IFRS Adoption

The First Wave in an Inevitable Tide of Change for All Companies

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In November 2008, the Securities and Exchange Commission announced a Roadmap for implementing International Financial Reporting Standards by public companies in the United States. The SEC's November 14, 2008 release set 2014 as the "most likely" date for mandatory IFRS usage with adoptions as early as 2010 available to qualifying firms. Even though 2014 is over five years away, early adoption and multi-year financial statement presentation requirements effectively accelerate IFRS conversion into the 2010-2011 timeframe—a mere two years from today.

A Historical Perspective

Since the 1990s, accounting standard setters have considered worldwide GAAP harmonization and convergence. Initial discussions concluded that U.S. GAAP represented the gold standard in transparent, comprehensive, high-quality financial reporting. This was a logical conclusion since international standards at the time were less comprehensive, voluntary and promulgated in a less formal fashion. Moreover, the accounting experts considered the Financial Accounting Standards Board (FASB) superior to the International Accounting Standards Committee (IASC).

The winds of change began to circulate in 2001. In April of that year, the IASC reorganized into the International Accounting Standards Board (IASB). James Leisenring, a former FASB chairman, joined the inaugural 14-member board. At the same time, the IASB began a closer working relationship with U.S. standard setters and the SEC.

In 2002, FASB and the IASB entered into the Norwalk Agreement. Under the terms of the agreement, both groups agreed to jointly consider emerging financial reporting issues and seek the convergence of the separate sets of rules and principles into one worldwide set of accounting standards. Expansion of international business demanded a common set of principles for financial reporting. More significantly, the cost of preparing financial statements under multiple sets of standards was becoming increasingly costly and time consuming. The moment had come for deeds not words.

The first significant step came in January 2005 when IFRS became mandatory in the European Union. At the same time, the efforts of IASB-FASB standard convergence accelerated. Since then, the two standard setting bodies published numerous updated pronouncements. IFRS 3 and SFAS 141R, dealing with business combinations, are current examples of this joint development process.

Although these convergence efforts have been productive, they still do not address the costly impact of issuing multi-standard financial statements—particularly in the United States. In November 2007, the SEC took a huge leap forward in addressing the restatement issue when it announced that foreign registrants could report their operating results under IFRS and not be subject to U.S. GAAP reconciliation. The commission followed this announcement with a series of town-hall style meetings that led to the Commission's statement in December 2007 regarding the potential expanded use of IFRS in the United States.

SEC Chairman Christopher Cox initially cited a release date for the adoption timetable of June 2008. That date slipped into August and the timetable morphed into a press release with a promise of more to come.

The Current Situation

On November 14, 2008, the SEC published its proposed Roadmap for IFRS use by U.S. companies. The lengthy document sets 2014 as the date for general adoption. "Early users" as defined in the Roadmap will be eligible for usage in 2010. There has also been a flurry of IFRS adoption activity in other corners of the accounting profession. Each of the four major international firms, for example, has invested significant resources, research and opinion on the global accounting standards issue. PricewaterhouseCoopers believes significant action will occur in early 2009 after the Roadmap's comment period ends. Ernst & Young senses a similar timeframe and views the adoption of international standards as the single most important initiative in the financial reporting world.

KPMG appears to have the most robust IFRS information effort in its IFRS Institute. The Institute is always an interesting source of IFRS comment and perception. For example, it recently noted a considerable debate remains over the rush to global standards. One position, led by the PCAOB, recommends slowing the adoption process down in order to more fully absorb the impact of the global financial crisis. Those at the other end of the spectrum believe that the current international financial crisis actually demands a single set of high-quality standards that reflect reality.

Another international firm, Deloitte and Touche (D&T), offers IFRS training and consulting services to firms wishing to stay ahead of the adoption curve. Both KPMG and D&T concur that the adoption effort is still very much alive.

While there is a slight delay in announcing the full adoption timetable, the FASB and IASB have accelerated their completion date for the seemingly unending convergence project. Following their September 2008 joint meeting, the two boards set 2011 as the deadline for resolving the remaining four open issues on their agenda. The targeted areas for discussion include financial statement presentation, liability and equity classification, lease accounting and revenue recognition.

Although some conflict remains over a firm calendar for adoption, no one disputes one issue. All knowledgeable parties believe that much more than simple financial reporting changes are at stake. Since the changes required to convert to international standards are both numerous and complex, now is the time to initiate your IFRS learning curve and to begin the design of your IFRS adoption strategy.

More than Just an Accounting Exercise

Even if adoption of international accounting standards in the United States involved "simply" the acceptance of a new set of pronouncements, the task would be daunting. Consider the impact of changes in the following four areas: revenue recognition, LIFO inventory, research and development costs and asset valuation.

Revenue recognition under U.S. GAAP is very specific. There are unique rules, for example, with respect to individual industry practices, computer software and real estate transactions. Conversely, a single standard (IAS 18) governs general revenue recognition under IFRS. This absence of specificity is symptomatic of the related conceptual issue of principles-based versus rules-based accounting.

The lack of LIFO inventory valuation under IFRS (IAS 2) presents additional challenges. Will the Internal Revenue Service relax LIFO conformity rules as part of the switch to international standards? If so, how will this change income tax strategy for U.S. firms?

