

National Professional Services Group

IFRS: The right step for US business

What executives and directors need to know
about the important IFRS public-policy debate



*connectedthinking

PRICEWATERHOUSECOOPERS 

Table of contents

Situation p. 02

Recognizing the value of high-quality, global accounting standards, the SEC is considering measures that could lead to retiring US GAAP and adopting International Financial Reporting Standards (IFRS) in the US. This would be a dramatic change that deserves executives' attention now, as the debate begins.

Our perspective p. 07

Although there will be significant challenges along the way, the transition to IFRS will bring considerable benefits to US business.

Implications p. 21

Companies need to begin preparing without delay to be ready to take advantage of the benefits of IFRS when they become available. While the initial IFRS conversion will come at a cost, it will be outweighed by the benefits gained.

Situation

The US is considering adopting IFRS, a reporting framework that is well-positioned to become the new global standard.

International Financial Reporting Standards (IFRS) is the framework used by most publicly traded companies in the world today to report their financial results. With support from important constituencies, the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) have taken first steps toward a likely transition to IFRS from the accounting and reporting framework currently in place in the US. Is the US really going to set aside US generally accepted accounting principles (US GAAP)? The answer is almost certainly yes. Within a few years the SEC is likely to designate a date for mandatory adoption of IFRS by all US public companies.

Why is this shift occurring? Four factors stand out:

- 1. Globalization rules.** The globalization of business and finance has inevitably led to calls for a common set of high-quality, global accounting standards. IFRS has been successfully adopted by more than 12,000 companies in almost a hundred countries. The US is the largest of the few remaining hold-outs.
- 2. Complexity of current US standards is taking a toll on domestic companies.** Decades of detailed guidance and bright-line accounting treatments from multiple US standard-setting bodies are increasingly difficult to navigate and apply. The result has been a higher cost of compliance and increasing incidents of mistakes in applying the standards. It has also proven difficult to unravel that complexity. IFRS offers a sophisticated and simplified platform for a fresh start.
- 3. Convergence of the two dominant accounting frameworks is a tough proposition.** To date, the path to a common set of global standards has been an attempted convergence between IFRS and US GAAP. Much good has been accomplished since the FASB and the International Accounting Standards Board (IASB) agreed in 2002 to embark on an effort to align their standards. Both boards remain strongly committed to a convergence agenda. But complete convergence may elude the standard setters because of differing cultural, legal, regulatory and economic environments. Nonetheless, the difficulty and cost of maintaining two sets of standards is not sustainable.
- 4. IFRS will create cost efficiencies for companies.** A number of forward-looking US companies are already preparing for the conversion to IFRS with a goal of substantial savings and efficiencies.

First stop: Foreign private issuers. Next up: US companies?

The reality of IFRS as a proven, high-quality financial reporting framework led the SEC to a landmark proposal in July 2007: eliminating the requirement for foreign private issuers (FPIs, i.e., non-US companies whose securities are registered in the US) that use IFRS to reconcile to US GAAP.

If adopted, the SEC's proposal would represent an historic moment for the US, rich in consequence. If and when IFRS financial statements are fully acceptable in the US capital markets, the next logical step is to consider whether US companies should also be allowed to use IFRS. In a separate document issued in August 2007, the SEC asked for public feedback on that very question.

Eliminating the reconciliation is the right thing to do. Many capital market participants believe that the reconciliation no longer adds sufficient value, primarily due to the timing of its filing and the increased market understanding of IFRS. Eliminating the reconciliation removes the unnecessary burden and cost of maintaining two sets of accounting records. This step may make the US capital markets both more competitive with other major capital markets and more attractive to foreign companies.

IFRS for US companies?

Points of view on this question vary. Some believe that eliminating the US GAAP reconciliation is simply an accommodation for the relatively small population of FPIs. Others believe that further improvements are needed before IFRS is good enough for US companies.

In the interest of fairness and free market competition, we believe that domestic US companies should have the option to use IFRS once the US GAAP reconciliation requirement for FPIs is eliminated. US companies shouldn't be disadvantaged by having fewer choices than their foreign competitors.

There will be significant debate and valid arguments on both sides concerning what is best for US companies and investors. Having the option to apply IFRS or US GAAP unleashes an important dynamic: it will allow market forces to determine whether the adoption of IFRS by US companies is in the best interest of market participants, and it's likely to generate experience that will be useful to consider as US policy takes shape. The IFRS option will also encourage market familiarity and allow many companies and stakeholders to learn from the experience of early adopters in advance of a future mandatory adoption date.

