Perspectives on Eventual IFRS Adoption

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Perspectives on Eventual IFRS Adoption

Annette Or
May 2012

Abstract
Will the effects of eventual adoption of International Financial Reporting Standards (IFRS) be more positive or negative for practitioners and companies in the United States? How will IFRS affect stakeholders, including Chief Financial Officers (CFOs), investors, bankers, Chief Executive Officers (CEOs), chairmen, taxpayers, Certified Public Accountants (CPAs), and publicly traded companies? This paper will discuss the challenges faced, the opinions regarding the transition process, and the implications of IFRS implementation.
Table of Contents

Introduction............................................................................................................. 1
Benefits of IFRS Adoption..................................................................................... 4
Drawbacks of IFRS Adoption ................................................................................ 7
The Transition Process......................................................................................... 10
Conclusion............................................................................................................. 13
Works Cited........................................................................................................... 15
Introduction

International Financial Reporting Standards (IFRS or iGAAP), a set of accounting regulations, is becoming the global accounting standard for the preparation of public-company financial statements. “Today approximately 113 countries require or allow the use of IFRS for the preparation of financial statements by publicly held companies” (AICPA, 2008). These countries include European Union and Asia Pacific members, Canada, Korea, Brazil, Japan, and India (Leskela, 2009). From 2014 forward, many companies in the United States will face the challenges of converting financial statements from U.S. GAAP (Generally Accepted Accounting Principles) to IFRS.

The Securities and Exchange Commission (SEC) has the primary role in the progress and development towards adoption, using the Financial Accounting Standards Board (FASB) to accomplish the implementation. In September 2002, the SEC announced its support of the Norwalk Agreement. This agreement was formed between the FASB and the International Accounting Standards Board (IASB) to “develop high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting” (AICPA, 2008). This was the first step towards adoption; the initial full adoption date was set for April 2005.

In April 2005, the SEC published a “Roadmap,” a proposed timeline for adopting iGAAP, which included a series of key milestones (AICPA, 2008). This “Roadmap” was then revised, in November 2008, showing a possible path for adoption in the U.S. However, there was “no further announcement from the SEC on the direction they would take” until February 2010, at which time Mary Shapiro, Chairman of the SEC, made a statement (PricewaterhouseCoopers (PwC), 2011). According to Shapiro, matters need to be further analyzed. Since then, regular
public updates on the progress of the “Roadmap” have been issued; there is always an indication that adoption is imminent, though the final decision seems to be lingering.

As of December 2011, the SEC’s latest update regarding progress indicated “they would need additional time to complete a final report on the work plan (now expected in 2012) and make a recommendation . . . on whether, when, and how to further incorporate IFRS into the U.S. financial reporting system” (PwC, 2011). The timeline below illustrates the SEC’s progress towards adoption in the U.S., working in cooperation with the IASB and the FASB.

(AICPA, 2008)
The SEC’s plans for upcoming years and the duration of IFRS implementation may be uncertain and unpredictable, but specific impacts on publicly traded companies are known. Depending on the stakeholders and their interactions with adoption, there are varying opinions on whether IFRS adoption will be positive or negative. Nonetheless, it is clear that many aspects of a U.S. company's operations will be affected by the conversion to IFRS. IFRS will influence more than just the accounting and reporting of financial statements; it will have an effect on information technology systems, tax reporting requirements, internal reporting, key performance metrics, the tracking of stock-based compensation, and much more, as shown in the diagram below. Additionally, “IFRS may present different opportunities and challenges for companies, based on their size, industry, and degree of complexity” (Heffes, 2008). Subsequent sections will discuss how the implementation of iGAAP will affect specific stakeholders.

(AICPA, 2008)
Benefits of IFRS Adoption

Some of the stakeholders mentioned above are developing a more positive attitude towards the adoption of IFRS. The SEC, via the FASB, has been working on establishing a single set of standards that is not only understandable and enforceable, but also helpful in preparing straightforward and comparable financial statements. If adoption proceeds, numerous benefits are expected by Certified Public Accountants (CPAs), Chief Financial Officers (CFOs), investors, and Chief Executive Officers (CEOs) and chairmen of major accounting firms.

CPAs responsible for creating and auditing financial statements expect the change from GAAP to iGAAP to be beneficial, since they will no longer have to reconcile GAAP with IFRS. Companies can avoid converting financial statements from IFRS to GAAP for international subsidiaries.

