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TalkingPoint: ACCOUNTING STANDARDS IN THE US – CONVERGENCE WITH IFRS

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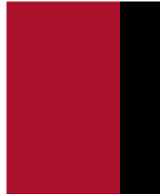

FW moderates a discussion covering accounting standards in the US between Charles Lundelius at FTI Consulting, Scott A. Ehrlich at Mind the GAAP, and Barry Jay Epstein at Russell Novak & Company.

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FW: Could you explain the main differences between IFRS and US GAAP, and what benefits might be derived from shared standards around the world?

Lundelius: Given that IFRSs are less specific than US GAAP, IFRSs are simpler in concept. Also, some items addressed in the IASB's accounting pronouncements are addressed in the US auditing standards, and some IASB requirements mirror SEC rules instead of FASB rules. There are also complicated application differences, for example with the calculation of earnings per share, the accounting for intangibles, and use of revaluation accounting. Although there are now common requirements for measuring fair value, there are still differences for measuring the fair value of investments in investment companies. And the topics of accounting for insurance contracts, financial instruments and hedges have yet to be converged by IASB and FASB. Shared standards are necessary for global capital markets. Worldwide comparability will bring more options and better information to investors. Shared standards will make it easier for companies to raise foreign capital, consolidate with foreign subsidiaries, and make cross-border acquisitions.

Ehrlich: In some cases, US GAAP and IFRS differ at a principles level. For example, goodwill is tested for impairment at the 'reporting unit' under US GAAP whereas, under IFRS, the test is often performed at a much lower level of the organisation. But, to be honest, there are relatively few differences in principles between US GAAP and IFRS. There are many – perhaps thousands – of application level differences between the two accounting frameworks, though. One of the benefits of moving to a global set of accounting standards is that we wouldn't have two different sets of rules that arguably are trying to get us to same overarching principles. Another real benefit is that companies could save substantial preparation and audit costs for statutory filings assuming that a single set of global rules are eventually adopted for statutory reporting purposes as well.

Epstein: Both IFRS and US GAAP are comprehensive sets of rules governing external financial reporting, and in fact IFRS largely mirrors US GAAP. However, even after almost a decade of convergence efforts, differences remain. Most prominently, IFRS bans LIFO inventory costing, which is permitted under US GAAP and popular with many corporations. Also, IFRS permits revaluations of long-lived tangible and intangible assets and investment property, which is prohibited under GAAP; the use of 'extraordinary item' classification has been banished from IFRS; and GAAP requires expensing of research and development costs as incurred, whereas IFRS expenses research but capitalises development costs. Furthermore, the methodologies for asset impairment testing and measurement differ between the two sets of standards. The extent of detailed guidance is generally lower under IFRS than under GAAP, which has some appeal but may prove challenging to some preparers and many auditors.

FW: What fundamental implications does convergence bring for US businesses, fund managers and investors?

Ehrlich: For businesses, convergence means one-time costs of identifying accounting areas that will change, and developing new processes or implementing new systems to effect those changes. Companies also will need to analyse the bottom-line impact of adopting the new rules and communicate these results with key stakeholders. In addition, there will probably be a little more focus on training in the years leading up to, and immediately following, the transition to global standards. Fund managers, investors, and creditors will need to understand how changes in accounting rules affect the companies in which they are analysing, investing, or lending. At the end of the day, most investors and creditors are most interested in a company's future cash flows. Changing accounting systems shouldn't affect those cash flows, but investors and creditors still might need to amend the financial models they use in making decisions whether to invest, divest or lend, since the starting point for those models are the accrual basis financial results, which will change following adoption of global standards.

Epstein: True convergence – or an outright adoption of IFRS in the US – would ease understanding of financial statements prepared by non-US companies, facilitating cross-border investing by eliminating, or at least reducing, so-called 'accounting risk'. This would be a positive development not only for investors, but also for companies seeking to raise capital, since a larger pool of investor funds would tend to lower the cost of capital. On the other hand, any change in financial reporting standards creates a need for learning, which can be time consuming and costly, and a wholesale shift to IFRS would necessitate massive re-education for financial statement preparers and auditors. However, those already knowledgeable about GAAP should be able to master IFRS with a few days of study. Additionally, there would also be systems conversion costs, plus the inevitable disruptions that would happen even with the best of planning.

Lundelius: Fund managers and investors, along with analysts who assist them, will demand more thorough disclosure of US businesses as convergence proceeds. Since IFRS operates with simplified concepts, greater variances in accounting practice can develop within a

given industry. Disclosure, then, becomes more essential to assist the users of financial statements in assessing the differences in accounting policies and practices from one firm to another, even within the same peer group.

