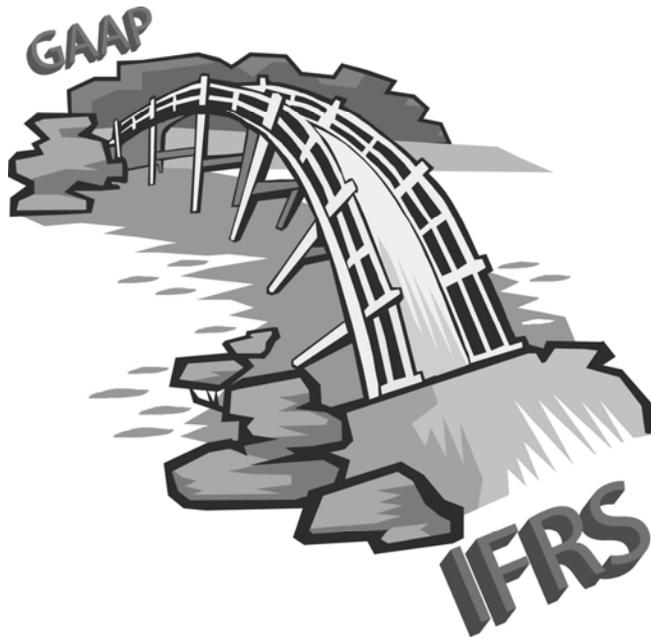


The Credit Research Foundation

Bridging the GAAP to IFRS



Special Report

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Executive Summary:

- ✧ The Securities and Exchange Commission recently announced a roadmap for the conversion of accounting principles used by public companies. Currently, public companies submit SEC filings under the accounting rules of GAAP, or Generally Accepted Accounting Principles. Under a proposed rule issued by the SEC on August 27, 2008, some large multinational companies would be allowed to report earnings according to international accounting beginning in 2010. This accounting change, if adopted, would initially affect, in 2010, about 110 companies based on their market capitalizations.
- ✧ The international accounting standards are known as International Financial Reporting Standards or IFRS. In this CRF article entitled, "Bridging the GAAP to IFRS" just exactly what is IFRS and how it differs from GAAP is outlined along with, among other issues, the advantages and challenges in switching accounting systems from GAAP to IFRS. The article also offers some good advice on what companies should do to prepare for the transition from GAAP to IFRS.

Bridging the GAAP to IFRS

Credit analysts – get ready to learn a new language. This is not the kind of language taught in the foreign language department either. This new language, spurred by the global nature of commerce in the 21st century, will facilitate the common understanding and interpretation of public corporate financial statements regardless of the reporting company's country of origin.

This new language is called IFRS, or International Financial Reporting Standards, and it's already recognized by the SEC (Securities and Exchange Commission) as an acceptable form of filing financial statements by foreign private issuers. It has been the mandated standard for filings of all publicly traded companies in Europe since January 1, 2005, and so far nearly 100 countries require or allow the use of IFRS for the preparation of financial statements by publicly held companies, according to The American Institute of Certified Public Accountants.

Currently, public corporations in the U.S. must file financial statements with the SEC in accordance with U.S. GAAP or Generally Accepted Accounting Standards. However, it seems likely that in the next few years either the SEC or market forces or both will eventually result in the replacement of GAAP with IFRS. SEC Chairman Christopher Cox, referring to IFRS, said in an address to the annual conference of the International Organization of Securities Commissions in Paris on May 28, 2008; "... a common language of mutual understanding is vitally important to commercial integration among the world's many cultures and nations. Global markets simply cannot achieve their full potential without it." Cox noted how French has been referred to as the lingua franca, or common language, among people speaking different languages. In much the same way, Cox contends IFRS will be the common language of the financial world. Cox said, "One of the more revolutionary developments in the world's capital markets is the remarkably quickening pace of acceptance of a true lingua franca for accounting."

Global markets that are inexorably tied together require a common language for financial reporting noted Cox in a speech earlier in 2008. He said, "It is no longer possible for the SEC to do its work in the United States without a truly global strategy – because, in large measure due to today's instant communications and technology, what goes on in other markets and jurisdictions is now intimately bound up with what happens here." For U.S. investors, the need to analyze the financial statements of foreign public corporations has grown dramatically. As reported in a New York Times article on July 5, 2008, "In the decade ending last November, American holdings of foreign stock increased to \$4.3 trillion from \$1.2 trillion."

