

10 Minutes on IFRS

What you need to know about financial topics essential to your business. Brought to you by PricewaterhouseCoopers.

October 2007

International Financial Reporting Standards: The right move for US business

International Financial Reporting Standards (IFRS), the framework used by most of the world today, has growing support in the US. So much so, in fact, that within a few years the SEC may designate a date for mandatory adoption of IFRS by all US public companies. When IFRS conversion comes, it will be beneficial for a number of reasons. The question is, will your company benefit early from this change or scramble to meet the challenge?

Highlights:

- Expect a shift in the US to International Financial Reporting Standards.
- The option for US companies to apply IFRS should come sooner rather than later, with a mandatory conversion date in the not-too-distant future.
- Use of globally accepted standards will increase the competitiveness of US capital markets by removing barriers.
- Preparing now accelerates benefits.

Why is IFRS in the US a near-inevitability?

1. Globalization rules. The globalization of business and finance has led to the successful mass adoption of IFRS by more than 12,000 companies in over 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 answers are difficult to navigate and apply correctly. IFRS offers a sophisticated and simplified platform for a fresh start.

3. Convergence of the two dominant accounting frameworks is a tough proposition. Much good has been accomplished by recent efforts to converge US GAAP and IFRS. But complete convergence may elude the standard setters, and the law of diminishing returns will soon kick in.

4. IFRS will create cost efficiencies for global companies. A number of forward-looking US companies are already preparing for conversion to IFRS with a goal of substantial savings and efficiencies.

At a glance

Why the change to IFRS is good

- retains transparency
- encourages a more informed global marketplace
- presents new opportunity to streamline operations
- reduces complexity, fewer accounting errors
- allows exercise of professional judgment

Some key challenges

- planning and preparing for change
- adapting to a principles-based environment
- understanding how IFRS affects financials
- capturing cost and process efficiencies
- educating investors

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

The reality of IFRS as a proven financial reporting framework has led the SEC to a landmark proposal: eliminating the requirement for foreign private issuers using IFRS to reconcile to US GAAP.

If adopted, the SEC's July 2007 proposal will represent an historic moment for the US. If and when IFRS financial statements are acceptable in US capital markets, the next step is to consider whether US companies should also be allowed to use IFRS.

Eliminating the reconciliation removes unnecessary cost and operating complexity. US capital markets will become more competitive. And in the interests of fairness and free market competition, all domestic US companies should have the option to apply IFRS until a mandatory change-over date is reached. They should have the same choices as their foreign competitors.

No silver bullet but a major step forward

The US financial reporting environment is too complex and threatens to become a competitive disadvantage. IFRS is simpler. While few think it will solve every issue immediately, nearly everyone who looks at IFRS agrees that it offers a satisfactory global platform with the opportunity for further advances.

IFRS offers many positive attributes:

- a high-quality, principles-based framework
- fewer rules and exceptions (it's less cumbersome to apply than US GAAP)
- allows the exercise of more professional judgment
- brings transparency to the economics of transactions

The initial IFRS conversion will come at a cost. That one-time cost will vary depending on the size and operating structure of individual companies. However, the long-term benefits for US companies will make it a worthwhile effort. Here's why.

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

- increase global comparability
- enhance the efficiency of capital allocation
- increase the competitiveness of US companies and capital markets by removing barriers
- reduce complexity and the risk of errors
- generate process and cost efficiencies

Any great change comes with challenges. Here's what to expect.

Pride and politics

National pride and fear of losing the power to set our own standards 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. But 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.

Equitable global standard setting

Moving to IFRS requires acceptance of the International Accounting Standards Board (IASB) as the global standard setter. US perspectives are already represented at the IASB, through three American board members and five American trustees. Some believe that US interests are already well represented, while others believe that with half of the world's equity value resident in the US, American interests are under-represented. The influence of US constituents, full strength at the FASB, will be diluted at the IASB.

We can expect growing pains as the IASB begins to directly address the world's largest, most sophisticated capital market. Key concerns include ensuring that the IASB's processes can withstand any particular territory's influence. A well-designed, equitable funding mechanism is needed to ensure the right leadership, staffing, resources, and independence at the IASB.