FW: Over the last year or so, what progress has the SEC made on the path to convergence? What challenges has it faced along the way?

Ehrlich: The SEC has worked very deliberately in determining whether to accept IFRS for US-based registrants. Earlier this year, the SEC published a detailed staff paper on a possible transition method of adopting global standards and has held public roundtables on the pluses and minuses of conversion to IFRS. The SEC is definitely taking the decision seriously and is soliciting lots of feedback. In my view, the biggest challenge the SEC faces is competing priorities. The Commission is understaffed and underfunded. To make matters worse, it has been tasked with writing numerous rules to implement Dodd-Frank. It also didn't help that the SEC was down one commissioner out of five for a few months this past summer.

Lundelius: The SEC staff updated its Work Plan in May of 2011, and that plan addressed some of the challenges that lay ahead. Most notably, the Staff demonstrated that implementation of

IFRS would not be inconsistent with the SEC maintaining its ultimate authority over US accounting standard setting. Concurrent with that view, the Staff also stated that "the FASB would remain the standard-setting body responsible for promulgating US GAAP" if the SEC incorporated IFRS into US accounting standards. Both of these positions address significant concerns among US regulators, legislators and accountants, that the US would lose control over accounting standard setting should IFRS be adopted in some form.

Epstein: The SEC is not really driving convergence – rather, that is a collaborative effort of FASB and IASB, and it has borne significant fruit. For example, current standards on accounting for business combinations have been almost fully converged, and forthcoming standards on lease accounting and revenue recognition will likewise be identical or nearly so. FASB and IASB are also developing look-alike conceptual frameworks, and in a number of instances GAAP has been replaced by superior IFRS, or vice-versa. The SEC's late 2007 decision to permit foreign private issuers to file IFRS financial statements in the US did, however, raise public awareness and probably enhanced the desire to standardise financial reporting principles.

FW: Do you believe it makes sense for the SEC to provide companies with an option to adopt IFRS?

Lundelius: This is truly a free-market approach that would let the capital markets decide which set of standards is most suited to a given company's shareholder clientele, and, conceivably, a company's board of directors could even authorise a preference vote on the ballot at the next annual shareholders' meeting and determine which standard is preferred. So the approach is, theoretically, workable. Also, the approach is advocated by the American Institute of Certified Public Accountants. That said, the sorting out process may prove to be too cumbersome in practice.

Ehrlich: There is no doubt in my mind that IFRS are a high quality set of accounting standards. I actually believe that certain IFRS pronouncements are superior in some cases to comparable US GAAP guidelines. Disclosures under IFRS tend to be more succinct and better presented – for instance, there seems to be far more tables in IFRS financial statements than you see in US GAAP accounts. Therefore, US investors are not going to lose anything by companies moving to IFRS. So, if companies have a compelling reason to move to IFRS, I don't see why they shouldn't be allowed to do so. After all, foreign private issuers are already allowed to use IFRS and, arguably, investing in a FPI involves more risk than in a comparable US corporation. Said another way, if IFRS is good enough for FPIs, why shouldn't it be good enough for US companies too?

Epstein: It makes sense to level the playing field with foreign private issuers that already have been granted the privilege of using IFRS. Although in the near term this creates the likelihood of greater diversity of financial reporting practices, it should be seen as an important next step on the road toward universal adoption of IFRS, which would be beneficial for capital markets, investors and others.

FW: In your opinion, what is the best transition method (such as condorsement, 'all in', etc.) that companies should use when converting to IFRS? What should they take into account when making this decision?

Epstein: Until quite recently, the routes to IFRS use in the US were seen to consist of three main alternatives: adoption/conversion, meaning a switch from US GAAP to IFRS, without converging them first; convergence, implying a gradual migration from US GAAP to full or near-IFRS; and simple endorsement of new or amended IFRS before they become legally binding. A fourth route was floated in late 2010 and now appears to be the SEC's

preferred way forward, although a formal decision has yet to be announced. The term 'condorsement' was first used by SEC Deputy Chief Accountant Paul Beswick to signify its apparent new position that would preserve a residual role for FASB as our national financial reporting standard-setter. It would encourage the already-ongoing convergence process, but would preserve for the FASB the right to then endorse – or not endorse – additional IASB-promulgated standards on topics where actual convergence had not already been achieved. Such a system would create the risk of having a US-modified version of IFRS with multiple carve-outs, which obviously is not consistent with the goal of universal adoption of a single system of high quality financial reporting standards.