The flagging U.S. economy is encouraging more domestic companies to seek more business in foreign export markets. From the perspective of domestic corporate credit departments, a common financial reporting standard might make the analyses of foreign corporate financial statements easier and more relevant. IFRS would also facilitate comparative analyses of foreign and U.S. corporate financial statements. Regardless of country of origin, comparing financial statements from one country to another would be the proverbial equivalent of "comparing apples to apples."

The Marriage of GAAP and IFRS

Beyond global market pressures and possible SEC mandates, there has been a cooperative effort of constructing one global financial accounting standard by the two accounting standards setting bodies of GAAP and IFRS. They are, respectively, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Boards (IASB). For the past five

years FASB and IASB have been working to merge U.S. accounting rules with IFRS, under a memorandum of understanding called the “Norwalk Agreement.”

Just what will be left of GAAP when the process is finally completed remains to be seen. In the April 1, 2008 edition of *CFO Magazine*, an article on this very subject was entitled, perhaps prophetically, “Goodbye GAAP.” Dr. Steven Isberg, CRF Senior Research Fellow said that while any blending of standards will lead to the disappearance of GAAP as we know it, what remains will be determined by the degree to which interest groups get involved in the final process of approving the changes.

So far, it is looking like the resulting standards may more closely resemble the international accounting standards. As quoted in *CFO Magazine*: “... this so-called convergence is shaping up to be more of a takeover than a merger of equals – many who favor a single global standard hope to wipe out GAAP altogether.” However, there have been GAAP standards that have been incorporated into IFRS so it’s unlikely a merger of the two would look completely foreign to those familiar with and used to GAAP.

Success Factors for an International Accounting Standard

During SEC Chairman Christopher Cox’s speech in Paris, he outlined the principles that a unifying set of international accounting standards must embody. To summarize they are:

- ✧ The standards must be “crafted in the interest of investors.”
- ✧ The standards setting process should be transparent to ensure integrity and quality.
- ✧ The standards setter must be independent from special interests, regional and national biases and the political process.
- ✧ The standards must be accountable by meeting the needs of investors and other stakeholders and should be updated in a timely fashion.
- ✧ The stakeholders in the standards must participate in the standards setting process.

GAAP vs. IFRS

The broad conceptual difference between GAAP and IFRS is that GAAP is rules-based and IFRS is principles-based. In a rules based system, an accountant can look at transactions and determine what rules to apply when posting it to an account that affects the financial statements. This has enabled many accountants to interpret rules with the objective of presenting a certain view of the company’s performance. Dr. Isberg pointed out that in some cases, such as Enron, interpretation of the rules is pushed beyond the point where the outcome accurately reflects the true standing and/or performance of the company. In such cases, an accountant approaches the transaction with the outcome in mind rather than rendering a transparent representation of the transaction or event. This often puts accounts in the position of being advocates for their clients rather than the investors.

In contrast, a principles-based accounting system, such as IFRS, requires a view of a transaction that reports it based on reality, or its substance. Some accounting professionals view a principles-based system as one that is more thoughtful and transparent and reflective of the true nature of each transaction. In other words, what is the intended consequence of that transaction as opposed to finding the most beneficial rule that can apply to that transaction based upon the financial directives given to the accountant. It is a more transparent process generally than a rules-based system.

In an article in the April 2008 edition of *Treasury & Risk* magazine entitled, “Mind the GAAP,” Bob Burns, director of policy and research at the Center of Audit Quality, a non-profit Washington-based group that tries to “bring together” and address the issues of investors, auditors and corporate finance officers, was quoted as saying: “With GAAP, it is all about the numbers. IFRS, in contrast, is numbers and disclosure about what’s going on. So all in all, I think investors may get more information from IFRS statements.”

In addition to differences in the conceptual approaches, there are some practical differences between GAAP and IFRS. For example, many U.S. firms use what is called “last in, first out” (LIFO) methodology to account for inventory. Those firms that utilize LIFO are required by U.S. tax law to use it for their tax filings as well. However, IFRS doesn’t accept LIFO. Such a change in inventory accounting away from LIFO could be very costly to some firms. The “Mind the GAAP,” article in *Treasury & Risk* magazine also pointed out the following areas of differences between GAAP and IFRS:

- ✧ The handling of research and development, which is an expense charged to operations under GAAP, but which under IFRS has research charged to operations and development depreciated;
- ✧ The differences in business combination accounting, with GAAP permitting no contingent liabilities after a merger while IFRS allows contingent liabilities; and
- ✧ The treatment of minority non-controlling interests, which are calculated at fair market value under GAAP, but can be calculated at fair market value or book value under IFRS.

