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At a Crossroads: The Impact of International Financial Reporting Standards in the U.S.

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AT A CROSSROADS: THE IMPACT OF INTERNATIONAL FINANCIAL REPORTING STANDARDS IN THE U.S.

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ABSTRACT

Public companies in the United States face a new challenge. As set forth in its roadmap for implementation, the Securities and Exchange Commission ("SEC") is considering the potential use of financial statements prepared in accordance with international financial reporting standards ("IFRS".) The chief goal of these global standards is to establish a uniform system to improve comparability of companies' financial positions. For decades, Generally Accepted Accounting Principles ("GAAP") have been the framework of financial statement preparation for public companies in the U.S. The movement to IFRS represents an unprecedented change in the basis of financial reporting, since IFRS would supersede GAAP. This paper examines the current status of the SEC plan and a variety of issues raised by the U.S. transition to IFRS. Some fundamental accounting differences between IFRS and GAAP, the impact of IFRS on financial statements, the benefits and costs of adoption and the obstacles to implementation of IFRS in the U.S. are among the issues discussed.

INTRODUCTION

Public companies in the United States are facing a new challenge. In November 2008 the SEC published its document "Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers" which established a timeline for U.S. companies to change its basis for preparation of financial statements and disclosures from U.S. Generally Accepted Accounting Principles ("GAAP") to standards issued by the International Accounting Standards Board ("IASB"). The roadmap provides the SEC, Public Company Accounting Oversight Board (PCAOB), Financial Accounting Standards Board (FASB) and other stakeholders with an outline of the key steps required for U.S. markets to make this transition.

Since 1973, GAAP has been the framework of financial statement preparation for public companies in the U.S. The Securities and Exchange Commission ("SEC") has allowed the private sector to develop and enforce these accounting standards created by the FASB and its predecessors. The shift to IFRS represents an unprecedented change in financial reporting, since IFRS would supersede GAAP. The chief goal of these standards is to establish a uniform global system to improve comparability of companies' financial positions across countries.

This paper examines a variety of issues raised by the U.S. transition to IFRS. First, a brief historical context of the emergence of international standards is provided, including the expected benefits of a single international reporting framework. Second, some fundamental accounting differences between IFRS and GAAP are presented to highlight distinctions between the two approaches to financial reporting. Through specific examples, the impact of these differences on financial statements prepared in the U.S. is illustrated. Finally, the potential costs of adoption and the current obstacles to implementation of IFRS in the U.S. are explored.

THE EMERGENCE OF INTERNATIONAL FINANCIAL REPORTING STANDARDS

Accounting standards enable companies to capture and report its economic transactions; they represent a structure used by managers and preparers for recording and summarizing business transactions into meaningful financial reports so that users can understand the effects of the events and the overall financial health of the reporting entity. However, accounting standards that are established in each country generally can result in differences both in the amount and manner in which firms report the same economic transactions. Variations in cultural, political, and economic characteristics are among the reasons for differences in accounting standards that lead to financial statements reporting different income and financial position, given the same economic activities. [Plumlee]

Historically, a system of separate, distinct standards for each country worked relatively efficiently. But with the development of the global economy, American companies conduct business internationally, and merge with foreign firms to create international conglomerates. "A large number of U.S. companies do more than 50 percent of their business overseas." [Cohn] Even individuals are affected by the globalization of business, since they can now purchase stocks on foreign exchanges. Consequently, in terms of the financial markets, capital formation and trade, the use of different reporting standards by firms operating in different countries has grown ineffective for purposes of comparability and efficiency. Having to restate and convert accounting data from one country's system to the next is a financial reporting burden. Thus, the pressure from various stakeholders to report the same transactions consistently has led to the development of International Financial Reporting Standards.