Ehrlich: Back in 2004 and 2005, we worked with European companies that were forced to use a 'big bang' or 'all in' approach in adopting IFRS. In our experience, it really wasn't all that painful a process. It took the average company about a year to make the switch, including the creation of new accounting policies and implementing systems changes. For that reason, I'm an advocate of the 'all in' approach, but I can certainly appreciate the benefits of 'condorsement' as well. Perhaps the strongest argument for condorsement is that it allows the underlying US GAAP system to be retained. US companies would not convert to IFRS, but instead, US GAAP would adopt the principles and rules of IFRS. It seems like semantics, but it actually would help companies save on non-value added conversion costs. For instance, they wouldn't have to amend debt covenants to reference IFRS instead of US GAAP.

Lundelius: Conversion to IFRS will take time for US companies. If the SEC sets a date for conversion, say 2016, then US registrants filing with the SEC will need to go live with IFRS no later than 2014 to capture the accounting data needed to prepare three years of comparative financial statements required by the SEC. Also, the SEC requires five years of summary data, which could push a company's conversion back to 2012. Preferably, the IFRS accounting system would run in parallel with the US GAAP system until the actual conversion date; therefore, a company would be 'all in' US GAAP until conversion and 'all in' IFRS thereafter

FW: What are the pros and cons of the SEC's condorsement proposal?

Epstein: The SEC believes that its mandate – protecting investors – cannot be fulfilled if a non-US standard setter (IASB) were given free rein to establish rules for domestic private issuers without oversight and veto power residing with a body (FASB) over which the SEC exerts influence. Even conceding the validity of this concern, it risks preventing the achievement of the full benefits that would flow from true standardisation of world-wide financial reporting standards.

Lundelius: The pros are that the condorsement process would allow for a lengthy, comprehensive assessment period that would solicit input from many constituents. The chief con is that it's slow. According to the originator of 'condorsement', SEC Deputy Chief Paul Beswick, under condorsement, "a new set of priorities would be established where the FASB would work to converge existing US GAAP to IFRS over a period of time for standards that are not on the IASB's agenda". To accomplish this task, the FASB would agree to not take up any new projects. So we would place US GAAP on hold and proceed to converge the present version of US GAAP with IFRS. By the time the parties work through 'standards not on the IASB's agenda', such as not-for-profit accounting and other topics, our grandchildren may get to see the finished product.

Ehrlich: As mentioned previously, condorsement allows for the underlying US GAAP framework to be retained. Another pro of condorsement is that it puts the US on a level playing field with how other major jurisdictions adopt new IFRSs. One last benefit of condorsement is that the FASB retains a role in US standard setting. The FASB gets its fair share of criticism, but they have smart people and a vast amount of institutional knowledge that might get lost under other transition methods. The biggest negative to condorsement is that it will take too long for full convergence. We could be looking at convergence efforts ongoing into 2024 or 2025 for some of the category 2 or category 3 projects. When you have that long a runway, there is just too much temptation for political forces to derail the process midstream if something controversial arises during the earlier phases of adoption.

FW: What should companies be doing today regarding IFRS conversion? Looking ahead, what steps should they prepare to take in 12 months or so?

Lundelius: Companies should be developing a transition plan that includes risk evaluation, a timeline, and a budget and they should be working to build IFRS proficiency within management, the board of directors, and the audit committee. Companies should also be evaluating how IFRS could impact their accounting for existing loan, lease, and employee compensation agreements. In 12 months or so, companies should be changing their IT infrastructure to permit parallel reporting and working with their external auditors to address audit complications that may arise due to parallel reporting.

Ehrlich: Personally, I have advised all of my clients to just sit tight until the point that the SEC makes a final decision regarding IFRS conversion. Until that time, there is no sense in planning for something that may not happen. Besides, if the SEC does set a date certain for conversion, it will likely be at least four years from now, which should be plenty of time for companies to prepare. Once – and if – the SEC announces that conversion will happen, I would suggest spending the following 12 months learning about IFRS and identifying some of the key differences between IFRS and US GAAP affecting your business or industry. It may also be helpful to speak with some of the companies that went through a transition to IFRS in the 2004-05 timeframe to identify lessons learned and best practices for conversion.

Epstein: Gaining an understanding of the differences between GAAP and IFRS is the first step. Despite popular misconceptions, these differences are quite limited, and the similarities are vastly more numerous. Developing an understanding would eliminate some of the fear of change, and provide a basis for actual adoption of IFRS, if and when it finally happens. It might also be useful to have preliminary assessments prepared of the timing and cost for systems modifications that may ultimately have to be made, but actual implementation would have to be postponed until a firm conversion date has been established. ■