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IFRS: WHAT IT IS AND HOW IT IMPACTS YOUR ORGANIZATION

An Overview of the International Financial Reporting Standards, the key differences with the US Generally Accepted Accounting Principles and its impact on organizations today from a business, financial and technology perspective.

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Introduction

It is hardly surprising, given the current economic climate, that there appears to be a state of 'wait and see' regarding future developments in worldwide accounting standards. Most observers are aware that, for sustainable confidence to return to the global financial markets, changes will be needed. In the US the Securities and Exchange Commission (SEC) has set forward a proposed roadmap for the conversion of the current US Generally Accepted Accounting Principles (GAAP) to the International Financial Reporting Standards (IFRSs). Many knowledgeable observers view this as a step in the right direction. However, there is also an understanding that this transition will not be easy.

In this guide "IFRS: WHAT IT IS AND HOW IT IMPACTS YOUR ORGANIZATION" we review the background of IFRSs and its value proposition. We then examine current plans for the implementation of IFRS in the US and illustrate some notable high-level differences between IFRSs and US GAAP. We also consider the effects of the current financial crises to IFRSs. We go on to highlight the impact that a move to IFRSs will have to affected companies. We conclude by pointing out what organizations should be doing to prepare for the move to IFRSs. We hope you find the Guide useful.

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IFRSs the Background

International Financial Reporting Standards (IFRSs) are the Standards, Interpretations and the Framework (i.e. in situations where Standards and Interpretations that apply to an accounting transaction are not available the IFRS Framework stipulates that management should use its best judgment to both develop and apply an accounting policy that produces information that is reliable and relevant) adopted by the International Accounting Standards Board (IASB).

IFRS are primarily made up of International Accounting Standards (IAS) issued by the International Accounting Standards Committee (IASC) from 1973 to 2001. In 2001 the IASB made a decision to aggregate all the IAS into one umbrella called the IFRSs. Since 2001 the IASB has continued the development of the IFRSs.

IFRSs as they stand today are 'principle-based' as they set forth broad rules in addition to dictating specific accounting treatments. There are two key underlying principles that underpin the IFRSs. These are the accruals principle and the going concern principle. The accruals principle assumes that the effects of transactions and other relevant events are recognized as they happen and not when cash is received or paid out. The going concern principle assumes that financial statements for an entity are prepared on the basis that the entity will continue to operate for the foreseeable future.

Today IFRSs are used in many parts of the world, including the entire European Union, Australia, Malaysia, Singapore, Hong Kong, Turkey, Pakistan, Russia and South Africa. As at June 1 2009 approximately 117 countries globally either stipulated or permitted IFRSs reporting for domestic listed companies. Brazil, Canada and South Korea plans to implement IFRSs for public profit oriented enterprises by the end of 2011 with Mexico following in 2012.

IFRSs the Value Proposition

With the increased level of consistency that comes with the use of IFRSs, investors all over the world will be able to compare like for like when reviewing company accounts. For example in the US approximately two-thirds of investors own shares in non-US companies, the majority of which have either adopted or are planning to adopt IFRSs in the near future.

Along with the move towards the global implementation of IFRSs and the harmonization of accounting standards will come an eventual reduction in costs for multi-national companies as a result of economies-of-scale. Not just multi-nationals will be impacted, as smaller companies who seek investment or alternative form of funding from abroad will need to be cognizant of the standards.

Champions of IFRSs have used its increasing permutation globally as an opportunity to take a closer look at the quality and integrity of management boards through the judgments they make when reporting financial results. This is an important point given the recent high profile corporate failures we have witnessed within the last year.

IFRSs in the United States (US)

Currently US companies that are registered with the United States Securities and Exchange Commission (SEC) are required to prepare and file financial statements in accordance with US Generally Accepted Accounting Principles (GAAP). In November 2008 the SEC proposed a roadmap for the evaluation and eventual adoption of IFRSs. Under the proposed roadmap, the SEC will make a decision by 2011 as to if US listed companies will be required to adopt IFRSs commencing in 2014. Under this plan some large companies, who meet certain qualifying criteria related to their size and the penetration of IFRSs in their industry, may be allowed early adoption of IFRSs starting in 2010.