Prior to 1973, companies that were listed on multiple stock exchanges in different countries were required to issue multiple versions of financial reports in order to comply with each country's separate reporting guidelines. In 1973, the International Accounting Standards Committee ("IASC") was formed with the mission of establishing a uniform reporting system in response to the growing desire for a single set of standards. This goal was initiated by accountants within Canada, the UK and the U.S. Through the 1990s, efforts increased to further develop the quality and application of such standards internationally. Approximately 41 international standards were developed before the IASC was replaced with the establishment of the International Accounting Standards Board (IASB") in 2001.

Several significant events have occurred in recent years which have fueled the more widespread international acceptance of IFRS. In 2002, the security market regulators of the European Union ("EU") decided to require all companies whose securities are listed on an EU-regulated stock exchange to adopt IFRS by 2005. In that same year, the Sarbanes-Oxley Act was passed in the U.S. with the goals of increasing transparency of financial statements issued by publicly held companies, protecting investors and restoring investor confidence in the financial markets. Also, in 2002, the Norwalk Agreement between the FASB and IASB was established, with the goal of 'convergence' between GAAP and IFRS. In July 2007, the SEC eliminated the costly reconciliation requirement in the annual filings for Foreign Private Issuers. Previously foreign firms that listed on the U.S. security markets (non-U.S. public firms) were required to prepare form 20-F, which is a comprehensive schedule detailing the reconciling differences between their reported IFRS based financial statements and the results if GAAP were applied. In making this change, the SEC was not only encouraging more companies to list on the U.S. markets but also signaling that IFRS is a high quality set of accounting standards that is an acceptable alternative to GAAP.

Finally, in November 2008 the SEC published its 'roadmap' with a timeline for preparing financial statements in accordance with international financial reporting standards ("IFRS".) This plan starts with the largest companies' reports for fiscal years beginning on or after December 15, 2014, provided certain milestones are met by 2011. These four milestones relate to:

1. Improvements in accounting standards.
2. Development by the IASB of an independent funding mechanism.
3. Assessment of the IFRS transition process, including the cost and acceptance by stakeholders.
4. Education and training in the U.S.

[SEC]

POTENTIAL BENEFITS OF IFRS IMPLEMENTATION

Implementation of IFRS as the basis of financial reports provides several potential benefits to U.S. companies. First, it could streamline costs for firms that operate globally by reducing the costs and complexity in reporting. U.S. companies would no longer need to produce two sets of financial statements (one for U.S. and one for other capital markets) or to reconcile the reports created under two sets of standards. Companies could "achieve greater efficiency with fewer different reporting requirements across multiple jurisdictions and bring a new level of comparability for investors" [Heffes] Second, this increase in comparability is keynote in allowing users of financial statements to make better investment decisions because they will not need to translate information reported under multiple sets of standards. In other words, use of IFRS would create greater transparency of financial information for investors and allow for greater exchange of capital at a lower cost. Third, a single global set of standards would benefit preparers, investors, bankers and creditors by simplifying the learning process since they would only need to master one set of accounting standards. They will be able to review the early adopters' initial reconciliations between GAAP and IFRS and leverage that information to improve staff training. In addition, "the roadmap recognizes that many large, institutional investors are currently familiar with and use IFRS" and will be motivated to educate their employees. [AICPA] In short, "the adoption of a single, high-quality, and comprehensive set of accounting standards will produce transparent financial reports, and thereby, lower the cost of capital and facilitate capital formation" [Plumlee] IFRS is a desirable reporting system because it would enhance market efficiencies with improved access to financial markets, and bring a "higher degree of investor understanding and confidence than currently exists." [Heffes]

CONCEPTUAL FRAMEWORK DIFFERENCES BETWEEN FASB AND IASB

A conceptual framework forms the backdrop against which standard setters make decisions in establishing accounting standards. Although the frameworks of the FASB and IASB have many similarities, the differences bring about the disparity in standards for accounting and reporting financial results. GAAP is oriented more towards reliability of information whereas IFRS seems to place greater weight on relevance of reported values. Similarly, FASB's approach considers consistency an important attribute of financial information, whereas IASB places more emphasis on the understandability of presented information. The FASB and IASB are working jointly to develop a common conceptual framework to guide the definitions of financial statement elements (i.e. assets, liabilities, revenues, and expenses) and their recognition, measurement and reporting. [Plumlee]

