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Preparing for IFRS: What your company can do to stay ahead of the curve

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One of the most critical and controversial issues to ever affect accounting in the United States is the proposed convergence between U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). Convergence efforts have been in place for almost six years, but the movement has been gaining steam with a recent ruling from the SEC, a pending announcement from the commission, recent actions on the part of the AICPA and a great amount of support from companies that do business abroad.

Many companies are apprehensive about such a large shift in policy, which is natural. But in this case the benefits do outweigh the risk involved. Any companies that were hoping that IFRS convergence would not happen, or at least not happen for a long time should accept that this will occur, and sooner rather than later. Recent developments, including the AICPA Council recognizing the International Accounting Standards Board (IASB) as the authoritative body for establishing IFRS, are clear signals to all companies that convergence is inevitable, it is just a question of how quickly it moves.

Convergence overview

The convergence movement began in 2002 as the Financial Accounting Standards Board (FASB) and the IASB met to discuss producing a set of high-quality financial accounting standards that could be used for reporting in both the U.S. and abroad. This meeting produced the historic Norwalk Agreement, which laid groundwork to merge the two groups of standards and ensure that they would be compatible in the future.

Over the last six years, there have been several steps that have solidified the two governing bodies' commitment to convergence. The "Roadmap for Convergence Between IFRS and U.S. GAAP" was published by the two entities in February of 2006. Then in late 2007, the SEC issued a rule whereby foreign private issuers in their filings with the commission were allowed to file financial statements prepared in accordance with IFRS as issued by the IASB without reconciliation to U.S. GAAP. Additionally, in August of 2007, the SEC also issued a Concept Release seeking the public's feedback on a proposal whereby all companies (domestic and foreign) filing financial information with the SEC would be allowed to file that financial information prepared in accordance with IFRS as issued by the IASB.

Over 100 foreign nations currently use IFRS, or a close representation, including the European Union, Hong Kong, Pakistan, India and Russia. Japan is aiming to have IFRS in place within three years and Chinese businesses that are listed on the Hong Kong exchange are permitted to report using IFRS standards. Canada will be implementing IFRS effective in 2011.

For any company that does business overseas, or one that has global aspirations, the use of IFRS represents an opportunity to speak the same financial language as their global counterparts. It will represent a substantial opportunity to seamlessly use and provide financial information around the world. For acquisition of capital, it just makes it easier for everyone involved without having to use two sets of languages.

IFRS puts more pressure on auditors because many times, the auditor is not going to have a set of rules to audit against; management is using their judgment and the auditor is going to have to use theirs as well. This use of judgment is however, exercised within the confines of a set of principles. Everyone will just need to act with integrity and do their jobs.

Where are we now?

Convergence is currently in a holding pattern until the SEC makes a much-anticipated announcement that will help to determine the course of IFRS in the United States. It is critical for a body in the U.S. with the authority to step forward, such as the SEC, and acknowledge that this is the right way to go for a multitude of reasons. The SEC's statement will not only have an impact on public companies, but also on the general business environment that we all work in.

Once IFRS starts to be adopted, there will be a ripple effect that will carry all the way down to smaller private companies and local banks eventually. At some point, a business may be put at a disadvantage as a result of not using IFRS.

With the AICPA rolling out IFRS.com, the training, even in the U.S., is here. Becoming active and getting on board with training and education as soon as possible will be of immense benefit to businesses and will save a substantial amount of money and time in the long run. There is currently no shortage of IFRS conversion courses and seminars and they are likely to be substantially less expensive than they will be three years from now.

Why converge?

Many foreign parent companies of businesses in the U.S. want IFRS, and for good reason. It is much easier to compare and contrast the revenue and progress of subsidiaries around the world if the same language is being used.

The attractiveness of some businesses in the U.S. that may be looking at acquisition as an exit strategy may also be negatively effected until IFRS is adopted. If a private equity group that does business overseas is analyzing possible transactions, they like to compare apples to apples. Having different information could slow down or stop the acquisition process, leading to adverse effects.

There also tends to be some confusion when companies are dealing with two different sets of standards. The financial statements for U.S. automaker Chrysler had very different meanings when filed under IFRS by their former European parent company, Daimler. In fiscal year 2006, IFRS was credited with contributing to higher than expected revenue, but in 2007, it was also blamed for record losses due to the way the standard dealt with some of the company's restructuring efforts differently than U.S. GAAP.

IFRS did not change the fundamental value of the company, but the public perception of the company was hurt. Many individuals that may not have been familiar with the situation just heard that Chrysler had lost $6.8 billion and did not know the reasoning behind it.

What should you know about IFRS?

It is one thing for preparers and auditors to understand that standards are set in Norwalk, Conn., as they currently are with U.S. GAAP. It is a little scarier to envision that there is a body of people located in London that are establishing accounting standards to be used in the U.S. Fear of the unknown is a natural response, but this will allow everyone to be comparable and on the same, level playing field.

It is very important for people to understand that when a company initially switches to IFRS, management has a lot of choices to make about what accounting policies they are going to employ. Executives should begin now to understand the judgment calls they will have to make, and to develop a sound rationale for making the right calls for their companies. Because IFRS does offer a lot of alternatives, as it is more principles based, there is more pressure involved for management who makes those decisions.

Once those accounting decisions are made, there is nothing in IFRS that says that every year you have to make a new set of elections. One needs to employ the same accounting policies year after year, so, in theory, your consistency should still be there.