A change as significant as transitioning to IFRS may prove to be something of a test of our national identity and pride: are we as a nation going to limit the range of IFRS because it's "not invented here," or are we going to embrace the global trend and work with our global economic partners to steadily improve it? Embracing the global trend has the future on its side.

Until a US policy is adopted that establishes IFRS as the primary reporting framework in the US, allowing the IFRS option means that for a limited number of years there will be two financial reporting languages in use in the US, and the possibility of market confusion is a valid concern. In the long run, the capital markets will be better served by a single financial reporting language. Therefore, a definitive deadline for adopting a US policy on the use of IFRS, with well-planned transition steps, will be an important part of a successful conversion to the new framework. A future mandatory IFRS adoption date for all US companies that accommodates a reasonable planning horizon is essential to ensure a smooth changeover with minimal disruptions.

Tracking the dialogue

2002

The idea of “compatibility”

The FASB and the IASB express interest in integrating their standards. At this time, their language is guarded, though optimistic.

They pledge to “make their existing financial reporting standards fully compatible” and “coordinate their future work programs to ensure that once achieved, compatibility is maintained.” Of course, compatibility does not mean full integration.

2005

New emphasis on convergence

The Boards speak of “reaffirming their commitment to the convergence of US GAAP and IFRS.” The drive toward compatibility is over; convergence becomes the focus – a gradual cooperative process begins, with the goal of developing “high-quality, common standards over time.”

2006

Moving toward IFRS

The Boards co-publish a Memorandum of Understanding that sets specific goals for short-term and longer-term convergence. The agenda is clear: fix the easier problems in the short term, launch efforts to approach the more difficult ones, and jointly rethink the conceptual framework of accounting and reporting so that future standards can be built on common ground. The Boards will not double back to fix old standards but instead will develop new common standards.

As the SEC explores the possibility of eliminating the requirement for non-US companies to reconcile their IFRS numbers to US GAAP, questions rarely asked before become urgent.

- If foreign private issuers have the option to use IFRS, why shouldn't US companies have the same option?
- If high-quality, global standards are the goal, and if convergence of two systems is likely to be a very difficult, long road, wouldn't it make sense to retire one of the two accounting and reporting frameworks?
- Since most countries in today's world use IFRS, wouldn't it make sense for the US to adopt those standards?

Moving from compatibility to convergence to possible adoption of IFRS would represent an historic shift for US capital markets and its stakeholders.

That said, today there are still questions that need answers and points of views that need to be reconciled.

Our perspective

Although some thorny issues need attention, moving to IFRS is all but inevitable and will be entirely worthwhile.

IFRS is not a silver bullet but it's a major step forward. The US financial reporting environment is too complex, and that threatens to become a competitive disadvantage for US capital markets. For years, many influential people in the US who generate, use, and oversee corporate reporting have been calling for change.

While many IFRS standards are simpler than their US GAAP counterparts, few people take the view that IFRS will solve every problem right away. But nearly everyone who looks at it agrees that IFRS offers a satisfactory global platform with the opportunity for further advances. Financial reporting cannot always be simple because financial transactions are often complex, but reporting can always be clear and informative. In response to investor reporting needs, IFRS delivers:

- a high-quality, principles-based framework
- transparency to the economics of transactions
- fewer rules and exceptions; it's less cumbersome to apply than US GAAP
- ability to exercise greater professional judgment

These are qualities most executives and investors can embrace.

The benefits and challenges of moving to IFRS

IFRS will help in many ways beyond the points just noted. As with any significant change, challenges and obstacles will need to be planned for and addressed.

Benefits

A common accounting and financial reporting language, applied consistently and rigorously worldwide, will:

- increase comparability for investment analysis
- enhance the efficiency of capital allocation on a global basis and decrease the overall cost of capital
- increase the competitiveness of US companies and capital markets by eliminating barriers (costly requirements to report in, or reconcile to, other GAAPs)
- reduce accounting complexity and the risk of errors
- generate process and cost efficiencies for preparers, investors, auditors, and others by operating in essentially a single accounting environment

These are clear gains for forward-thinking companies that strive to manage their businesses with a combination of diligence and entrepreneurial drive in an open global marketplace.

