GAAP would then be fully superseded by IFRS, at least for publicly held companies, at that time.

PRINCIPLES-BASED ACCOUNTING

A transition for US companies from rules-based accounting to IFRS will be challenging because IFRS places greater emphasis on broad principles and the substance of transactions. IFRS also requires professional judgment to be utilised more frequently and extensively. US professionals who are already knowledgeable about US GAAP may find IFRS relatively easy to understand as most (but not all) fundamental underlying principles are near-identical (which cannot be said regarding many other national GAAP regimes).

Perhaps the biggest change, for many US issuers, accountants and investors, will be the expanded reliance on preparer and auditor judgments. This practice contrasts with the detailed rule-driven approach under current US GAAP. This is more similar to US GAAP as it historically existed. Over the years, however, the (US) Financial Accounting Standards Board ('FASB')'s constituents requested (and were given) detailed and specific standards. The incentives for FASB to release additional guidance included being able to eliminate uncertainties on structuring transactions, limit the number of difficult disputes companies had with clients, provide parties defences in litigation, and enforce required practices with more ease. Because of this, US GAAP currently comprises about 24,000 pages of guidance.

In contrast, IFRS focuses somewhat more on transparency – that is, because IFRS is concerned with whether the financial statements of an entity represent the economic reality underlying the transactions and events presented in the financial statements. As of 2008, IFRS guidance only comprises roughly 2,700 pages of material, which is still a significant increase from a mere 1,200 pages in 2000. To gain full acceptability (including from the SEC), expanded guidance will inevitably have to be forthcoming, even under this principles-based set of standards.

As rules became more complex under US GAAP, the exercise of professional judgment often focused on determining where within numerous scope exceptions and inconsistent guidance a transaction or event fell. In adopting IFRS, US issuers, auditors, regulators and users will need to exercise more judgment and to rely less on bright lines. This was a lesson learned from the Enron debacle, and now being re-learned from the ongoing credit crisis. Despite increased emphasis on corporate governance and internal controls in the post Sarbanes-Oxley era, adequate risk management and due diligence were lacking in a number of major financial institutions. High-quality financial reporting, accounting and auditing standards, and disclosures require strong corporate governance, regulatory and enforcement regimes as well as systems for training and educating market participants.

CONVERGENCE OF US GAAP AND IFRS

The contrast between principles-based IFRS and principles-based, but also rules driven, US GAAP is perhaps most visible in the area of revenue recognition. US GAAP contains an estimated 200-plus individual revenue recognition provisions which are in many cases industry-specific and/or arrangement-specific. Those provisions are often inconsistent with fundamental principles of US GAAP and with each other. IAS 18, on the other hand, consists of a small number of authoritative general principles and contains almost no specific rules.

As promised by the 2002 Norwalk Agreement, FASB and IASB continue working towards the goal of converging US GAAP and IFRS – which, if achieved, would certainly ease transition to IFRS for US issuers. In the current environment, convergence toward the more principles-based standards has proceeded slowly. As a result, fears over the transition are still driving participants to require more 'rules-based' standards. Conversion to IFRS will require a change in attitude and behaviour by market participants, including parallel changes in approach by legal and regulatory bodies, to be more accepting of reasonable judgments made by issuers and auditors. All stakeholders – including US issuers, auditors, taxing authorities, banking regulators, insurance regulators, lending institutions, credit and equity analysts, etc – will need to respect reasonable professional judgments and tolerate reduced reliance on bright line rules. Currently, second-guessing of professional judgments, and hindsight by the SEC, Public Company Accounting Oversight Board, litigants etc, impedes movement towards more principles-based accounting standards.

FASB and IASB are conducting a joint *Conceptual Framework* project. The project's overall objective is to create a sound foundation for future accounting standards that are principles-based, internally consistent, internationally converged, and lead to financial reporting that provides relevant and faithfully represented information for capital providers and others. The project is being conducted in eight phases. At the completion of the first phase of the project, in May 2008, the Exposure Draft ('ED') *The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information* was issued. By embracing a more conceptual approach to financial reporting, a greater emphasis will be placed on underlying principles, objectives, and expanded use of judgment in the application of the standards.

In 2008, the SEC's Committee on Improvements to Financial Reporting ('CIFR') issued recommendations for making financial reporting judgments under IFRS. CIFR recognised three judgment areas: transaction analysis, accounting research, and decision making. Based on CIFR's recommendations, companies will spend more time on transaction analysis and decision making, and less time on accounting research, under IFRS than under US GAAP. Companies will also spend additional time analysing the business purpose and substance of transactions, as under IFRS economic substance is paramount and often involves considerations beyond accounting.

In decision making, CIFR recommended increased emphasis on the appropriateness of assumptions and estimates, and adequate disclosure. As part of its continued efforts, the CIFR will develop a framework for exercising professional judgment by preparers and auditors. This is of particular importance, as IFRS will require exercising additional judgment in the areas of financial statement presentation, consolidation policy, property, intangibles, leases, revenue recognition, provisions, and financial instruments.