DIFFERENCES IN FINANCIAL STATEMENT PRESENTATION

The set of statements required by FASB and IASB is the same: they both include the income statement, balance sheet, statement of stockholders' equity, statement of cash flows and footnote disclosures. However, slight differences exist in the format and terminology of the financial information contained in these financial statements. On the income statement, there are some variations in the classification of expenses, while the balance sheet format differs in terms of order of accounts presented both within categories and among categories. For example, current assets precede long term assets according to GAAP and current assets are presented in order of liquidity, from most to least liquid. In contrast, IFRS balance sheets list least liquid assets first, in terms of asset category and within the current asset classification.

Some variations are also revealed in the presentation of data constituting stockholders' equity. These differences do not alter the overall reflection of a firm's profitability or financial position, as they ultimately report the same information and therefore require little adjustment of interpretation to attain comparability across financial statements. However, on the Statement of Cash Flows, "the classification of cash flows among operating, financing and investing may differ between GAAP and IFRS. Initially, this may seem to be a cosmetic difference, [but] given the importance of ratios and other tools for analysis, these differences in classification will complicate comparing GAAP and IFRS prepared financial reports." [Plumlee] Finally, while GAAP requires significant footnote disclosures, because IFRS is not as prescriptive as GAAP, its footnotes require far more detailed descriptions.

SUBSTANTIVE DIFFERENCES IN REPORTED TRANSACTIONS AND EVENTS

Substantive accounting and reporting differences cause financial statement impact that affects comparability. These differences occur because of variations in classification of items, valuation of economic events, the timing of when business transactions are recognized, and philosophical approaches to financial reporting. They consequently create differences in financial statement information reported at a given point in time under GAAP versus IFRS. These differences, outlined below, represent areas of disparity between the two systems, which must be resolved before IFRS can be fully adopted in the U.S.

1. Reporting differences arise due to the variation in criteria used to classify items by IFRS versus GAAP. Since assessments are often made through application of ratio analysis, such reporting differences can significantly influence how financial statement users evaluate the firm. For example, deferred tax assets or liabilities are treated as a noncurrent item under IFRS whereas GAAP classifies these as current or noncurrent depending upon the anticipated timing of when the tax difference will reverse. In another instance, hybrid securities such as convertible bonds are treated entirely as debt under GAAP (i.e. no value is attributed to the conversion feature) whereas IFRS reports this financial instrument as part debt and part equity (using a relative value basis for the respective classifications.) These discrepancies in financial reporting can lead to differing assessment of a firm's liquidity, solvency and valuations related to equity.

2. Recognition deals with the determination of when an item becomes an element of the financial statement. In other words, differences between IFRS and GAAP

criteria can create a difference in the timing of when a transaction gives rise to a revenue earned or an asset is created, and when an expense is incurred or a liability is created. Although these differences are temporary, because they ultimately reverse, they cause financial statement balance differences, which can compromise comparability of the results. For example, under IFRS, research and development expenditures are initially treated as assets, affecting the balance sheet in the year of recognition, and subsequent income statements in future years through amortization expense. Under GAAP, these expenditures are fully expensed in the income statement in the period incurred, and are not ever recognized on the balance sheet. Over the time period of amortization under IFRS, both the balance sheet and the income statement will reflect different asset and expense balances related to the same transaction than those reported in accordance with GAAP.