Today many global companies manage multiple financial reporting demands at both the consolidated and subsidiary levels. They are required to report to capital market regulators and to meet statutory reporting obligations in foreign territories and often to other stakeholders such as industry regulators. Historically, the language of financial reporting was dictated by territory – UK GAAP, German GAAP, etc. – and required multiple levels of expertise, accounting policy translation, reconciliation, and cost. Ultimately, the ability to report in a common accounting language in all territories will offer unprecedented opportunities to centralize and streamline operations and lower the risk of accounting errors. Several large multinational companies are planning (or already have projects underway) to consolidate reporting functions and take advantage of the growing acceptability of IFRS for statutory and regulatory reporting.

Benefits will outweigh costs

The initial IFRS conversion will come at a cost. That one-time cost (e.g., to analyze and adjust historical financial statements, convert existing reporting systems to accommodate the IFRS framework, and educate preparers and users of the company's financial information) will vary depending on the size, diversity, and operating structure of individual companies. But the long-term benefits should be more than worth the effort. The ability to centralize accounting functions and move financial personnel freely around the world should lower costs and strengthen internal controls. Increasingly, global M&A activity requires IFRS reporting, and using the globally accepted accounting language will increase global comparability and open doors to new sources of cost-effective capital.

For companies competing solely in the US and concerned about cost/benefit, the IFRS transition is likely to have a longer time horizon, but these companies can also expect to achieve benefits outweighing their implementation costs. Domestically focused companies and smaller companies that may have less depth in accounting resources will benefit from the simplification that IFRS brings.

Challenges

A change of this magnitude calls for adaptation and compromise on many levels.

Pride and politics

US national pride and fear of losing the power to set standards for the home market will likely run high as the IFRS debate gains traction. Many in the US will initially balk at the idea of abandoning US GAAP, long held to be the gold standard of accounting and reporting. A survey of participants in a May 2007 Financial Services Executives-Forum, sponsored by PricewaterhouseCoopers, showed that an overwhelming majority support the idea of global GAAP, but only about a third favor handing over responsibility to the IASB to develop it.

That wariness runs on both sides: parties outside the US fear the long reach of the SEC interfering with IFRS and interpreting it in a narrow, prescriptive manner. The SEC will have to perform a delicate balancing act to promote the acceptability of IFRS while continuing to fulfill its mandate to protect US investors. To that end, the SEC is working closely with IOSCO and CESR to establish procedures for reviewing IFRS filings and identifying and resolving issues on a globally consistent basis.¹

¹ IOSCO is the International Organization of Securities Commissions; CESR is the Committee of European Securities Regulators.

Representation at the IASB

Representation at the global table should be a concern. By design, the IASB is independent, not aligned or beholden to any sovereign state. The influence of US constituents, full strength at the FASB, will be diluted at the IASB. The IASB has been criticized from time to time by some of its European constituents for turning a deaf ear to certain concerns. A board with a global constituency will have to weigh many views, as well as carry the responsibility of adopting high-quality solutions for all.

From its inception, the SEC and the FASB were closely involved in the creation and development of the IASB and its predecessor organization. US perspectives continue to be represented at the IASB, and currently 3 of the 13 IASB members are American, as are 5 of the 22 trustees charged with overseeing the Board. Some believe that US interests are already properly represented, while others believe that with half of the world's equity value resident in the US, American interests are under-represented. The IASB has an open due process system, similar to the FASB's. US companies can and should contribute to that process by voicing their views.

US capital markets will
become more attractive
to foreign companies.

Responsibility to protect US interests

In legal terms, the SEC has formal responsibility for developing accounting standards in the US for US companies whose securities are registered with the SEC, and designates the FASB to carry out that responsibility. However, the SEC takes its FASB oversight role very seriously. The historical manner in which the SEC has interacted with the FASB will undoubtedly be different than its relationship with the IASB.

One of the FASB's most important objectives is to help the SEC meet its responsibility to protect investors by setting high-quality financial reporting standards. The SEC needs to be comfortable that an international organization with international members and constituencies could fulfill that same objective. Experiencing the need to protect their unique self-interests, other territories currently using IFRS have put approval processes in place to meet their objectives. The EU instituted a multi-level endorsement process, necessarily political to some degree because so many sovereign states are stakeholders. In Australia, the local standard-setting body must endorse standards issued by the IASB before they can be used by companies.