The roadmap as it currently stands calls for a staged transition beginning with large accelerated filers for fiscal years ending on or after Dec. 15, 2014. Next will come a second wave of accelerated filers for fiscal years ending on or after Dec. 15, 2015. Finally, all the remaining non-accelerated filers, including smaller reporting companies, will start filing for fiscal years ending on or after Dec. 15, 2016. The SEC has proposed to reconvene in 2011 to evaluate progress towards these milestones and to evaluate information gathered from early adaptors before making a final decision on setting any mandatory dates.

John Smith a member of the International Accounting Standards Board (IASB) in a statement made to the European Commission Conference on May 7th 2009 stated "I believe it is in the interest of the United States to adopt IFRSs in the next five years. With Brazil, Canada, China, India, Japan and Korea committed, with the European Union already using IFRSs, the cost to the United States of failing to adopt IFRSs will be high. If it doesn't adopt, it will be the outlier and those countries already adopting and committing themselves to IFRSs will not accept a situation where the United States remains outside the system indefinitely, yet has a seat at the table".

It is clear that the US cannot ignore IFRSs as its proliferation spread globally. Some experts, however, have warned that the implementation of IFRSs in the US could take while to achieve. In May 2009, Robert Herz, chairman of the US Financial Accounting Standards Board (FASB), speaking to Reuters concluded that while most people are arguing that work on the project must go on, it could take more effort than they expect. He added that the SEC will have to do more to make the public policy case if America is to ever adopt IFRSs. According to Mr. Herz, the current process of convergence is sustainable for the "next three to five years" but a decision on full adoption will need to be made after this point.

IFRSs Vs. US GAAP

In this section we will highlight some of the differences between IFRSs and US GAAP. This is not intended to be an exhaustive list but more a representation of what we view as some of the notable differences.

Principle-based vs. rule-based – A major difference between IFRSs and US GAAP is that on the one hand IFRSs are 'principle-based' and on the other US GAAP standards are 'rule-based'. Generally, it is easier to apply and enforce rule-based standards than it is principle-based standards. However, with rule based standards come exceptions. These exceptions have been the Achilles heel of the US GAAP as they add a layer of complexity that often result in application issues. In comparison IFRSs being principle-based account for exceptions by permitting judgment to be used when applying the standards to a company's financials. A notable factor here is that US GAAP, while encouraging companies to comply with laws, discourages these very companies from fully evaluating the economic substance of their activities.

Financial statement presentation – US GAAP in certain circumstances allows the presentation of a single year of accounts. IFRSs stipulate that comparative information (i.e. the previous year's figures) must be disclosed for all amounts reported in the financial statements. Additionally, IFRSs prohibit extraordinary items from the income statement while US GAAP only restricts such items.

Consolidation – IFRSs requires that subsidiaries must adopt the accounting policies of their parent company when consolidating the financial statements. US GAAP also has a similar requirement. However, the difference lies in how each standard requires that parent subsidiary relationships are determined. US GAAP is based on who has the right to incur the income and losses of a related entity. While with IFRSs it is based on the notion of 'control' over an entity to determine if a parent subsidiary relationship exist.

Financial Instruments/ Fair value measurements – IFRSs views fair value as neither an entry nor exit price, but the price that an asset could be exchanged, or a liability settled between willing parties. US GAAP has one measurement model for fair value that is based on an exit price that would be received upon sale of that asset or paid to transfer a liability in the primary or most advantageous market for the asst or liability.

Financial Instruments/ Fair Value Option - With US GAAP financial instruments can be measured at fair value with changes in fair value reporting through net income, apart from specific ineligible financial assets and liabilities. This is also the case with IFRSs with the main difference that it is only available provided that certain criteria, which are more restrictive than under US GAAP, are met.

Financial Instruments/ Debt vs. Equity Classification – US GAAP identifies certain instruments with characteristics of debt and equity that are required to be classified as liabilities. While with IFRSs the classification of such instruments centers on the contractual obligation to deliver cash, assets, or an entity's own shares. Additionally, with IFRSs economic compulsion is not classified as a contractual obligation.