3. Measurement differences relate to the monetary amounts assigned to the elements of the financial statement. These differences are not temporary, but rather they create permanent variations in the reported values. For example, GAAP uses historical cost (original exchange or purchase price) as the basis to value fixed assets whereas IFRS allows the measurement of fixed assets at fair value. This difference stems from the difference in emphasis placed on reliability by FASB (because of objectivity and verifiability of historical cost) and relevance by IASB. In addition, with regard to fair value, GAAP defines its measure as the exit price of an asset (its net realizable value or the net proceeds received if the asset were sold) whereas IFRS uses the entry value (i.e. replacement cost) as the basis for fair value. Measurement differences such as these can compromise the comparability of GAAP-based versus IFRS-based financial statements.

4. In general, financial reporting differences arise because of the rules-based orientation of GAAP versus the principles-based perspective of IFRS. The rules-based nature of GAAP has caused its standards and guidelines to exceed 30,000 pages of text, while IFRS is only approximately 3,000 pages. GAAP has developed into a set of prescriptive rules and regulations to account for transactions, and those guidelines are incorporated into the body of the financial statements and through disclosure. These guidelines are often referred to as 'bright line rules', which set forth unambiguous criteria for accounting. In contrast, IFRS does not establish specific accounting rules in all instances, reflecting its more principles based approach to financial reporting. This difference in orientation results in some major differences between GAAP and IFRS reporting, including variation in the required footnote disclosures. For example, with regard to lease accounting, both systems broadly define a capital lease as one in which the risks and rewards of ownership are transferred to the lessee. However, FASB sets forth specific, objective and numeric criteria for the determination of whether a lease is a capital lease (resulting in the creation of an asset and related liability) or an operating lease (resulting in rent expense on the income statement). Unlike GAAP, IFRS permits professional judgment in assessing the ownership risks and rewards providing no specific rules or criteria for defining a capital lease. Consequently, IFRS statements require substantially more detailed and lengthy footnote disclosures so that financial statement users can understand and properly interpret the leasing transactions. IFRS footnotes "will necessarily expand to fill in the details formerly supplied under U.S. GAAP." [Katz] Another critical difference in rules is that GAAP allows the use of LIFO (last-in, first-out) for inventory valuation whereas IFRS does not. This distinction could significantly affect reported operating results and related income taxes, particularly because of the U.S. LIFO conformity rule. This convention requires firms that use LIFO inventory valuation for tax reporting purposes to also use it for financial accounting purposes. Unless this tax rule is modified or eliminated, shifting to IFRS would eliminate LIFO costing, which would result in a large current tax liability for companies that use the method. [Hoffman]

THE COSTS OF IFRS

A survey by Accenture found that U.S. executives expect to pay more than their European counterparts did to implement IFRS. They anticipate spending between .1%-.7 percent of annual revenue to change from GAAP to global rules [Johnson]. It will be more expensive because U.S. companies will have to maintain GAAP and IFRS systems simultaneously to be in compliance with the SEC's parallel reporting requirements during the transition period. In contrast to U.S. accounting standards, European countries' accounting rules were more similar to the principles-based IFRS, making its transition simpler. Some have argued that the switch to IFRS in the U.S. will be four times more costly than compliance with Sarbanes-Oxley. [Johnson] The magnitude of cost is even greater because IFRS "is not just driven by government policy, it is also driven by capitalization of global markets." [Deloitte] Costs will be incurred to work through the differences between the two standards on technology infrastructure, financial reporting systems and processes, technical accounting and tax, internal controls and processes, and underlying databases to incorporate specific data to support IFRS reporting. [Deloitte] Variation in "costs will stem from a company's industry, size, complexity, staffing abilities and accounting policies." [Johnson] Companies may need to "reexamine contracts and debt agreements, treasury policies, employee benefits, education and training, and communications." [Deloitte] Naturally, significant audit fees during the period of change are likely to be incurred as well. [Katz]

POTENTIAL CHALLENGES OF IFRS IMPLEMENTATION

Not everyone agrees that U.S. movement towards IFRS financial reporting is in the best interest of U.S. investors. Concerns relate to the reliability of financial statements, the lack of centralization in securities market regulations, the timeline for implementation given current economic conditions, and the need for sufficient education of preparers and users of financial reports.