According to an international survey done by the Association of Chartered Certified Accountants (ACCA), CFOs and investors demonstrate growing support for IFRS (Lee, 2011). One hundred sixty-three CFOs and investors from various nations believe IFRS “could prove beneficial for audit, corporate governance, and non-financial reporting” (Lee, 2011). Survey results suggest CFOs and investors expect “a positive answer from the SEC would give a tremendous boost to the cause of financial reporting and more importantly the world economy” (Lee, 2011). However, “ACCA reported that the IFRS benefits of accurate cross-border comparisons will only be maximized if ‘carve outs’ of standards by governments and other national add-ons to rules and regulations are kept at a minimum” (Lee, 2011). Adoption of IFRS can be beneficial, if country-specific modifications of IFRS are rare.
ACCA’s “Towards Greater Convergence,” a report based on surveys of CFOs and investors, revealed the following selected statistics:

- 60 percent of respondents saw international standards as facilitators of more consistent regulation
- 44 percent of investors responded favorably and 30 percent saw little or no benefit
- 37 percent of CFOs said they believe standards will improve non-financial reporting on corporate social responsibility and environmental risk and only 9 percent disagreed
- 70 percent of CFOs and investors believe standards will encourage more long-term thinking in the boardroom
- Two-thirds of respondents find benefits in integrated reporting, with 39 percent seeing that manifest in better decision-making and 28 percent envisioning a more accurate picture of overall performance

(Lee, 2011)

The belief is that “more long-term thinking in the boardroom” will facilitate more effective decision-making from the board of directors, creating a more successful company (Lee, 2011). Additionally, CFOs and investors expect “a more accurate picture of overall performance” will be provided under IFRS (Lee, 2011). As demonstrated by the results of ACCA’s survey and report, adoption of IFRS is generally favored by CFOs and investors.

Adoption of IFRS is also favored by these stakeholders because it opens up reporting possibilities not previously available. Under IFRS, U.S. companies will be able to reclassify certain equity, such as callable common or preferred stock, as debt, and implement improved transfer pricing policies (Deloitte, 2008). Regarding transfer pricing policies, Deloitte said, “Implementing transfer pricing policies [regarding prices parent companies charge for goods sold to subsidiaries] may eventually become easier. Fewer procedures may be required as more companies use IFRS and differences in profitability arising solely from differences in accounting
methods are reduced between comparable companies” (Deloitte, 2008). Thus, this will encourage less distortion in transfer prices.

Along with CFOs and investors, CEOs and chairmen of major accounting firms also believe switching to IFRS can improve financial reporting. According to Timothy P. Flynn of KPMG International, the U.S. should mandate conversion as soon as possible “to ensure comparability and competitiveness with peer global companies using IFRS” (Heffes, 2008). Furthermore, James S. Turley, Chairman and CEO of Ernst & Young (EY), views the transition as a way to “help companies achieve greater efficiency with fewer different reporting requirements…” (Heffes, 2008). As Turley states, a common set of standards will “provide a foundation for capital market activity that promotes investment and strengthens economies” (Heffes, 2008).

Chairman and Senior Partner Dennis Nally of PricewaterhouseCoopers (PwC) and Barry Salzberg, CEO of Deloitte, share a similar perspective with Flynn and Turley. Nally asserts IFRS will allow U.S. issuers to better “compete for capital with non-US companies in capital markets around the world” (Heffes, 2008). Adoption is in the best interest of U.S. companies if they do not want to lose sight of success. Additionally, he feels “embracing a single set of global accounting standards will contribute to a higher degree of investor understanding and confidence than currently exists. Costs will also drop, as companies will not need to prepare two sets of financial statements or continually reconcile and explain the differences…” (Heffes, 2008). Salzberg, of Deloitte, further supports the view that adoption of IFRS will provide “greater transparency of financial information for investors, enhance market efficiencies with improved access to foreign markets, and reduce cost and complexity in reporting” (Heffes, 2008).
Drawbacks of IFRS Adoption

Overall, CPAs, CFOs, investors, and CEOs and chairmen of major companies view IFRS as a “common financial reporting language that would benefit investors, as well as issuers and capital markets” (AICPA, 2011). Nonetheless, some members of these groups hold more negative opinions. GAAP has been viewed by U.S. accountants as the “gold standard” since its creation in 1930. Turner Investments Partners contends that, because accountants are so accustomed to traditional GAAP, there will be mental and emotional resistance (2012). Major CPA firms, as well as individual practitioners, are likely to face this resistance.

Deloitte has indicated adoption of iGAAP will cause tax complications. Since IFRS will change the way net income is calculated, it will also change companies’ effective tax rates. For instance, iGAAP’s definition of equity may eliminate tax benefits for hybrid instruments; hybrid instruments are equity, such as “interest that is treated as dividends” (Deloitte, 2008). IFRS will also eliminate last-in, first-out (LIFO) inventory valuation. Companies will have to report using other methods, such as the first-in, first-out (FIFO) or weighted average methods, resulting in higher net income and higher tax liabilities, although actual sales will not have increased (Kinney & Rood, 2008). An illustration of the difference between LIFO and FIFO or average cost method is provided.

