

IFRS!!!

Ready or Not

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Key Points

1. United States **almost certainly will** entirely switch to IFRS (International **F**inancial **R**eporting **S**tandards) over the next 5 to 10 years.
2. Foreign companies publicly traded in the U.S. can use IFRS.
3. U.S. GAAP and IFRS are very, very similar.
 - Some differences exist in the details.
 - Rules vs. Principles
4. Enforcement and national politics are the remaining barriers to complete international convergence.



FASB & IASB Beginnings

- Both established in 1973.
- Initially, the IASB was called the IASC (International Accounting Standards Committee).
- Important difference: The IASC was run by the CPAs of the world.
 - Does the business community want the accountants setting all of the rules?
- Initial IASC standards were often just descriptions of diverse national practices.
 - No guidance on HOW.



FASB & IASB
Early IASC Examples

- Inventory
 - Original standard: LIFO, FIFO, average, base stock
 - 1992: Kill base stock, LIFO survives as “allowed alternative treatment”
 - Now: LIFO is dead
- Interest capitalization
 - Original standard: “Capitalise” OR expense (but be consistent)
 - 1989: benchmark method -- capitalization
 - 1993: Capitalization not allowed
 - Now: Capitalization required ... plus a twist



FASB & IASB
FASB in the Lead

- Until about 1995, the FASB was the clear front runner as the source for a common set of worldwide accounting standards.
- International reluctance:
Do the French want their accounting rules set by the Americans?



FASB & IASB
“IASB” Restructuring

- In 2001, IASC was restructured into IASB.
 - Business representation
 - Emphasis on comprehensive, consistent set of standards
 - Independent Board members
- Basically, the IASB became an international clone of the FASB.



**FASB & IASB
Norwalk Agreement**

- In 2002, IASB and FASB signed the **“Norwalk Agreement.”**
 - Jointly pledged to work together to develop a fully compatible set of standards.
- Peaceful cooperation on the surface, intense competition behind the scenes.
- For a time, the IASB Web site was almost like a **scoreboard** proudly proclaiming the number of countries that had accepted IASB standards as their national standard.



**IASB
SEC Stance – pre 2007**

- The SEC has legal authority over accounting standards in the United States.
- Until 2007, the SEC required foreign registrants to either
 - Prepare full financial statements using U.S. GAAP or
 - Prepare a summary reconciliation (net income and equity) of local GAAP to U.S. GAAP
- **Served as a substantial barrier to foreign companies listing on U.S. exchanges**



**SEC 20F Reconciliation
Example: Daimler-Benz**

Daimler-Benz Form 20F Reconciliation for 1993

(in millions of DM)

Net income under German GAAP	602
– Changes in appropriated retained earnings: provisions, reserves and valuation differences	(4,262)
	(3,660)
Other adjustments	(806)
Deferred taxes	2,627
Net loss under U.S. GAAP	(1,839)



SEC & IASB

The Indirect Impact of Enron

- Enron, WorldCom, and the rest **led to**
- Sarbanes-Oxley **which led to**
- Increased U.S. regulatory costs **which led to**
- A decrease in non-U.S. companies listed on U.S. exchanges **which led to**
- A broad reconsideration of the costs of U.S. securities regulation **which led to**
- **Proposals to drop the 20F reconciliation requirement for non-U.S. IFRS users.**



SEC & IASB

SEC Endorses IFRS

- In 2007, the SEC announced that non-U.S. companies would no longer be required to use FASB standards in order to list their shares on a U.S. stock exchange.
- **Implied message from the SEC: IFRS have reached the point where they are good enough for U.S. shareholders.**



SEC & IASB

IFRS in U.S. – Is Anyone Opposed?

- **So, since 2007, non-U.S. companies can trade in the United States using financial statements prepared under IFRS.**
- **Who would complain about this?**
- **What is the next natural step**



SEC & IASB
The BIG SEC Announcement

- On August 27, 2008, the SEC proposed requiring U.S. companies to use IASB standards.
- “The Securities and Exchange Commission signaled the demise of U.S. accounting standards, kicking off a process Wednesday that could ultimately require all publicly listed American companies to follow an international model instead.”



SEC & IASB
The “Road Map”

- **Announced Timeline (or “Road Map”)**
 - 110 large U.S. multinational companies would drop FASB standards and begin using IASB standards exclusively starting in 2010.
 - All U.S. publicly-traded companies would be required to use IASB standards by 2014.



FASB vs. IASB
The IASB Has Won?!?

At this point, it looked like the deal was done.

**Stick a fork
in the FASB??**

Not so fast.



FASB vs. IASB
The IASB Has Won?!?

- **Concerns** about the SEC proposal to completely adopt IFRS
 - U.S. investors can't understand IFRS.
 - Some U.S. companies might manipulate IFRS (which is more flexible than FASB standards) to deceive U.S. investors.
 - Who will enforce IFRS?