There is a great deal of skepticism and concern that financial statements prepared using IFRS may actually turn out to be less transparent and not of the high quality desired, thereby reducing comparability. The simple question is: will a principles-based system improve financial reporting by allowing preparers and managers to increase their application of professional judgment in creating such reports? Given the less structured guidance under IFRS, investors may not be receptive to the judgment that is the "linchpin of a principles-based system" [Katz] The unease stems from the chance that financial reporting consistency may not be realized and instead there may be a wider variety of results than currently occur under GAAP reporting. Ironically, in the long run, this could lead to IFRS becoming a more rules-based set of standards.

The lack of centralization in the current regulation of the security markets could also impede creating a set of standards producing consistent financial reports. Currently, financial statements produced by firms are filed with and regulated by the security markets where those firms are traded. To achieve the desired comparability, ultimately there should be consistent regulation of IFRS. [Plumlee]

The current U.S. economy, in which there are lower earnings, lower asset values and tightened credit, makes U.S. companies reluctant to assume the costs and risks of transitioning to IFRS. Transition costs will be high since multinational firms will need to gather information, and make modifications to accounting policies, processes and control systems. In addition, firms may need to renegotiate debt and other agreements currently linked to their financial results under GAAP that change as a result of shifting to IFRS reporting basis. Many believe that now is "not the time to increase the cost of doing business." [SEC] Rather, the timeline for implementation is too accelerated; by slowing it down, the transition at a later point in time may be easier and thus less costly.

Another obstacle to IFRS is that the U.S. market is simply not prepared for the transition. IFRS implementation requires a new orientation by variety of people who will require training to deal with less detailed application guidance, such as board and audit committee members, investors, analysts, creditors, customers, and suppliers. [Heffes] Further, the education of accountants, academics, and auditors must take place to ensure they possess appropriate skills and training for proper adoption and adherence to IFRS. Additionally, a concern has been voiced about the lack of sufficient IFRS education provided to accounting students, who as entry-level CPAs will need to be bi-lingual with respect to accounting standards. [Heffes]

CONCLUSION

No one can argue that with the advent of global financial markets the development of one high quality set of financial reporting standards is a laudable goal. As recently as September 2009, the G-20 leaders, embodying international economic cooperation, called for "international accounting bodies to redouble their efforts to achieve a single set of high quality, global accounting standards within the context of their independent standard setting process, and complete their convergence project by June 2011." [Lamoreaux] Multiple sound reasons compel the international accounting bodies to work towards the implementation of IFRS worldwide, and in the U.S. in particular. "The appeal of IFRS is: simplified reporting, reduced operating costs, greater transparency and comparability for investors, [and] improved access to capital." [Deloitte] However, the magnitude of the shift in the U.S. mindset for reporting under IFRS, in terms of explicit costs and the impact of new financial reporting systems on businesses and stakeholders presents a number of issues that must first be resolved, which may create detours on the roadmap to implementation.

SEC chairman Mary L. Schapiro has acknowledged the SEC has been focused on matters related to the economic crisis, financial regulatory reform and improvements in the agency [Millman], resulting in no recent movement toward adopting IFRS in the U.S. Although the two standard setters – FASB and IASB – have pursued a convergence agenda, many differences remain. [Heffe] The impact of the financial crisis has also forced both FASB and IASB to respond to their respective political pressures keeping them from being in sync. Serious concerns persist about the costs of IFRS implementation and whether the IFRS are in fact as good as or better than GAAP. [AICPA] It seems inevitable that at some point in the future, this historical trend toward convergence to a single set of global financial reporting standards will be achieved. The time line to fully develop it and the compromises it may require are yet to unfold. Implementation of IFRS in the U.S. is a complex endeavor that will be far reaching beyond just accounting and financial reporting. [Heffe]

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