<table>
<thead>
<tr>
<th>Units</th>
<th>Purchase Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st Inventory Batch</td>
<td>1,000</td>
</tr>
<tr>
<td>2nd Inventory Batch</td>
<td>1,000</td>
</tr>
<tr>
<td>3rd Inventory Batch</td>
<td>1,000</td>
</tr>
<tr>
<td>Total</td>
<td>3,000</td>
</tr>
<tr>
<td>Average Cost per 1,000 units</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>LIFO</th>
<th>FIFO</th>
<th>Average Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales (1,000 units @ $1.50)</td>
<td>$1,500</td>
<td>$1,500</td>
</tr>
<tr>
<td>COGS</td>
<td>$1,150</td>
<td>$1,000</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>$350</td>
<td>$500</td>
</tr>
<tr>
<td>Starting Inventory Value</td>
<td>$3,200</td>
<td>$3,200</td>
</tr>
<tr>
<td>COGS</td>
<td>$1,150</td>
<td>$1,000</td>
</tr>
<tr>
<td>Ending Inventory Value</td>
<td>$2,050</td>
<td>$2,200</td>
</tr>
</tbody>
</table>

(Jun, 2011)
Practitioners highlight another drawback, involving IFRS-based inventory valuations. Under GAAP, measurement based on lower of cost or market (LCM) permits writing down inventory, but marking inventory back up, if it regains value, is prohibited. On the other hand, under IFRS, the lower of cost or net realizable value method is required, with the additional option to mark up inventories to restore them to full value. Consequently, since entries are reversible under IFRS, earnings volatility will be created for U.S. companies.

Another tax issue is the requirement for research and development costs to be reported separately, under IFRS; research expenses must be recorded as incurred, while development costs must be capitalized. Additionally, this separation will cause continuous differences in accounting books and tax reports; therefore, “when it comes to tax reporting, companies [will have to] . . . re-examine their procedures for identifying and measuring book-tax differences” (Kinney and Rood, 2008). Consequently, as Deloitte reports, “an analysis of the statutory reporting options may reveal that the overall tax results under IFRSs are not as favorable as under local GAAP reporting” (Deloitte, 2008).

Furthermore, CEOs and chairmen of major accounting firms believe IFRS will create “an environment where there will be less detailed application guidance and fewer ‘bright lines’” (Heffes, 2008). CPAs will be expected to exercise more judgment, making many assessments based on “reasonable professional judgments,” rather than reviewing financials based on straightforward rules (Heffes, 2008). Because of this, financials will be more complicated to comprehend, and disclosures about changes and differences must be scrutinized more carefully. “Different people are going to look at similar transactions and perhaps come to different conclusions” (AICPA, 2009). As these statements illustrate, some stakeholders fear IFRS adoption will create unnecessary confusion.
An additional downside associated with IFRS is that it will create a bigger discrepancy between accounting- and tax-based bookkeeping for U.S. publicly traded companies. For instance, IFRS will alter the items allowed to be deducted in calculating net income. “Highly leveraged subsidiaries may be denied interest deductions in certain jurisdictions” (Deloitte, 2008). IFRS will also alter asset values and associated depreciation, amortization, and other deductions, such as those for goodwill and other intangible assets. “The tax basis in an asset generally drives the calculation of the deduction for tax purposes” (Deloitte, 2008). Consequently, changes in asset valuations and related depreciation deductions could ultimately cause a change in tax liabilities. IFRS share-based compensation rules also vary from existing GAAP, which will “adversely affect the effective tax rate” (Deloitte, 2008). “A company must evaluate the impact of converting to IFRS locally [in various jurisdictions] in order to assess its ability to deduct share-based compensation in the local tax return” (Deloitte, 2008). Practitioners will have to familiarize themselves with these more complex and conditioned standards and evaluate them accordingly.

Last but not least, some critics oppose IFRS adoption because they believe the fair value accounting method, associated with iGAAP, contributed to the credit crisis and financial dislocations in 2008. If the U.S. adopts iGAAP, the above-mentioned critics and other stakeholders, greatly affected by the fair value method, will undoubtedly pressure for adjustments to the International Accounting Standard (IAS) 39, Financial Instruments: Recognition and Measurement.
The Transition Process

Full adoption of IFRS should not be taken lightly; a carefully constructed plan could take longer than expected. Nonetheless, the transition process, during which the SEC will make definitive decisions involving iGAAP implementation, includes significant challenges that should be analyzed when weighing the pros and cons of adoption. Along with the AICPA, the SEC provides assistance for constituents affected, helping them during this period of indecision. Meanwhile, stakeholders must overcome the tactical challenges associated with imminent, but uncertain, IFRS adoption. The untoward effects of the prolonged transition process from GAAP to IFRS on investors, CPAs, professors, and other practitioners should be assessed.