In reality, the US has already yielded a degree of sovereignty in standard setting. There has been strong transatlantic cooperation between the FASB and the IASB for several years. All major standard-setting activities are jointly conducted in a way that takes into account what each Board will be addressing as part of its project. Even today, the IASB influences US GAAP – as evidenced by the new, converged standard on accounting for business combinations. It's unlikely that the US will cede all elements of sovereignty and control to an international body, no matter how effective that body proves to be. It's far more likely that the US, through the SEC, will put in place its own approval process, but the mechanics have yet to be decided; these are still early days.

One approach may be to retain some form of national standard-setting body. That body could continue to provide input to the IASB on issues related to public companies, play a role in the IFRS approval process, and be responsible for standard setting for private companies until such time as US GAAP is phased out. Whatever structure is put in place should continue the tradition of acceptance of standards as issued by the standard setter without political interference.

Sustainability of the IASB

The key question is whether the US can rely on the IASB for the long haul. To date, the IASB's independence and governance structure has withstood considerable scrutiny in delivering a stable, high-quality set of standards. Admittedly, there were growing pains as the IASB assumed responsibility for global standard setting while several national standard setters, including the FASB, provided assistance and resources. Those growing pains will likely continue as the IASB begins to assume direct standard-setting responsibility for the world's largest, most sophisticated capital market.

While the FASB is a tested, long-established entity, the IASB in its current form is relatively new, founded in 2001. The IASB has considerably less infrastructure than the FASB. In addition to sharing resources with the FASB for major joint projects, the IASB frequently outsources research and analysis work to other national standard-setting bodies. As the world's recognized standard setter, the IASB should now engage a fuller complement of multi-talented, permanent staff, while retaining the benefits realized from its historical resource-sharing tactics.

However, funding for the IASB is a key concern. The Sarbanes-Oxley Act secured funding for the FASB by levying fees on US public companies. The IASB is currently funded by private donors – a solution that could lead to conflicts down the road. Anticipating a move to IFRS, the US and our global partners need to develop a funding model that provides a steady flow of resources for the IASB and ensures that its processes are sufficient to withstand any particular territory's or entity's influence. An equitable funding mechanism will help ensure appropriate levels of leadership, staffing, resources, and independence for the IASB.

The US brings a rich legacy of sustainable, independent standard-setting expertise and an approach to financial reporting that gives high priority to investor protection. A transition to IFRS means that these strengths can now be shared more fully with the global community, and the US can benefit from the experiences of other traditions.

Thorny technical issues need attention

While IFRS is a positive step forward, there are still some thorny technical issues to address. For example, current IFRS standards result in very different reporting for securitization transactions, and IFRS does not allow the use of LIFO inventory accounting. The securitization issue is simple enough to state: US GAAP allows trillions of dollars in securitized financial assets and liabilities to stay off the books of originating financial services institutions, while IFRS would show most of those assets and liabilities on the balance sheet. Although adopting IFRS principles may result in dramatically different financial reporting, the underlying economics and cash flows from securitizations remain the same. State and federal banking regulators will need to assess the impact of these changes and address existing practices and requirements to ensure that regulatory objectives continue to be met. Timely planning and communication will be essential so that investors and other stakeholders understand the changed reporting. The transition in reporting will need to be a closely monitored process to guard against unwarranted industry disruption.

On the LIFO matter, the issue is cash flow. In the US, companies can use LIFO in their tax reporting to reduce taxes paid to the government but must also use it in their financial statements – this is the “LIFO tax conformity rule.” IFRS doesn’t permit the use of LIFO in financial statements. In this case, changing US tax laws should be considered, but changing tax laws is no simple matter. Creativity and adaptation will be required as options are explored. This obstacle must be addressed before mandatory adoption of IFRS occurs in the US. The self-evident goal for the US must be to minimize domestic economic disruption while furthering sound accounting standards for the global community.

IFRS is a work in progress. Like US GAAP, it needs improvement, and both Boards have challenging projects on their agendas. Some believe that the requirement to reconcile to US GAAP has been a motivating force at the IASB and that once the reconciliation is gone, competing political agendas may minimize incentives for further improvement and slow progress. Others believe that the gap between IFRS and US GAAP is still too wide in critical areas and that these areas must be addressed before IFRS is allowed to be used by US companies. Our point of view differs: we believe that the differences between US GAAP and IFRS are not nearly as relevant as the fact that both sets of standards need to improve, especially in several key areas. Regardless of whether the standard setters have convergence as their primary goal, demands for more transparent, understandable reporting will still drive necessary improvements. Therefore, advancement in important projects such as revenue recognition, distinguishing liabilities and equity, accounting for pensions, and financial statement presentation will continue to occur.