FASB vs. IASB
The IASB Has Won?!?

**It turns out ...
Concerns
were
justified.**



Concerns with the IASB
“Carve Outs”

- In 2004, the European Commission decided that it didn't like two provisions of IAS 39 on financial instruments. **So it changed them.**
 - Companies in “Member States” **cannot** apply the fair value option to financial liabilities.
 - Banks in “Member States” **can** apply interest rate hedge accounting to core deposits.
- “**IFRS as adopted by the EU**” as opposed to “**IFRS as issued by the IASB**”
- This is called a “carve out.”



October 2008 IASB Mess

EU Ultimatum to the IASB

- Change IAS 39 **IMMEDIATELY** ... or else.
- The “or else” was the threat of yet another “carve out.”
- By the way ... you’ve got 3 days to decide.
- Usually, an accounting standard change like this would be studied, drafted, exposed, and approved only after 3 years, not 3 days.

• **The IASB surrendered.**



October 2008 IASB Mess

U.S. Impact of the IASB Surrender

- **U.S. Implications of the Surrender?**
- This reinforced U.S. concerns:
 - Who enforces IFRS? There is no “international SEC.”
 - Does the U.S. business community really want accounting standards set abroad by a group susceptible to international pressure?



October 2008 IASB Mess

U.S. Impact of the IASB Surrender

- **This IASB surrender to the EU caused many in the United States to come to their senses.**



FASB & IASB
Aftermath of October 2008

The Current State of Affairs

- The FASB and IASB are still working towards convergence.
- The SEC has backed off of its aggressive timetable.
- Everyone is rethinking IASB independence and international enforcement.



SEC IFRS
Most Recent Word from the SEC

“Work Plan”

February 24, 2010

- “A single set of high-quality globally accepted accounting standards would benefit U.S. investors.”
- SEC staff to undertake “Work Plan” to address issues of concern
- Public report due no later than October 2010
- Conversion **no sooner than** 2015



SEC IFRS
Most Recent Word from the SEC

“Work Plan”

Key Issues

- Is IFRS good enough?
- Is the IASB process independent?
- What impact on U.S. regulations such as income taxes and regulatory reporting?
- Impact on contracts such as debt covenants?
- **Do U.S. preparers and users understand IFRS?**



SEC IFRS
Most Recent Word from the SEC

October 29, 2010 "Work Plan" Progress Report

Key Issues

- Is IFRS good enough? – **Varied implementation**
- Is the IASB process independent? – **Funding?**
- What impact on U.S. regulations such as income taxes and regulatory reporting? – **Work needed**
- Impact on contracts such as debt covenants? – **Transition help needed**
- **Do U.S. preparers and users understand IFRS? – This is us!!**



SEC IFRS Road Map
Summary

- **The Leaders of the G-20 have set a "complete convergence" date target of June 2011.**
 - IASB and FASB must "redouble their efforts."
- **G-20 has relaxed deadline to December 2011.**
 - IASB and FASB are still aiming for June 2011.



FASB, IASB, and You

- **International companies use IFRS and some or all **publicly-traded** U.S. companies will probably switch "soon" (about 5 years).**
- **FASB/IASB convergence (some IFRS now could become U.S. GAAP in the near future).**



**FASB & IASB
Similarities and Differences**

1. U.S. GAAP and IFRS are very, very similar.
2. Some differences exist in the details.
3. U.S. GAAP focuses on **Rules**
IFRS focuses on **Principles**



**FASB & IASB
Similarities and Differences**

WHY are they similar?

- Underlying, eternal accounting truth 😊
- FASB and IASB have been working for years to eliminate differences.



**FASB & IASB
Similarities and Differences**

HOW are they similar?

- Balance sheet, income statement, statement of cash flows.
- Assets, liabilities, revenues, etc.
- Debits = credits
- Depreciation, bad debts, etc.



**FASB & IASB
Similarities and Differences**

HOW are they DIFFERENT?

- Some technical differences
- Rules vs. Principles



**FASB & IASB
Similarities and Differences**

10 examples of technical differences

1. Short-term obligations to be refinanced
2. Cash flow categories
3. No LIFO!
4. Lower-of-cost-or-market reversals
5. Interest capitalization ... net
6. R&D costs
7. Asset impairment
8. Upward revaluation of PPE
9. Splitting convertible debt
10. Pension accounting ... the old way



Examples of Technical Differences: U.S. GAAP and IFRS
1. Short-term Obligations to be Refinanced

U.S. GAAP

Refinancing by the FINANCIAL STATEMENT DATE

IFRS

Refinancing by the BALANCE SHEET DATE



Examples of Technical Differences: U.S. GAAP and IFRS

2. Cash Flow Categories

Classification of	U.S. GAAP	IFRS
Interest paid	Operating	Operating or financing
Income taxes paid	Operating	Operating, investing, or financing
Interest received	Operating	Operating or investing
Dividends received	Operating	Operating or investing
Dividends paid	Financing	Operating or financing



Examples of Technical Differences: U.S. GAAP and IFRS

3. No LIFO!!

LIFO is not allowable under international financial reporting standards (IFRS). The United States will adopt IFRS some time in the next five to ten years.