The SEC attempts to assure gradual progress, helping companies smoothly phase into usage of IFRS. The AICPA also provides a website that helps accountants prepare for incorporation of IFRS; www.ifrs.com allows practitioners to familiarize themselves with this new set of standards. Furthermore, the AICPA regularly conducts an “IFRS Preparedness Survey,” which reflects U.S. participants’ readiness for iGAAP, allowing adoption progress to be monitored. As of 2008, “65.2 percent majority of CPAs say they have some knowledge of IFRS but need to learn more” (AICPA, 2008). The transition process can create hardship and confusion for many participants; careful preparations and planning are required to successfully adopt iGAAP and receive actual benefits.

Financial executives with multinational businesses are still doing double duty, reporting company results in both IFRS and GAAP, because of this prolonged delay towards adoption (AICPA, 2009). Significant differences constantly appear in the financials, which require reconciliation. In an AICPA case study, Michael Erdmann, controller at Krones Inc., reported companies waste time spent preparing dual financials, which they could spend improving their
businesses (AICPA, 2009).

The SEC’s long delayed acceptance of iGAAP is proving to be unsettling, not just for U.S. participants, but also for international bodies. According to the American Bankers Association (ABA), the IASB has been pressuring the U.S. about changing to iGAAP. Donna Fisher, senior vice president of tax and accounting in the ABA, states that “it’s almost as if there is a deadline… The IASB is saying, ‘we want a single set of standards so long as it’s by the end of 2011’ rather than ‘we’re going to have an ongoing effort even if the SEC doesn’t make that decision’” (Hickley & York, 2011). Fisher further believes the IASB “might have to lighten up on interaction with the U.S.… They would want to continue to work closely with the FASB,” given its important role in the adoption process (Hickley & York, 2011).

Some U.S. companies are deferring their preparation for adoption, whether as a result of underestimating the challenges of adopting or assuming IFRS will never really be fully adopted. Consequently, if companies continue to take this approach, last-minute panics, long-term expenses, and “disruption to untangle a mess of temporary fixes” may occur when actual adoption is required (Pugh, 2011). If too many companies postpone preparations and there is a limited supply of iGAAP experts, a shortage of qualified resources may exist, causing U.S. companies to fall behind their competitors. Many complexities must be dealt with quickly, even though the target date might appear distant. “Collecting additional or different data, … changing the way the data is structured in the chart of accounts, … making similar adjustments to the consolidation structures for group reporting, … and updating reporting and analysis tools and models…” are just some of the things that must be done (Pugh, 2011). However, panic can be avoided if U.S. companies "have the right advice and interoperable global accounting system[s] in place with flexibility to accommodate the move to IFRS," before the SEC mandates
adoption (Pugh, 2011).

Chairmen and CEOs of major accounting firms see the transition process as challenging, but not something practitioners cannot overcome (Heffes, 2008). According to Chairman Timothy P. Flynn of KPMG International, the conversion will be a “massive undertaking” (Heffes, 2008). Additional training and understanding of implications for accountants, integration of IFRS in curricula for academia, and enhancing investors’ ability to interpret new financial outcomes will be needed. Edward E. Nusbaum, CEO of Grant Thornton, further supports this outlook, saying, “nearly every accountant, foreign and domestic, will have to be retrained on the differences between local GAAP and IFRS” (Heffes, 2008). Accountants, employees, CFOs, and other professional associations will need more resources, like webcasts and comprehensive training programs, to help develop skills and to ensure practitioners become more knowledgeable. This will be an ongoing process, until firms are fully settled with the new standards. Moreover, firms will need to work with professors to help students through this conversion and understand IFRS better. However, a “need to create appropriate training” and provide “real-world experience with the implementation” will exist, requiring proper training and teaching materials (Heffes, 2008).