In the long term, capital markets will be better served by a single reporting framework.

Can a principles-based framework flourish in the US?

The development of US GAAP has been shaped by the unique legal and regulatory environment in the US, where the judgment of management, boards, and auditors is often second-guessed by regulators, plaintiffs, and third parties. A standard-setting culture that emphasizes rules, bright lines, and detailed guidance has been the natural response to that pressure. If an accounting and reporting framework that relies on reasoned, professional judgments rather than detailed rules is to flourish in the US, the regulatory and legal environment will also need to change. Regulators will need to respect well-reasoned professional judgments. The arrival of IFRS is not a pretext for advocating massive legal reform; however, it does suggest that prudent change will be needed. Regardless of what happens with respect to legal reform, a less complex, principles-based accounting framework that allows the use of sound professional judgment will be a very real improvement.

Another concern is that the increased use of principles and judgment under IFRS may temporarily reduce comparability across companies and hamper investment analysis. Others cite the lack of global regulation, enforcement, and auditing standards as critical obstacles on the path to achieving true global consistency and comparability. On both these points, market pressures are likely to motivate companies to conform to accepted industry norms, and the transparency provided by the IFRS disclosure framework may partially compensate for short-term problems. Disclosures that clearly communicate economics and the accounting policies applied should provide sufficient transparency for analysis. Cooperation among global regulators and consistent, rigorously applied global audit practices will be essential to achieve the full benefits of IFRS as the global accounting framework.

Adapting to a global standard setter

Individual territories have the right to establish securities laws for their own markets, a right that includes specifying accounting standards to be used. We expect territories to continue to use IFRS approval mechanisms since they provide a certain level of sovereignty and protection. Note that the SEC's proposal to provide relief from the US GAAP reconciliation requirement applies only to foreign private issuers that use IFRS as issued by the IASB. Over time, we recognize that approval processes may create some differences, but they should be kept to a minimum with the right level of collaboration amongst regulators, standard setters, and other constituents.

Participation in an independent, high-quality, global standard-setting body carries the responsibility to respect the process and output of that global cooperation. There is a time to debate, and a time to agree. Stakeholders in the IASB should be informed and demanding during the process of standard setting; this is the appropriate time for debate. Once the process is complete, a new standard is issued; territories should accept the outcome. Presuming tough-minded debate during the development process, standards ultimately issued by the IASB should be endorsed by territories without modification in nearly all cases.

Implications

Mandatory changeover could occur by 2013.

That leaves time for businesses to prepare and seize the benefits.

The financial reporting revolution outside the US has been rapid. The IFRS debate in the US is just beginning. While it's difficult to predict the timing of the transition, many indicators currently point to mandatory use of IFRS in the next decade.