FUNDAMENTAL IMPACTS OF A TRANSITION TO IFRS

The FASB and IASB have identified many areas in US GAAP and IFRS that are currently not converged, but that either are being or will be addressed in the future. Yet, despite this a number of significant differences and minor differences between the two sets of standards may remain and could have the potential to create material impacts on reported results. For instance, the Income Statement may change due to change in accounting for revenue, development costs, or other expense.

Differences between IFRS and US GAAP consequently may have significant impact on a company's market capitalisation, reported earnings, and volatility of earnings. Therefore, US companies adopting IFRS should have a broad understanding of the major differences between these sets of accounting standards. Going forward, US companies will need to determine the level of effort required to address those differences and to identify their impact.

KEY DIFFERENCES BETWEEN US GAAP AND IFRS

Last-In, First-Out ('LIFO') inventory accounting method

IFRS does not permit the use of LIFO, which allows taxpayers to defer inflation-related increases in inventory values. US companies commonly use this method for financial reporting due to a tax conformity requirement in the US Internal Revenue Code. Elimination of LIFO has frequently been threatened by Congress, and the growing use of IFRS, which does not permit LIFO, may precipitate abolition of this costing method.

Consolidation

Generally, under IFRS's consolidation policy more entities will be consolidated, including some with a significant equity investment, such as joint ventures, special purpose entities, and franchises. IFRS requires consolidation of all controlled entities, whereas US GAAP and SEC guidance is slightly less all-encompassing.

Liabilities vs equity

IFRS requires those shares which are determined to be redeemable by shareholders to be reported as liabilities, while US GAAP still includes these (with limited exceptions) in equity. Besides altering the debt-equity ratios, this results in non-comparable earnings per share amounts and other anomalies.

Financial instruments

IFRS measures financial instruments at fair value differently and not necessarily based on exit value, which is now the US GAAP standard approach. By adhering to IFRS, many financial arrangements, such as asset securitisations, that resulted in off-balance sheet treatment (ie, derecognition) under US GAAP will require full or partial recognition. IFRS does not recognise the concept of qualified special purpose entities. US GAAP may conform to the IFRS approach within the coming months, however. More instruments are likely under IFRS to be classified as liabilities, as opposed to equity (eg, instruments with contingent settlement provisions).

Revenue recognition

IFRS and US GAAP differ on revenue recognition, especially for service contracts, construction contracts, multiple-element arrangements, customer loyalty programs, software, and real estate development. Those differences require a detailed transaction-based analysis and may consequently impact how companies operate, including, for example, how they bundle various products and services in the marketplace.

Expense recognition

As a result of how IFRS handles expense recognition, for example, there may be a significant acceleration of the expense recognition of certain stock options with graded vesting (eg, awards that vest ratably over time). Consequently, companies could consider restructuring share-based plans. Furthermore, IFRS's computation of depreciation expense is more complicated as assets are to be depreciated on a component basis, and an asset's residual value is revalued each period.

Measuring non-financial assets

Under IFRS non-financial assets are measured at different amounts and there is an option to revalue long-lived assets. Development costs are to be capitalised (when certain criteria are met). The asset impairment testing model under IFRS may result in assets being impaired earlier and measured differently. Also, impairments are required to be reversed when conditions that led to impairments no longer exist. As a result, the balance sheet may be more volatile as both write-ups and write-downs are reported. No bright-line testing criteria exist for the classification of leases into operating and finance (capital) leases; also, there is different sale/leaseback accounting.

Liabilities

IFRS recognises and measures liabilities differently than US GAAP, particularly for items such as restructuring charges, litigation, onerous contracts, uncertain tax provisions and asset retirement obligations.

Ratio analysis

Adoption of IFRS will pose a strain on many financial institutions unless current banking regulations are modified. This is due to remaining differences between IFRS and US GAAP in areas such as derecognition, consolidation and offsetting of derivative fair values, the reported leverage ratios may be lower for the same positions reported under IFRS versus US GAAP. Revised ratios should be compared with debt covenants before conversion to IFRS, so that appropriate relief can be sought, if necessary, on a timely basis.

Industry specific guidance

IFRS provides substantially less industry-specific guidance. Under US GAAP a large amount of industry-specific GAAP is found in AICPA (American Institute of Certified Public Accountants) Audit and Accounting Guides and in Statements of Position; little that is comparable exists under IFRS. Consequently specific areas, such as investment companies, that have enjoyed robust specialised industry guidance will soon have to navigate in a sea of uncertainty. There remain significant differences between the reporting requirements under IFRS and US GAAP; however, IFRS at this point neither provide comparable nor instructive guidance to help these firms to be able to understand and to recognise the appropriate accounting methods they should employ.