Although the exact duration of the adoption process is unpredictable, it is definite that converting to IFRS will “impact more than accounting and reporting; it will affect a company’s business, systems and processes and people” (Heffes, 2008). All this retooling, including the retraining and reeducating processes, implementation of new systems, changes in templates, and setting new policies with accountants and auditors, will generate substantial costs – both financial and non-financial. Companies will need to reassess business implications, re-evaluating and revising systems and processes.
Conclusion

As CEOs and chairmen of major accounting firms confirm, it is difficult to arrive at a definitive conclusion whether adopting IFRS is more advantageous or disadvantageous, but the positives seem to outweigh the negatives (Heffes, 2008). One thing is certain: although the SEC’s actions are unpredictable and uncertain, transition from U.S. GAAP to IFRS and actual implementation will impact the corporate world, including accountants, firms, and other practitioners, causing most to face multiple challenges during the transition process.

Groups of stakeholders have varying opinions of IFRS implementation. For instance, some CEOs and chairmen see it as a “complex endeavor, but one that will be worthwhile” (Heffes, 2008). Other U.S. corporations fear the tax implications of iGAAP will increase tax liabilities. Since IFRS provides less specific guidance, requires more management-specific interpretation, and differs significantly from GAAP, corporate adoptions are bound to increase accountants’ workload. Already, practitioners are finding ways to capitalize on the transition process, whether their clients perceive it to be a crisis or a highlight in business history.

Although IFRS is not yet universally mandated, companies will have to remain vigilant, monitoring the SEC’s progress towards adoption as well as the responses of their domestic and international competitors. This will assure their ability to maximize benefits from the transition process. Every publicly-traded company, sooner or later, will have to develop proficiency in IFRS; therefore, gradual transition is recommended by the AICPA and the SEC (PwC, 2011).

Adoption will be difficult and time consuming because of all the retraining and reorganizing that needs to be done. The transition process, without which successful adoption would be impossible, should not be neglected. However, despite the challenges faced, certain stakeholders will reap many benefits, such as those discussed above. Recognizing this, the list of
countries proceeding with adoption, requiring the usage of IFRS, continues to grow, according to the IFRS Foundation (2012).

<table>
<thead>
<tr>
<th>Country</th>
<th>Status for listed companies as of December 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>Required for fiscal years beginning on or after 1 January 2012</td>
</tr>
<tr>
<td>Australia</td>
<td>Required for all private sector reporting entities and as the basis for public sector reporting since 2005</td>
</tr>
<tr>
<td>Brazil</td>
<td>Required for consolidated financial statements of banks and listed companies from 31 December 2010 and for individual company accounts progressively since January 2008</td>
</tr>
<tr>
<td>Canada</td>
<td>Required from 1 January 2011 for all listed entities and permitted for private sector entities including not-for-profit organisations</td>
</tr>
<tr>
<td>China</td>
<td>Substantially converged national standards</td>
</tr>
<tr>
<td>European Union</td>
<td>All member states of the EU are required to use IFRSs as adopted by the EU for listed companies since 2005</td>
</tr>
<tr>
<td>France</td>
<td>Required via EU adoption and implementation process since 2005</td>
</tr>
<tr>
<td>Germany</td>
<td>Required via EU adoption and implementation process since 2005</td>
</tr>
<tr>
<td>India</td>
<td>India is converging with IFRSs at a date to be confirmed.</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Convergence process ongoing; a decision about a target date for full compliance with IFRSs is expected to be made in 2012</td>
</tr>
<tr>
<td>Italy</td>
<td>Required via EU adoption and implementation process since 2005</td>
</tr>
<tr>
<td>Japan</td>
<td>Permitted from 2010 for a number of international companies; decision about mandatory adoption by 2016 expected around 2012</td>
</tr>
<tr>
<td>Mexico</td>
<td>Required from 2012</td>
</tr>
<tr>
<td>Republic of Korea</td>
<td>Required from 2011</td>
</tr>
<tr>
<td>Russia</td>
<td>Required from 2012</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>Required for banking and insurance companies. Full convergence with IFRSs currently under consideration.</td>
</tr>
<tr>
<td>South Africa</td>
<td>Required for listed entities since 2005</td>
</tr>
<tr>
<td>Turkey</td>
<td>Required for listed entities since 2005</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Required via EU adoption and implementation process since 2005</td>
</tr>
<tr>
<td>United States</td>
<td>Allowed for foreign issuers in the US since 2007; target date for substantial convergence with IFRSs is 2011 and decision about possible adoption for US companies expected in 2011.</td>
</tr>
</tbody>
</table>

(IFRS Foundation, 2012)

Despite all the varied opinions, great uncertainty lingers regarding iGAAP adoption. As of 2011, the issue of required reporting, under IFRS, remains an active topic on the SEC’s agenda. PwC suggests companies should perform assessments, focus on the challenge, maintain corporate oversight, and identify what can be done now (PwC, 2011). This approach is recommended to help companies gradually ease into the new set of standards, while waiting to find out what the SEC has to say on the matter of eventual adoption.