Differences also abound in the area of research and development costs. FAS 2 requires that companies expense all R & D costs as incurred. IAS 38, on the other hand, categorizes R&D expenditures as either research or development activities. IAS 38 expenses research costs, while it capitalizes development costs as an intangible asset.

Lastly, and perhaps the most problematic issue from the perspective of transparency, is the valuation of operational assets. Under IFRS (IAS 36 & IAS 38), companies may reverse impairments to tangible and intangible asset impairments, other than goodwill, if they meet certain conditions. This "elevator effect" of valuations constantly moving up and down will challenge both independent auditors and financial statement users alike.

As you can see, compared with mere accounting conformity, the IFRS-related operational issues are much more challenging. All firms, public and private, face major adjustments in their business practices. From wholesale systems redesign to management and financial statement user re-education, U.S. companies will experience a significant change management event.

Changes in earnings will affect the computation of financial institution lending covenants. Right now, we do not know how lenders will respond to these modifications. Similarly, there will be changes in the determination of incentives and bonuses based upon profitability. Institutional investors and labor unions may not respond favorably to these potential revisions in compensation. The anticipated implementation of IFRS will also require comprehensive training of investors, board members, management personnel and financial statement preparers.

Assisting these stakeholders in assuming a principles-based thought process will be incredibly difficult. The adoption of approximately 2,500 pages of new pronouncements will be, by comparison, easy.

For the past thirty years, professionals familiar with financial statements have operated in a cookbook-oriented world. Nearly 25,000 pages of rules governed accounting practices in detail. Students, auditors and attorneys all learned how to conduct business within the bright lines of U.S. GAAP. Now, in a matter of 2-5 years, international standards will expected them to respond to an increasingly complex array of issues armed only with a broad set of principles. A heightened sense of accounting and business judgment will be essential.

Faced with accounting changes, operational changes and behavioral changes, what must firms do today to be prepared for the inevitability of tomorrow?

A Checklist for Action

The natural reaction to for the pending IFRS conversion is denial. Many small organizations believe that the adoption process will not affect them. Nothing could be further from the truth. The AICPA, which governs professional activities for non-SEC practitioners and private firms, believes the time to initiate IFRS discussion and knowledge is now. The trend towards globalization, the need for international sources of capital and the increasing number of foreign-based acquisitions are just three reasons why the AICPA consider immediate action mandatory.

Given this sense of urgency, consider the following ten points as your IFRS Roadmap for Action.

1. Initiate a review of IFRS fundamentals. Utilize all available sources for building your company's knowledge of international accounting standards. After establishing a basic competency in IFRS, prepare a summarization of how the new standards apply to your organization.

2. Inventory IFRS talent. Discover who has IFRS knowledge in your organization. It could come from several sources—new employees with multinational experience, international-based executives, global partners or recent college graduates. Consider the creation of a transition team including these potential subject matter experts.

3. Prepare preliminary IFRS-based financial statements. Draft a set of pro-forma IFRS financial statements. Compare them with your current U.S. GAAP financials. Calculate key ratios and metrics under both methods.

4. Ascertain potential strategic and operational issues impacted by IFRS adoption. Critically examine the results of your comparative analysis. Identify possible changes in strategic objectives or immediate operational activities. Develop action plans based upon your findings.

5. Monitor the internet including the SEC, FASB, IASB, AICPA and relevant international accounting firm websites. Stay on top of the status of the adoption process. Any announced timetable will

be a work-in-process. The current global financial crisis and the incoming Obama administration present wild cards in the IFRS implementation game. Pay close attention to the IASB's exposure draft on "IFRS for Private Entities" due for release in early 2009. Remain both agile and flexible in designing your ultimate game plan.

6. Consider the centralization of accounting activities. Use the transition to IFRS as an opportunity for streamlining your accounting operations. Centralization will make the transfer of information and the adoption of new accounting systems easier to implement.

7. Identify necessary debt agreement or contract modifications. Armed with the results of your pro-forma analysis, review the implications on lending covenants and terms with your current lenders. This will be particularly important if the current credit crisis continues. Banks and other financial institutions may use the IFRS-related ratio adjustments as an excuse for trimming their debt rosters.

8. Scope required changes in financial systems. Many new IFRS accounting products will appear in the next few years. Begin a thorough assessment of your organization's specific needs. Involve IT professionals early. The acquisition and implementation of updated systems is likely to be one of your major transition costs.

9. Design a comprehensive user-education program for management, investors and other stakeholders. The information these groups routinely receive will change dramatically. Establish brown-bag sessions for gradually communicating how to use and interpret the new information.

10. Above all, take action now. Remember, denial is the first step in the inevitable path to change.

Final Thoughts

The purpose of this article has been to both inform and alert you. It contains information for updating all financial professionals about the transition to international financial accounting standards in the United States. More importantly, it serves as an alert for action that needs to begin today.

All firms, public and private, will face the issues that IFRS adoption brings. All global customers will demand an understanding of IFRS-based statements. Many lending activities will require new IFRS-driven assessment. This is not just a public company accounting issue. This is a major business transformation issue affecting all companies in the United States.

A wave of change in accounting standards is coming. Plan to establish your IFRS breakwater today. Don't be caught unprepared when the international accounting standards tidal wave hits your beach!

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