Feature

Biog box
Eva K Jermakowicz, PhD, CPA, is professor of Accounting and Chair of the Department of Accounting at Tennessee State University, Nashville. Barry Jay Epstein, PhD, CPA, is partner in the Chicago, Illinois firm, Russell Novak & Company LLP, and consults with corporations and accounting firms on the application of IFRS. Drs Epstein and Jermakowicz are co-authors of Wiley IFRS 2008 and Wiley IFRS Policies and Procedures. Elaine Vullmahn, CPA (Russell Novak & Company, LLP) also assisted with this article. Email: ejermakowicz@tnstate.edu and BEpstein@rnco.com

Tax planning, provisions and compliance

Although the impact will vary between companies, IFRS will affect, amongst others:

- Current payments for taxes (eg, IFRS does not permit LIFO accounting);
- Effective tax rates (due to differences in accounting for share-based payments, intercompany sales, and changes in foreign currency exchange rates, etc);
- Calculation of deferred taxes (eg, accounting for investments);
- Reassessment of unrecognised tax benefits;
- Compensation and benefit plans; and
- Increased importance of tax planning.

Potential significant changes in infrastructure

The use of IFRS requires a new perspective. This is particularly true for certain industry-specific issues. For example, investment companies assessing whether to adopt IFRS will face unique issues due to underlying differences in accounting for certain investment holdings under IFRS.

The number and significance of different accounting outcomes associated with the application of US GAAP and IFRS will vary from issuer to issuer and will depend on important factors such as the industry the company operates in and the accounting policy choices the company has previously made. The expectation for US issuers going forward should be that the 'devil is in the detail'. Adopting IFRS is much more than an accounting issue. Adopting IFRS may impact key performance metrics, treasury options, business combinations, pension plans, tax liabilities, debt covenants, investor relations and communications with the markets.

ADVANCE PLANNING

Advance planning is the best way for US companies to prepare for implementing IFRS and to take the opportunity to reassess financial policies and processes. US companies need to begin by assessing current IFRS reporting obligations within their organisations. Overall, adoption of IFRS should bring greater transparency in the treatment of industry-specific issues and help simplify and streamline statutory reporting. In addition, IFRS should harmonise internal and external reporting by creating a single accounting language throughout the entity.

In transition to IFRS, US companies will need to consider potential barriers presented by their other regulatory and contractual financial reporting requirements, which might be based on US GAAP. For example, lending arrangements and covenant terms should be revised to comply with IFRS. In some cases, dual financial reporting systems may be needed to satisfy incremental statutory or contractual requirements, hopefully only for a period of transition. An assessment of current risk exposure under existing IFRS reporting requirements should also be completed.

Other barriers in adopting IFRS are principally related to cost and education. Conversion experience in Europe, Australia and Asia indicates that the implementation process often takes more time and resources than anticipated. This has led some foreign companies to rush, risk mistakes, or outsource more work than is necessary. These actions can hinder an organisation's personnel in attaining the requisite level of IFRS knowledge necessary to perform day-to-day operations.

Companies need to evaluate the impact of IFRS adoption on accounting policy. How companies address this challenge will be one of the more important issues they will face during the transition. Some areas of accounting will require new policies due to existing differences in standards. In other areas, there may or may not be differences, depending on the choices made. As an example, companies will need to restate their opening balance sheet as of the date of transition to IFRS and report under both US GAAP and IFRS on that date. A calendar-year-end company, then, which is eligible to adopt IFRS in 2009 would have 1 January 2007 as the transition date.

An entity adopting IFRS for the first time may also have a choice among accounting standards as well as accounting policies as a result of:

- Options with accounting standards (newly issued IFRS);
- Options within accounting standards.

The IASB has a number of projects currently on its agenda where standards might be finalised prior to the transition date with application dates beyond that date and with early adoption permitted. In addition, on first-time adoption of IFRS, an entity has certain choices between different options of accounting policies where permitted under accounting standards. Examples of areas where options within IFRS exist include:

- cost versus revaluation basis of accounting for property, plant and equipment and intangible assets (IAS 16, IAS 38);
- cost versus fair value basis of accounting for investment property (IAS 40);
- proportionate consolidation versus equity accounting of jointly controlled entities (IAS 31); and
- fair value versus proportionate share of the acquiree's identifiable net assets to measure non-controlling interest in consolidated financial statements; this choice will result in recognising goodwill relating to 100 per cent of the business or recognising goodwill relating only to the percentage interest acquired.

Under IFRS there are several other areas where companies will have a choice of accounting policies they may select to implement. Companies need to be cognisant that the accounting policies they elect could have a significant impact on an entity's future results. Once an accounting policy is adopted, opportunities to change may be restricted to justified situations where the change would result in a more appropriate presentation.

In summary, there is no question that the SEC roadmap is an important step toward a single set of high-quality global accounting standards. A firm commitment by the US to make a mandatory switch in 2014 would serve as a strong impetus for positive changes to financial reporting, regulatory and legal systems as well as spur benefits to the global capital markets. In order to be ready for the change, companies should begin planning by assessing how their current internal operations and external activities might be affected by converting in the near term to IFRS. ■