Management Compensation – IFRSs stipulate that compensation for key management is disclosed in the financial statement while US GAAP has no such requirement.

Inventory – IFRSs requires that the first-in-first-out (FIFO) costing methodology for inventory is used and prohibits the use of last-in-first-out (LIFO) that is permitted under US GAAP.

Depreciation - Under IFRSs if an asset has different components that have varying life expectancy the asset must be depreciated in segments rather than as a whole. This practice although allowed by US GAAP in not commonly used.

The Current Global Economic Climate's Impact on IFRSs

Some concerns with IFRSs have been raised primarily in the US where the ongoing debate around the adequacy of the capital market regulations has influenced views of IFRSs. This is because as a set of regulations IFRSs are less prescriptive than US GAAP and this can be viewed as less restrictive at a time when voices are calling for more regulation over financial reporting and the capital markets. In the US the SEC will have to consider the impact of the financial crises very closely in its decision around the final roadmap to implementing IFRSs.

However, the recent adverse global economic climate has served to highlight the manner in which global markets are highly dependant on one another. It has also highlighted the need for financial statements and accounting language to be harmonized globally. Financial institutions, regulators and investors globally failed to understand adequately the risks being taken by many companies that either failed or suffered heavily during the global economic downturn. Accounting needs to play an important part in assisting all parties in this regard. Therefore, there is a need globally to provide additional transparency to the risks being taken by financial institutions and provide meaningful information to both investors and regulators alike.

IFRSs the Impact to Companies

Business and Accounting Impact - The implementation of IFRSs will impact companies in numerous significant ways. For example under IFRSs the accounting impact on a company's revenue recognition will be different. This could result a change in business strategy for some companies as certain financial products may no longer be profitable and new business opportunities may arise.

From an accounting perspective there will be changes required in the structure of charts of accounts, analysis codes and journal definitions. Companies will also need to re-evaluate their hedging strategies, as what are currently acceptable hedging strategies may no longer attract hedge accounting treatment. There will also be a change in financial reporting requirements as new rules around consolidation and financial statement presentation are required under IFRSs.

Technology Impact - As IFRSs impacts business and accounting approaches for companies it will also have a significant impact to Technology. New requirements will force organizations to assess their current data very closely. Availability and completeness of required data and where available the granularity of the data will have to be considered. Companies will also need to factor the consistency of definition for data elements and the relevancy of such data.

From a platform perspective, companies will need the ability to consolidate General Ledger data based on IFRSs. Specialized software or system upgrades may be required to handle items such as share-based payments, consolidated GL data, insurance contracts, mapping of charts of accounts, analysis codes and journal definitions. New system interfaces may also be required.

The business, accounting and technology impact of the move to IFRSs will result in many organizations putting IFRSs transition Programs in place to effectively co-ordinate all of the moving pieces.

Conclusion – IFRSs What Should Your Organization Be Doing?

Notwithstanding the drawn out timeline for US implementation and the current priorities on the financial crisis, companies need to stay focused on IFRSs. It seems a matter of when rather than if the US will fully adopt IFRSs.

Companies, particularly those that participate internationally and who seek funding from other nations, should start to formulate a thoughtful, measured and strategic approach for addressing IFRSs. This approach should start with a preliminary analysis in order to identify any relevant accounting, tax, business, investor, systems and control issues that may arise with the transition to IFRSs.

Companies need to view an IFRSs conversion as more than a change in accounting policy, as a successful IFRS conversion must plan and manage change across business processes, technologies, and the entire organization impacting both the group and business unit levels. This fact is highlighted by the plight of many European Union companies that used manual workarounds to meet tight IFRS deadlines. These companies are now feeling the pain and spending heavily to redesign processes and augment systems in order to eliminate the inefficiencies these workarounds created.

As companies determine strategic plans for the coming years they should also factor in the impact of IFRSs to their business model. It is also best to maintain a 'corporate view' of the implementation of IFRSs for any subsidiaries that are required to implement IFRSs earlier than a US parent.

With the advent of the economic downturn there will be changes in the regulatory environment that will impact both US GAAP and IFRS. Companies should stay up to date with these changes and try to anticipate any circumstances that will result in significant changes to their business models, risk environments and financial reporting requirements.

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