As the movement toward IFRS advances, it's unlikely that the US will cede all control to an international body, no matter how effective it proves to be. The SEC will likely put an approval process in place for new IFRS standards to be used in the US, but the mechanics have yet to be decided; these are still early days.

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. Adopting IFRS principles may result in dramatically different financial reporting, but the underlying economics and cash flows from securitizations remain the same. Timely planning and communication will be essential so that investors and other stakeholders understand the changed reporting. A closely monitored process will be needed to guard against unwarranted industry disruption.

On the LIFO matter, the issue is cash flows. 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 law is no simple matter. Creativity and adaptation will be required as options are explored.

There are other important issues. If an accounting and reporting framework that relies on professional judgment rather than detailed rules is to flourish in the US, the legal and regulatory environment will need to evolve in ways that remain to be seen. The arrival of IFRS is not a pretext for advocating extensive legal reform; however, it does suggest that behavioral changes on the part of companies, regulators, and others will be needed to allow IFRS to reach its potential in the US.

Adapting to a global standard setter

With US participation in an independent, global standard-setting body comes the responsibility to respect its process and output. No doubt there will be tough-minded debate during the standards drafting process. However, standards ultimately issued by the IASB need to be endorsed by territories without modification in almost all circumstances to ensure a smooth and successful transition and to leave behind, once and for all, the complexity that now plagues the US financial reporting environment.

Preparing now means reaping benefits earlier

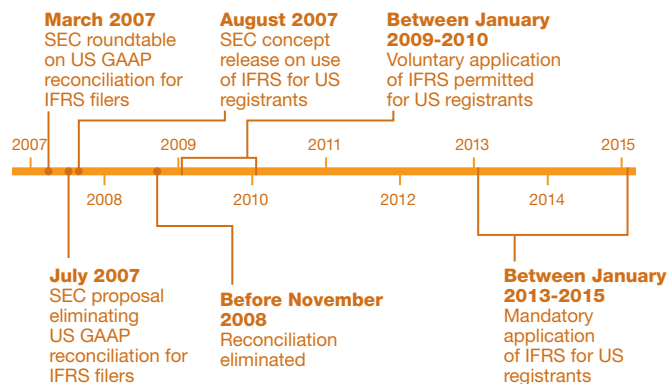
Many indicators currently point to mandatory use of IFRS in the next decade. That may feel like a distant horizon. The lead time, however, should be used wisely by companies to prepare for change. Those who are prepared will reap rewards sooner and gain advantages over their peers.

For further information on the US transition to IFRS, please see our full white paper, available in print and online, at www.pwc.com/10minutes

Items to plan and prepare for include:

- Do your own analysis of the costs and benefits of transition.
- Look at change management strategies.
- 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.
- Embed IFRS into operations and existing systems.
- Educate investors and other stakeholders on how IFRS impacts your financial reporting.

Our view of the IFRS timeline



Upcoming 10Minutes topics:

M&A accounting: new standards, new strategies

The FASB and the IASB have issued their first jointly developed standards. They concern business combinations—close to the heart of every growing business. Look here for a plain-English discussion of key points and strategies.

Materiality: a technical controversy with hugely practical implications

Behind the scenes today, there is a hot debate about measuring materiality in a company's financial reporting. Does it make sense to measure quantitatively by some set percentage of financial condition? Or qualitatively in terms of impact on overall financial reporting? Or by a mix of the two? What's at stake is management's mandate to exercise its own best judgment.

The SEC complexity agenda in perspective

SEC Chairman Christopher Cox vows to simplify financial reporting for investors, companies, and the markets. 10Minutes asks: Will business benefit?

How "fair value" can affect your bottom line

Fair value, or marking assets and liabilities to market, is an idea on the march. It's showing up in many new accounting standards, and it has bottom-line impact. 10Minutes will discuss the things you need to know without the technical jargon.

New concepts for financial reporting

The basic formats of the income statement and balance sheet have remained all but unchanged for decades. They are the foundation of public reporting and investor financial analysis. Today the standard setters are rethinking form and content and considering dramatic changes. What may have seemed set in stone is in reality set to change. In this issue of 10Minutes, an update on the state of play.

How PwC can help

To have a deeper discussion about how IFRS may affect your business please contact:

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