The Issue

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Impending Accounting Changes

Adoption of IFRS will have wide-ranging impacts

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Background

Normally, proposed accounting changes are of interest only to academics, theorists and those whose business will be directly impacted. However, there are some upcoming changes incorporated in the proposed International Financial Reporting Standards (IFRS) that will affect all businesses, and they are close enough to implementation that management should be aware, and start to take action.

International Accounting Standards are being developed in the public interest as a single set of high quality, understandable, global accounting standards. Over 120 countries either require or allow IFRS reporting for public companies, including all European Union listed entities. Australia adopted a modified version, while Canada, Brazil, India and South Korea are also adopting. The US, along with China and Japan are taking a convergence approach.

It is critical that businesses consider the impact of IFRS on their operations now, as opposed to waiting until implementation is required for reasons discussed below.

Companies are already encountering IFRS in trans-border M&A activity, dealings with foreign suppliers and customers, as well as international subsidiaries required to use IFRS for tax and statutory reporting purposes. As the US has been conforming its new accounting requirements to international standards, it is critical that organizations understand and prepare for reporting prior to conversion.

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US Companies will be permitted to submit their reports to the SEC and shareholders under IFRS for the year ended December 31, 2015. Since two comparative years are required under SEC reporting requirements, and IFRS requires the presentation of an IFRS compliant balance sheet at the beginning each accounting period presented, many SEC reporting companies must report a balance sheet prepared in conformity with IFRS as of December 31, 2012.

In addition to financial reporting, IFRS will affect apparently unrelated items such as:

Contracts – many contracts include revenue, cost and expense provisions. The new rules may also affect the amount and timing of these items.

Tax policy - international subsidiaries may already be required to file financial and tax reports in their local jurisdictions. Since tax and financial reporting are identical in many countries, and change in policy may be next to impossible in some cases where the election had been made for statutory reporting, elections made in those reports may impact parent tax and financial reporting.

Financial planning and budgeting – the new rules may impact the financial planning process.

System requirements – Financial and IT systems may be seriously impacted. The system must have the capability to report under multiple sets of assumptions, as subsidiaries reporting under IFRS will have to be consolidated into statements using US GAAP. The US reporting company will have to report under US GAAP until conversion, where three comparative years will have to be reported, and, upon conversion to IFRS, will have to reconcile to previously reported US GAAP statements

Communication – stakeholders such as investors, lenders and regulatory authorities will have to understand that reporting differences do not necessarily reflect changes in the business operations, but merely in the standards used to measure them.

Credit facilities – differences in the timing and measurement of revenues, expenses, assets, liabilities and equity will impact ratios. For example, the capitalization of leases formerly classified as operating leases, will negatively affect current and quick ratios, overall debt ratios, and may impact bank covenants under certain lending arrangements.

Employee compensation plans – the amount and timing of stock based compensation will change. Some awards that currently are expensed when certain activities occur may now have to be recorded as liabilities.

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Accounting Differences

Although there are still many unresolved differences, the US and international standards bodies are actively working toward conformity. Major open projects include:

- **Revenue recognition –** US GAAP has many standards governing revenue recognition across industries that are confusing and that sometimes result in dissimilar results for similar transactions. IFRS is a principles based approach that applies broad principles across all sectors that can result in differences in the timing and amount of revenue being recorded. Examples include sales incentives that are sometimes considered marketing expense under current rules, but would be considered an element of revenue under international accounting principles, and in some instances, estimated uncollectible accounts may be required to be deducted from revenue, as opposed to being shown under operating expenses..
- **Accounting for leases –** this could be the difference that affects the most companies, as it almost completely eliminates the operating lease for terms over one year. The intent is to put all leases on balance sheets. In this instance, lessees, who currently record the periodic payment as an expense when due, would establish a "right to use" asset with a related liability on its balance sheet. The liability would be reduced over time by use of the interest method, as under current accounting rules covering finance leases. However, there are still differences between the US and the International Accounting Standards Board (IASB) as to how the asset will be expensed. The lessor would continue to carry the asset on its books, which would result in the lessor showing the lease receivable as well as the underlying asset under assets on its balance sheet. .
- **Consolidations –** there are different concepts regarding entities to be consolidated
- **Property, plant and equipment –** property will be required to be accounted for at the component level, rather than on a composite basis as is done by many companies.
- **Financial reporting –** The basic statements of statement of financial position, statement of operations, statement of cash flows, statement of stockholder's equity, and statement of comprehensive income would change under IFRS. For instance, the order of assets on the balance sheet would not be in order of liquidity, as in current US GAAP. Other differences are reflected in the tables below.
- **Comprehensive income** must be reported in a separate statement, or included in the statement of operations. It can no longer be included in the statement of stockholders equity.