What problems do you see arising if LIFO is abolished in the United States?



Examples of Technical Differences: U.S. GAAP and IFRS

4. LCM Reversals

Under IFRS

- Lower of cost or net realizable value
- Writedowns are reversed if selling price subsequently recovers



Examples of Technical Differences: U.S. GAAP and IFRS

5. Interest Capitalization ... Net

Under IFRS

- Amount capitalized is
 - Capitalizable interest paid
 - Less interest received on idle investment funds from construction borrowing



Examples of Technical Differences: U.S. GAAP and IFRS

6. R&D Costs

	U.S. Normal R&D	U.S. Software R&D	IFRS all R&D
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Research Begins

Research costs Expense Expense Expense

Technological Feasibility

Development costs Expense Asset Asset



Examples of Technical Differences: U.S. GAAP and IFRS

7. Asset Impairment

Impairment

U.S. GAAP

- Compare Book Value to Undiscounted Cash Flows
- If Undiscounted Cash Flows are less, the asset is impaired
- Impaired asset is written down to Fair Value

IFRS

- If Fair Value is less than Book Value, write the asset down to Fair Value



Examples of Technical Differences: U.S. GAAP and IFRS

8. Upward Revaluation of PPE

Under IFRS

- Upward revaluation of PPE is allowable, but not mandatory
 - The “gain” is reported as Revaluation Reserve (essentially AOCI).
 - The revaluation “gain” bypasses the income statement when the PPE is sold.
- Is there any reason a company would NOT want to upwardly revalue PPE?



Examples of Technical Differences: U.S. GAAP and IFRS

9. Splitting Convertible Debt

Under IFRS

- All convertible debt is split into debt and equity components.



Examples of Technical Differences: U.S. GAAP and IFRS

10. Pension Accounting ... the old way

Under IFRS


- Balance sheet amount is still a conglomeration of the net over/under funded amount, deferred gains/losses, prior service cost, etc.
- New IFRS expected SOON (1Q 2011)
 - No more corridor amount ☹



U.S. GAAP & IFRS
The BIGGEST Difference

Rules vs. Principles

- U.S. GAAP = detailed rules.
- IFRS = general principles with the details being left to the judgment of the accountant.



U.S. GAAP & IFRS
The BIGGEST Difference

Rules vs. Principles

Example:

Is a lease to be accounted for as a rental (operating) or as a purchase (capital)?




U.S. GAAP & IFRS
The BIGGEST Difference

Rules vs. Principles

IFRS Lease Accounting Standard

“A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.”



U.S. GAAP & IFRS
The BIGGEST Difference

Rules vs. Principles

U.S. GAAP Lease Accounting Standard

The criteria for classifying leases set forth in this paragraph and in paragraph 8 derive from the concept set forth in paragraph 60. If at its inception (as defined in paragraph 20)) a lease meets one or more of the following four criteria, the lease shall be classified as a capital lease by the lessee. Otherwise, it shall be classified as an operating lease. (See Appendix C for an illustration of the application of these criteria.)


a. The lease transfers ownership of the property to the lessee by the end of the lease term (as defined in paragraph 5(f)). 10a

b. The lease contains a bargain purchase option (as defined in paragraph 5(d)).

c. The lease term (as defined in paragraph 5(f)) is equal to 75 percent or more of the estimated economic life of the leased property (as defined in paragraph 5(g)). However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease.

d. The present value at the beginning of the lease term of the minimum lease payments (as defined in paragraph 5(j)), excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon, equals or exceeds 90 percent of the excess of the fair value of the leased property (as defined in paragraph 5(c)) to the lessor at the inception of the lease over any related investment tax credit obtained by the lessor and expected to be realized by him. However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease. A lessor shall compute the present value of the minimum lease payments using the interest rate implicit in the lease (as defined in paragraph 5(k)). A lessee shall compute the present value of the minimum lease payments using his incremental borrowing rate (as defined in paragraph 5(l)).

5(l), unless (i) it is practicable for him to learn the implicit rate computed by the lessor and (ii) the implicit rate computed by the lessor is less than the lessee's incremental borrowing rate. If both of those conditions are met, the lessee shall use the implicit rate.




U.S. GAAP & IFRS
The BIGGEST Difference

Will principles-based accounting standards work in the U.S. legal environment?


- Accountants and auditors can never be sure their judgment will survive after-the-fact scrutiny by lawyers, juries, and judges.
- Increased legal risk → more audit work

More audit work → higher audit fees 😊



Key Points

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The Key Point

Enforcement and national politics are the remaining barriers to complete international convergence.