The Convergence of International and U.S. Financial Reporting Standards

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Historically, United States public companies have been required to file and prepare financial statements according to U.S. Generally Accepted Accounting Principles, or GAAP. Until recently, companies that have operations in other countries that prepare financial statements in those countries based on the International Financial Reporting Standards, or IFRS, had to convert those statements to GAAP for reporting in the U.S. The SEC, in December of 2007, made the unprecedented move to allow select foreign filers to report in the U.S. without making such a conversion. Many believe that this is a precursor to adoption of IFRS for all U.S. reporting companies.

This has fueled the movement to replace GAAP with IFRS. The growing acceptance of IFRS as a basis for U.S. financial reporting represents both a fundamental change for the U.S. accounting profession and a change in financial reporting for U.S. based companies. Today nearly 100 countries require or allow the use of IFRS for the preparation of financial statements by publicly held companies. In the United States, the Securities and Exchange Commission is considering taking steps to set a date to allow U.S. public companies to use IFRS, and perhaps make its adoption mandatory. The SEC stated in a release dated Aug. 27 that it would release an implementation timetable by year's end. Mandatory reporting under IFRS could start in 2014 for some U.S. companies.

What is IFRS?

IFRS is a set of accounting standards, developed by the International Accounting Standards Board, or IASB, an independent accounting standards setting body based in London, which is becoming the global standard for the preparation of public company financial statements. The IFRS is a principles-based framework, whereas GAAP represents a more rules-oriented approach to financial reporting. Unlike U.S. GAAP, IFRS allows greater exercise of professional judgment because there are fewer cumbersome rules and exceptions to apply.

Why Change?

By adopting IFRS, a business can present its financial statements on the same basis as its foreign competitors, making comparisons easier, and perhaps adding a degree of stability badly needed by the capital markets today based on the presumption that investors will be able to make better informed decisions based on information with a greater degree of comparability. Furthermore, companies with subsidiaries in countries that require or permit IFRS may be able to use one accounting language companywide. Companies also may need to convert to IFRS if they are a subsidiary of a foreign company that must use IFRS, or if they have a foreign investor that must use IFRS. In addition, companies may benefit if they wish to raise capital abroad. Certain U.S. issuers without significant customers or operations outside the United States may resist IFRS because they may not have a market incentive to prepare IFRS financial statements, and they may not have the resources to invest in a significantly large learning curve. Some other U.S. issuers may have to continue reporting under U.S. GAAP because it is required for filings with other regulators and authorities, resulting in additional administrative costs by requiring more than one version of financial statements prepared under different financial reporting standards.

A potential negative impact of change is that many countries that claim to be converting to international standards may never get to 100 percent compliance. Most reserve the right to carve out selectively or modify standards they do not consider in their national interest, an action that could lead to incomparability ? one of the very issues that IFRS seeks to address. Both companies and the standard-setting bodies will also need to address the issues where guidance is provided by GAAP, but not by IFRS, such as accounting and reporting for incomplete construction contracts, an area not addressed by IFRS.

The Process

The successful acceptance of IFRS, both in the United States and around the world, means that now is the time to become knowledgeable about these standards. Once a critical mass of non-U.S. companies in a certain industry sector begins to report their financial results using IFRS, there will likely be pressure for U.S. issuers to do the same, to allow investors to more efficiently compare their financial results, and, as a result, make better decisions. But this issue will have an impact far beyond financial reporting. It will affect almost every aspect of a U.S. company's operations, everything from its information technology systems, to its tax reporting requirements to the way it tracks stock-based compensation.

The Financial Accounting Standards Board, or FASB, and the IASB laid out an ambitious agenda for converging their respective standards in the 2008 Memorandum of Understanding, which summarizes the major projects the standard-setters expect to complete by 2011.

The chairs of both boards called the document an important milestone in their long-term plan to converge U.S. generally accepted accounting principles with the IASB's IFRS.

The latest agreement is the third such document drafted by the two standard-setting bodies to document their plans to converge their respective accounting guidance, and it is the product of the most recent joint meeting of the two boards in London in April 2008, during which the standard setters discussed the ways they will complete projects included in their Convergence Project.

Convergence

The term "convergence" is misleading. It implies that, by definition, it will ultimately lead to a hybrid of GAAP and IFRS. This is not necessarily true. The objective was never to meet somewhere in the middle, but to develop a global standard based upon the best available thinking in the field, regardless of whether that resembled U.S. GAAP. Those companies that are hoping the IFRS will eventually look like GAAP may be disappointed. The FASB and the IASB are committed to creating standards that make the most sense and clearly depict the economic circumstances of the firm. It is important to understand what presentations currently allowed by GAAP are not supported by IFRS, and how this will affect financial statements. The technical details of these convergence differences are beyond the scope of this article, but they exist, and caution must be exercised.

Steps to Consider Now

Public companies should start thinking now about whether to replace GAAP with IFRS, so they could act quickly if given the option. It is suggested that companies:

- Gather a team to analyze the issues involved. Large multinationals are using their controllers as their point persons and turning to their IT, investor relations and treasury departments for input.
- Understand how reporting changes will occur and how to educate themselves and their investors well in advance of required implementation.
- Compare IFRS and GAAP. How will the balance sheet, financial-reporting process and disclosures be affected? Will the financial statements truly present the economic substance and impact of all transactions?
- 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 expand footnotes.
- Take a new look at contracts and debt covenants that require the use of GAAP and may need to be renegotiated.
- Evaluate staffing needs. Who would need to be hired and trained, and what are the time frames?
- Evaluate required changes in their information technology systems, internal controls, business processes and plan for change.

Final Thoughts

It appears that IFRS will become the global financial reporting standard, effectively replacing GAAP. The SEC is working on a road map for transitioning U.S. companies to the global standards. It is imperative that U.S. public companies and their advisors be ready for the change. Exercise caution and evaluate impact closely.

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