The *CFO Magazine*, “Goodbye GAAP,” article noted that company earnings may appear better under IFRS than GAAP. The article stated; “Another possible benefit from IFRS is better looking financial statements. More often than not, a company's earnings are higher under the international standards, according to a recent study of 129 IFRS-GAAP reconciliation reports of foreign companies. Daimler AG, for one, reported higher revenues, net income, and earnings per share (by 68 cents) when it reported its financial results under IFRS for the first time in April 2007.” The *CFO Magazine* article further pointed out that some multinational companies are investigating how the changes under IFRS to such areas as revenue recognition, taxation, and hedge accounting would affect their balance sheet and income statements.

Different But Not Irreconcilable

Mary Barth knows a lot about IFRS and how it is evolving. She is a professor of accounting and the Sr. Associate Dean for Academic Affairs at Stanford University’s Graduate School of Business. More importantly, she is one of two U.S. members on the IASB, who meet once a month in London to work on crafting the standards for IFRS. In her opinion, switching to IFRS from GAAP should be a relatively smooth process for many in the accounting field. She told CRF, “There are many similarities (between GAAP and IFRS). It’s not a huge sea change. Much of it will look very familiar.” As far as the major differences between the two accounting standards, Barth said, “It’s more the case that the U.S. has more rules than IFRS has.” However she added, “I think having fewer rules can promote more compatibility.”

In Barth’s opinion, switching to IFRS may even open up the meaning of financial statements more to non-accountants. In the “Mind the GAAP” article, Barth was quoted as saying; “But I think the rules/principles dichotomy is not as big as people are making out. With IFRS, you have a set of rules to make sure principles are met. In many ways, it can be easier to understand than GAAP. It’s less a secret society of accounting staff.”

Costs in Making the Switch

Taking the plunge into IFRS for GAAP-based public corporations will inevitably entail costs. “There’s got to be a first-time cost,” Barth said. She noted there will be educational efforts for accounting and financial analyst staffs. That will also take some time to accomplish. However, the costs will likely pay significant dividends, especially for those companies that must review and analyze financial statements of foreign companies. “Once you translate from German to English (for example), everything will follow whether you’re a credit or equity analyst,” according to Barth.

CFO Magazine addressed the issue of how much it would cost to make the accounting transition. The article stated: “How expensive? The large accounting firms won’t estimate how much it would cost companies to convert from GAAP to IFRS, but they acknowledge it won’t be cheap. ‘It’s too difficult to put down any kind of range,’ says Garry Illiano, a partner at Grant Thornton. Kenneth Nielsen Goldmann, partner and managing director of capital-markets services for auditor JH Cohn, says it would be ‘extremely costly.’ Procter & Gamble hasn’t pinned down an exact number, but expects a conversion project would cost tens of millions of dollars, according to comptroller of corporate accounting Mick Homan.”

Terry Callahan, president of the Credit Research Foundation contends that one of the biggest transition challenges will be adjusting historical financial statements to enable trend comparisons once the changes have been implemented. To offset this problem, it may even be a good idea for policy makers to require reconciliation statements for the first few years after the transitions.

The more business a company conducts overseas and the more affiliates it has operating overseas the more benefits a company will likely get from making the switch to IFRS. According to *CFO Magazine*: “Margaret Smith, UTC’s (United Technologies Corporation) controller, is one of the biggest proponents for making the switch — and as soon as possible. ‘With 62% of our revenues coming from international locations, and with more than 180 offices abroad, we’re watching this process carefully,’ says Smith, a vice president at the \$55 billion conglomerate. ‘While initially it would cost us more, there would be big savings in being able to move all our accounting operations into one service center that could do it all.’”

Europe’s Transition Experience

Barth said of the transition to IFRS in Europe that, “The transition was much smoother and less painful than everyone thought.” According to UTC Controller Margaret Smith; “You need only look at Europe. They had to make their transition to IFRS by 2005, and they didn’t even finish writing the standards until 2004. If they can do it there, where some of the countries had very arcane accounting standards, we can do it here.”

Prospects of IFRS Transition in U.S.