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Below is a summary of some additional differences in recording common transactions, as well as system impacts[i]:

Transaction	Primary Difference(s)	Impact to Systems
Inventory	IFRS does not permit Last In First Out (LIFO) method of measuring inventory Reversal of write-downs	Process and unit cost calculation changes may be required in inventory sub-ledger system
Property, Plant & Equipment	IFRS requires certain assets and depreciation be recorded at component level	PPE assets may be required to account separately by significant component pieces
Intangible Assets (such as R&D) and Impairment	Development costs may be capitalized when certain conditions are met and require more detailed reporting Impairment testing	System changes may be required to capture R&D projects' costs in more detail
Share-based Payments	Timing of recognition Valuation of liability-classified transactions	Changes may be required in the Payroll/HR/or alternative sub-ledger system

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The table below summarizes some reporting differences, and system impacts[ii]

Reporting/Presentation	Example of Difference(s)	Impact to Systems
Segment reporting	Basis of segmentation Segment reporting disclosures required may differ	Additional categorization may be required in the GL Secondary segment may need to be defined within the reporting system
Interim reporting	IFRS requires discrete period approach	Data capture may need to be revised to capture the information properly
Financial Statement Presentation and Disclosures	Presentation of comprehensive income Consolidation of subsidiaries	GL chart of accounts may need to be re-mapped to present dual reporting Data capture may need to be revised for a reporting or consolidation system
Internal Business Reporting	Potentially impact an organization's current reporting infrastructure	Data structure may need to be revised within a data warehousing environment Data capture may need to be revised within a business intelligence/reporting software

As shown above, there are many accounting, tax, system and business considerations affected by IFRS, which require executive attention now. An implementation timeline proposed by the American Institute of Public Accountants is shown below[iii]

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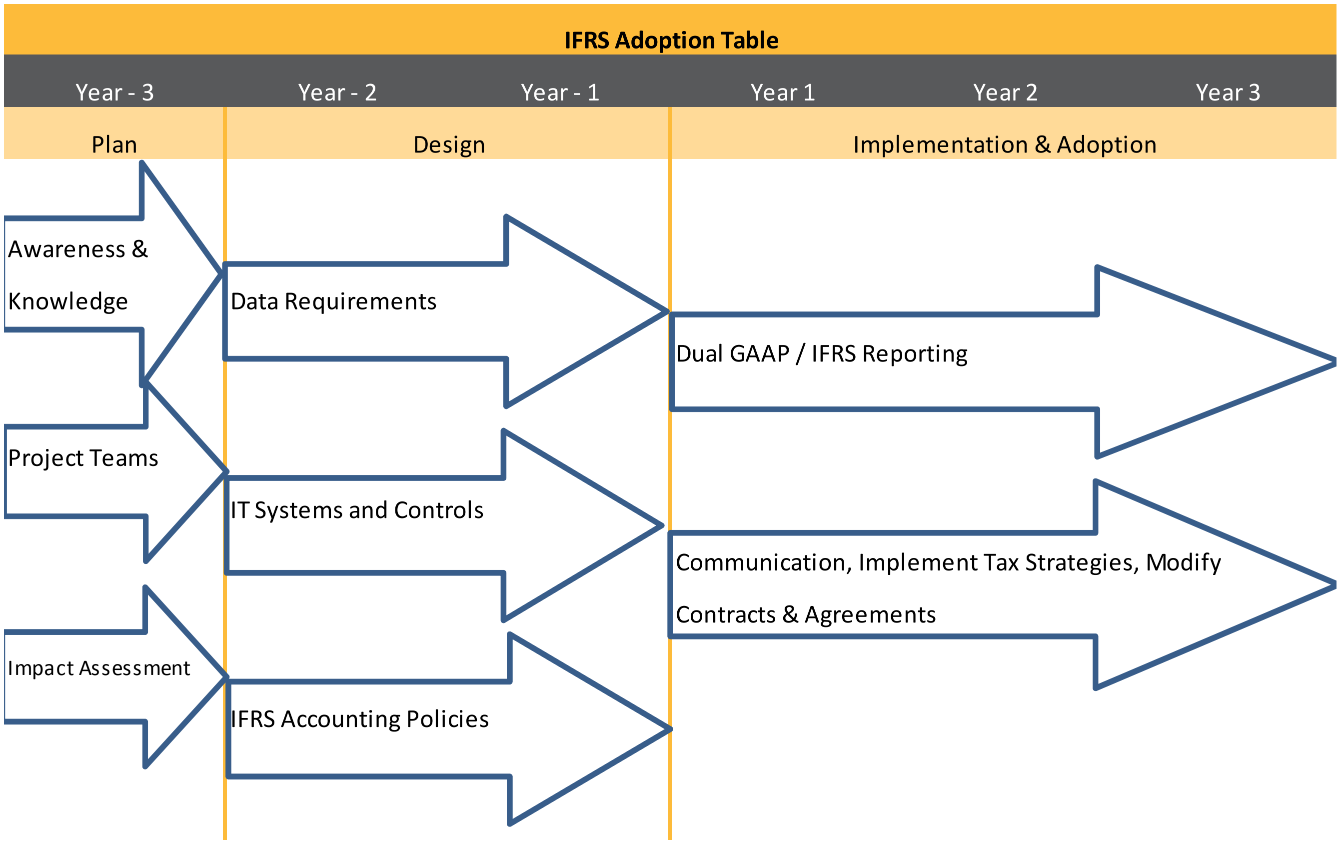