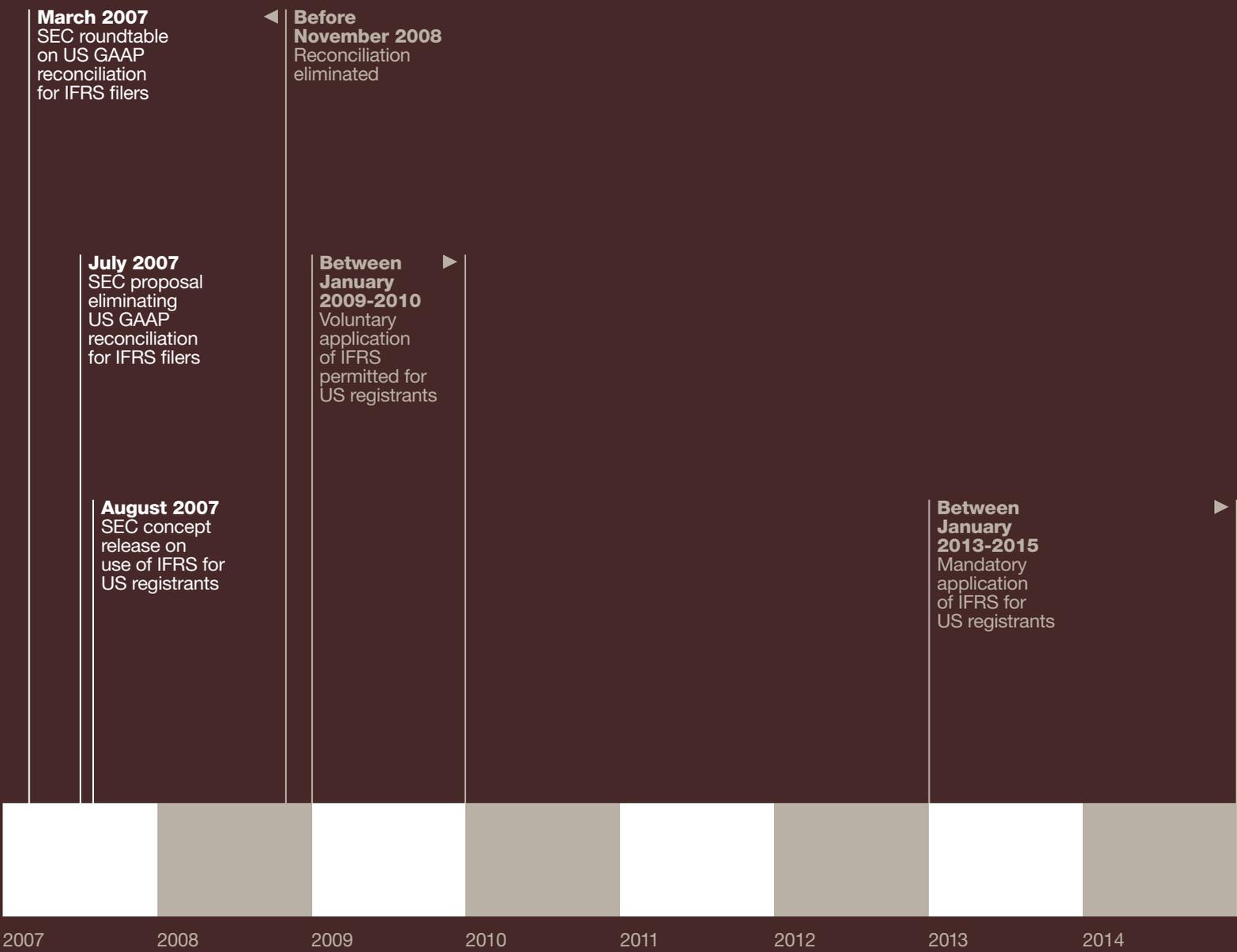
What will a timeline of this kind mean for companies? First and foremost, there is the need to plan and prepare for change. Companies will have some years of leeway, but if IFRS in the US is inevitable, why wait? It makes sense to get on board early to gain familiarity. Early adopters will have an advantage over their peers. Companies will also want to understand how IFRS has affected their global competitors, particularly how their accounting policy choices have affected reported results.

Items to plan and prepare for include:

- do your own analysis of the costs and benefits of transition to IFRS
- look at change management strategies that will smooth the way
- analyze IFRS accounting policies and their impact on reported results
- assess debt agreements and other contracts for modification as needed
- look for opportunities to centralize accounting functions across business units
- embed IFRS into operations and existing systems
- educate investors and other stakeholders on how IFRS impacts your financial reporting

Figure 1

Estimating the transition timeline



Final thoughts about a new beginning

IFRS as we know it today continues the tradition of investor protection and transparent financial reporting that has been the hallmark of US standards. As the global marketplace has changed and moved toward one set of global accounting standards, so must the US. US GAAP has grown to be too complex and now threatens to become a competitive disadvantage for companies and for our capital markets. We encourage all US stakeholders to think globally, plan for the transition, and embrace the benefits that IFRS will bring.

Questions

The white paper is intended not just to inform but to raise questions. Clients of PricewaterhouseCoopers may want to open a dialogue about IFRS with their engagement partner. In addition, two primary authors of this paper will welcome questions about IFRS:

Dave Kaplan
International Accounting Leader
PricewaterhouseCoopers
Phone: 973-236-7219
Email: dave.kaplan@us.pwc.com

Raymond Beier
Strategic Analysis Group Leader
PricewaterhouseCoopers
Phone: 973-236-7440
Email: raymond.beier@us.pwc.com