Barth told CRF in July 2008 that she thinks some action on setting out a roadmap in the U.S. is imminent. “I think there’s some pressure because of the upcoming election to do something in the next few months,” Barth said. “We’re going to do something in the next few months.” There seems to be a consensus among top accounting firms that sometime around 2013 large U.S. firms will be mandated to convert their financials to IFRS, with 2015 being the first year smaller companies could follow suit.

Update on IFRS Roadmap

Barth was right as shortly before the publishing of this article, the SEC voted to propose a "Roadmap that could lead to the use of International Financial Reporting Standards (IFRS) by U.S. issuers beginning in 2014. The Commission would make a decision in 2011 on whether adoption of IFRS is in the public interest and would benefit investors. The proposed multi-year plan sets out several milestones that, if achieved, could lead to the use of IFRS by U.S. issuers in their filings with the Commission." The proposal was issued on August 27, 2008 and was put out for a 60-day comment period.

Educational Stumbling Block In U.S.

As with GAAP, a vast army of accountants and auditors would have to be trained in IFRS to accommodate a switch to IFRS in the U.S. It takes about 30-50 course hours to be credentialed for GAAP. However, according to *Treasury Management*; "At present, there is not even one U.S. college textbook on IFRS accounting and university accounting departments offer, at best, only one course in IFRS accounting." In that same article Barth noted that a second-year elective on global financial reporting is offered at Stanford University's Graduate School of Business. Obviously, more higher education institutions in the U.S. will need to implement courses and curricula on IFRS in the coming years to produce adequate professional accounting skills among U.S. accountants.

Good Advice on Switching to IFRS

Sarah Johnson, a senior writer who authored the "Goodbye GAAP" article in *CFO Magazine* offered a list of suggestions by some accounting experts on how to be prepared to act quickly on implementing IFRS. The suggestions are as follow:

- ✧ Gather a team to analyze the issues involved. Large multinationals are using their controllers as their point person and turning to their IT, investor relations, and treasury departments for input.
- ✧ Look over the International Accounting Standards Board's agenda (on www.iasb.org). Decide which of its critical projects need to be finished before you would begin taking on a new accounting language, suggests Mary Tokar, head of the IFRS group for KPMG International.
- ✧ Compare IFRS and GAAP. How will your balance sheet, financial-reporting process, and disclosures be affected? Tokar recommends you identify your 10 biggest issues, rate each of them by its impact, and divvy them up to project teams that can forecast how much work each would take.
- ✧ Expect more disclosures, especially during the transition. To make up for the move from a more rules-based system to one that allows more judgment, companies will need to make up the differences with footnotes.
- ✧ Take a new look at contracts and debt covenants that require the use of GAAP as they may need to be renegotiated.
- ✧ Evaluate your people. Who would need to be trained, and how long would it take?
- ✧ Look over your shoulder. What are your competitors doing?
- ✧ Don't forget investors. The investor-relations groups at EU companies spent late nights scrambling to get stakeholders up to speed, Tokar says. When that first round of IFRS financials comes out, you want to "focus on the operations of the company and not have an accounting training session," she adds.

The Cost of Inaction

Many financial and accounting experts believe it's not a matter of *if*, but *when* IFRS will be the mandated financial accounting system for public corporations in the U.S. Preparing in advance for the switch would be a wise decision – whether the change is made by a company voluntarily or it is imposed by regulatory fiat. The push for IFRS in the U.S. will likely come primarily, at least in large corporations, from chief financial officers (CFOs). However, as 2009 approaches, it seems there is not a tidal wave of interest among CFOs for the switch. The “Goodbye GAAP” article reported that; “According to a fall Deloitte & Touche poll of 300 companies (ranging in annual-revenue size from under \$100 million to more than \$10 billion), only about 20% of CFOs would consider adopting IFRS if given the choice.”

Perhaps the best motivation for U.S. firms to at least take initial preparatory steps for the switch to IFRS is to look to Europe. If they could do it in three years in Europe, why can't public corporations in the U.S. do it over the course of several years? After all, the U.S.'s Marshall Plan begun in the Post-World War II era helped to rebuild a shattered Europe. That same “can-do spirit” has hopefully not vanished in the U.S. Certainly, in today's global economy, U.S.-based firms need every advantage they can muster to compete effectively against an economically resurgent Europe and the economic juggernauts of China, India and other Asian countries. Either U.S. companies keep pace with most of the rest of the advanced economies in the world by adapting IFRS along with them, or risk falling behind in the fast-paced and highly competitive global economy. Time may be running out for U.S. companies to learn a new language.



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