

# Deal Flash!\*

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## Keeping current on IFRS: an update for US CFOs

*International Financial Reporting Standards (IFRS) has become the common financial reporting language for much of the world, with over 70 countries mandating its use by public companies, and countries like China and Canada announcing their intent to adopt the standard. As IFRS and US GAAP converge and evolve, US CFOs are realizing that this new language has significant business, as well as financial reporting, implications.*

*US companies with overseas parents or competitors, as well as those looking to do deals in countries that require IFRS, must become conversant with these standards and stay tuned for new developments.*

### IMPACT ON TRANSACTIONS

#### IFRS moves transaction accounting center stage

IFRS has introduced new hazards for dealmakers and moved accounting for cross-border acquisitions into an earlier and more prominent strategic dealmaking role from its traditional post-deal position. Failure to recognize this can kill a deal. We have seen transactions that would have enhanced earnings under US GAAP become dilutive to earnings under IFRS.

IFRS can also alter the timing of revenue and expense recognition, which can affect not only the price of a deal, but also how post-deal performance is measured. Presentation and measurement differences can affect reported results and key performance indicators, for example:

- IFRS is likely to have an impact on **income-based performance measures** such as EBITDA, stock and income-based compensation plans used to reward management for post-deal success. Understanding these consequences will help management employ performance measures that appropriately report the impact of a transaction.
- **Common finance structures** such as redeemable preference shares, classified as mezzanine equity under US GAAP, are likely to be presented as debt under IFRS, with associated payments treated as interest rather than dividends. This can limit an acquirer's ability to meet debt covenants and, in some jurisdictions, pay dividends.
- **The purchase price allocation** of a business combination may change if reported under IFRS since the rules for measuring assets and liabilities, including financial instruments, contingent liabilities, restructuring provisions and goodwill allocation, differ. To complicate matters, there is often little time to convert financial information to IFRS to report a business combination.

#### IFRS may be required on cross-border deals and IPOs

If a US company is considering the acquisition or disposal of

operations overseas, it may be advantageous—or necessary—to present financial information under IFRS. Buyers looking to minimize foreign exchange risk by financing a European acquisition through a public debt or equity offering on an EU regulated exchange may be required to describe US GAAP/IFRS differences. Such requirements vary by country and exchange. The European Commission is also weighing whether to require US companies to provide qualitative and quantitative information on significant differences between US GAAP and IFRS in their European prospectuses.

### IMPACT ON FINANCIAL REPORTING

#### Ready to sign off on IFRS-based financial information?

A CFO responsible for reporting on the US operations of an overseas company may have to sign off on the completeness and accuracy of IFRS-based financial information either directly to the market or to the overseas parent. Executives in this position must fully understand IFRS and the specific issues it presents for their company.

#### Ready to explain IFRS to board members and investors?

Your company's net income and balance sheet can be significantly different under IFRS, so be ready to explain the reasons for these differences to board members and shareholders. You may need a communications program to educate stakeholders and actively manage perceptions.

Investors outside the US are becoming increasingly comfortable with IFRS. A recent PwC survey of European fund managers found that 59 percent felt IFRS provided a good basis for assessing the historical performance of a company, while 45 percent considered it more useful than US GAAP.

#### Expect more regulatory and tax scrutiny

The SEC, Committee of European Regulators (CESR), and International Organization of Securities Commissions (IOSCO) intend to step up enforcement of IFRS, so expect closer scrutiny of financial statements. The IOSCO has announced

that it is setting up a system for participating regulators to share decisions on the application of IFRS, cataloguing them in a database for future reference.

Similarly, the SEC has publicly stated that effective implementation of IFRS in Foreign Private Issuer (FPI) filings is crucial to eliminating US GAAP reconciliations by 2009.

### Leveraging efficiencies from IFRS

Having a standard financial reporting language creates efficiencies for multinational companies. Some multinational companies, for example, have created shared services centers to process and report transactions for foreign subsidiaries.

As the use of IFRS increases, many expect regulatory and tax authorities to require IFRS-based financial information. This will create efficiencies by eliminating the different bases of accounting required for financial and regulatory reporting.

### Convergence with IFRS will affect US GAAP

Because IFRS and US GAAP are promulgated by two independent standard setters, differences between the two models exist in virtually all topical areas. A movement to converge and simplify IFRS and US GAAP has been underway for some time. As the IASB (International Accounting Standards Board) and the FASB (Financial Accounting Standards Board) work together on projects, IFRS pronouncements are increasingly influencing US GAAP. For example, the FASB's decision to grant US companies the fair value option will enable them to report certain financial instruments at fair value, with changes in fair value reported through the income statement. This allows the accounting for these instruments to partially converge with IFRS. Constituents of both the IASB and the FASB are encouraged to comment on each others' exposure drafts, and many US companies are actively doing so.

## IMPACT ON OPERATIONS

### Adopting IFRS takes time, resources and judgment

A company adopting IFRS for the first time must retroactively apply the standards in a consistent manner across its reporting groups as of the reporting date, although certain exemptions are permitted. Consistent application could be a real challenge for US multinationals because IFRS is a more principles-based model with less application guidance than US GAAP. Further, first-time adopters of IFRS are provided certain exemptions to reporting full IFRS retrospectively.

To ensure consistent application of IFRS throughout its organization, a company must document its accounting policy elections and make sure they're followed consistently.

### Full transition requires system enhancements

Companies with overseas parents may have to report under both IFRS and US GAAP. For example, a bank with a UK parent is likely to use IFRS for management and group financial reporting and US GAAP for US credit and regulatory reporting. Reporting under two accounting systems is a time consuming process which requires more than financial reporting and internal control expertise. The bank's traders and underwriters, along with its operating, credit and valuation teams would also be involved.

Companies transitioning to or applying IFRS for the first time typically make manual adjustments from US GAAP to IFRS using spreadsheets and similar tools. But full transition will require enhancements to the financial reporting system and internal control structure to ensure adjustments to IFRS are complete and accurate. For example, a manufacturer who uses LIFO to report inventory and cost of sales under US GAAP will have to use FIFO or a weighted average for IFRS. Such a change generally entails using both inventory costing methods for US GAAP and IFRS reporting, and is likely to require some system enhancements.

### Competitive analysis should be easier, but...

By providing more transparency and consistency than existed when companies reported financial information in local GAAPs, IFRS theoretically makes it easier to analyze the sales, net income and balance sheets of competitors in foreign jurisdictions. A US company benchmarking itself against European competitors should find greater consistency in the application of IFRS and, with convergence, fewer accounting policy differences.

However, differences will occur, as companies choose alternative treatments and first-time elections and as local IFRS interpretations color financial reports, especially those of smaller companies outside the major markets. Dealmakers must carefully assess how targets and competitors are applying IFRS before concluding that their financial information can be compared.

### In summary

IFRS will have an increasingly important impact on US multinationals as it is adopted by more countries around the world, and continues to converge with US GAAP. Considering the impact of IFRS on a cross-border transaction, pre and post deal, is a must. Once a deal is complete, CFOs need to consider and monitor the ongoing impact on financial reporting and operations

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