As shown above, companies should be considering the impact of IFRS on their systems now.

<u>Current Status</u>

There are three approaches to move to IFRS that have been adopted by other countries. They are:

- Adoption – an outright change from current local standards to IFRS
- Convergence – migration of current local standards to being close to IFRS
- Endorsement – outright endorsement of new IFRS before they become binding.

A fourth approach called “condorsement” was suggested by a member of the SEC staff. This would entail keeping current US Generally Accepted Accounting Principles (GAAP), while allowing the IASB and FASB to continue the major projects on their agenda, and working with the IASB on new standards, while working on converging existing standards.

International standards are based on principles rather than rules as under current US accounting

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principles. This will require companies to choose among alternatives for accounting policies, and disclose the reasons why such selection makes the statements provide more transparency and provide results more representative of their business. This as well as other principals based disclosures will help increase the size of financial reports under IFRS to as much as an estimated one-and-one half the volume of the comparable report under US GAAP.

A Light at the End of the Tunnel

In light of all the accounting changes and additional disclosures, there is possible relief for many companies. In 2009, the International Accounting Board released IFRS for Small and Medium Sized Entities ("SME"s), with alternative standards for companies that are not publicly traded. Some countries such as the UK are actively pursuing IFRS for SMEs, while others such as France have taken no action to date.

In the US, the Financial Accounting Federation has been chartered to explore changes to the reporting structure for private companies. Although a "little GAAP" for US companies has been discussed for at least a half century, this process appears to have legs now, with support from many different areas. Please keep in mind though, that IFRS will still govern.

New from accounting sir.
Two and two are four again[iv]

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Summary

Like it or not, IFRS will be a factor in the future of your business. Since IFRS will affect many non-financial sectors such as such as contracts, tax policy, financial planning, system requirements, communication with stockholders and lenders, credit agreements as well as employee compensation and benefit plans, we recommend that you be proactive, and assess the business, accounting and system impacts on your enterprise, and take appropriate actions to prepare for its introduction. Call your CFOs2GO Partner to provide the expertise and resources to help you take these large, important steps.✍

Footnotes

[i] "Financial System Considerations in IFRS Conversion Projects", AICPA Information Technology Section, American Institute of CPSs Exhibit 2, Page 3

[ii] "Financial System Considerations in IFRS Conversion Projects", AICPA Information Technology Section, American Institute of CPAs, Exhibit 3, Page 4

[iii] "Financial System Considerations in IFRS Conversion Projects", AICPA Information Technology Section, American Institute of CPAs, Exhibit 4, Page 7.

[iv] "The SEC's Current Thinking on Endorsing IFRS2, Why You Should Start Planning Now", EASi Webinar Series, Equity Administration Services, Chuong Pham, April 31, 2012

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