With the flexibility in judgment, many people think that whatever management wants the statements to say, they will say. But then a story like Chrysler comes along, and it is evident that you will not simply be able to cover up or hide losses. Once you make your decisions in regards to which policy to employ, you are substantially locked into it unless of course, circumstances change.

People are generally fairly familiar with leasing standards in the U.S., and people know the four criteria for lease capitalization. Lease accounting is very rules based in the U.S. For example, if you trip across any four of those criteria, you have to capitalize the lease and put it on your balance sheet. Under IFRS, if you look at your leasing transaction, and if the terms of that lease essentially create a situation where the entity has taken the benefits of ownership of an asset and incurred an obligation for a liability, then that is the way it should be booked and capitalized.

This is a situation where people are uneasy because they don't have rules to solely rely on anymore. But with further investigation, IFRS does provide some guidance on leasing that you should think about when making these considerations. The four considerations that are listed under IFRS are the same four criteria that are listed under U.S. GAAP. But the beauty of IFRS is that it does not require a rules-based outcome. For example, under U.S. GAAP, if the present value of your minimum lease payments were 89 percent instead of 91 percent, you could avoid putting that asset and liability on your books. Under IFRS, that is not the case; 89 percent is just a consideration of how close you are to 90 percent. All things being equal, most people would say that there is substantively no real difference between 89 percent and 91 percent, so that asset probably should be put on the books and the liability, booked in that case also. So, IFRS is more principles based, but generally in a good way.

What can your business do to prepare for convergence?

After you accept the inevitability of what is coming, there are several steps that companies should take to prepare for convergence. You will want to consider these steps sooner rather than later.

Conduct an IFRS skills and needs analysis

Companies should look at their own financial and accounting department and CFO and determine what level of knowledge and skill they have internally – and what level of training they need to effectively position their company in regard to convergence.

Make an honest assessment of the competency and skills that the accounting staff have at all levels of the organization, mapping that against what is needed. It is like you are starting a business from scratch, and you have to hire a whole accounting department. In today's world, you would assess a candidate's U.S. GAAP skills, educational experience and their background. That same thing has to be done internally in regard to IFRS. In most cases, this is going to be the most important step because there is going to be an inadequacy, meaning there is a gap to fill.

More importantly, this becomes the road map for the company to determine the extent of training that is going to be needed to get their people up to an operational level of effectiveness with regard to IFRS.

Most of the training for IFRS now in the U.S. starts from "we all know U.S. GAAP, and here are the differences to be able to convert to IFRS." Clearly, if your needs and capability analysis indicates that you may even have a shortcoming on U.S. GAAP, you are starting in the hole. A skills and needs analysis needs to be done, and that will then identify a training plan for the company to undertake.

This is the first step, and included in that internal assessment, the company should determine how prepared their auditor is to address convergence, and what steps their auditing firm is taking to prepare its people, tools and methodologies. A good, pragmatic approach dictates that CFO's and controllers also have to be assessing where their external auditor is on that spectrum.

Take a close look at management information systems

After you get through the training needs analysis and GAAP identification, another consideration management really needs to look at is something that they may have not spent a lot of time thinking about. Current systems may not be set up to deliver the data that will be necessary to support adopting IFRS. At a minimum, systems might have to be modified to deliver the right data. In some cases, systems may need to be upgraded or replaced.

This is driven by particular industry, complexity of accounting information and other variables. The current systems that many companies have that work very well for U.S. GAAP may, or may not, be able to provide all of the information necessary to afford the accounting to be done properly under IFRS.

There are some differences, for example, such as impairment of asset accounting or impairment of goodwill accounting, where different methodologies are used in IFRS than U.S. GAAP. This means management is going to have to be monitoring different pieces of information, or at least assembling information in a different manner.

When your company adopts IFRS, can your current systems provide all of the information that is needed? In some cases, the response may be "yes, but with a little tweaking," and that would be the best answer. But in many situations, you may be looking at major system revamping.

Conduct a business analysis of ramifications of IFRS convergence

If you get through the training, the analysis and determine the impact on management information systems, then the last piece is determining what the impact on the business is going to be. Financial statement outputs serve as performance metrics used by stock analysts and lenders, and those metrics also can affect things like incentive compensation, employee benefit plans, and loan agreements. For example, if you have key performers with incentives tied to operating income numbers, you won't want them to suffer simply due to an accounting change. Businesses need to understand what financial statement output changes are likely, and then work with all affected parties to minimize the impact of those changes.

While employee compensation is important, also consider your key business relationships and contracts, not to mention external investors that make decisions on performance indicators. Just a change in your gross profit percentage by a couple of percentage points because revenue recognition is different under IFRS can trigger several implications with customers, vendors and investors.

There will likely be many situations where the impact isn't great, and companies will, possibly without really thinking about it, be fine. But there will be some companies that will get caught by surprise, and wake up and realize that all of a sudden that they have different financial statements, but the business did not change along with them.

Conclusion

While the timeline for convergence is not yet set, the changes necessary to prepare for it are far-reaching and companies are well advised to begin now in order to make the transition smoothly.

The train is coming, it's just a matter of the speed of the train and how long the tracks are before arrival. Companies need to make sure that they are out in front of the curve and properly prepared. As we saw with SOX and 404, when you get in a situation where you have to do something and are behind in the process, you have to pay a lot of money for help to get it done. It is much more prudent for companies to get out in front and look this issue in the eye and take care of it now. It will be much better for you in the long run from an effectiveness standpoint and from a cost-efficiency standpoint.

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