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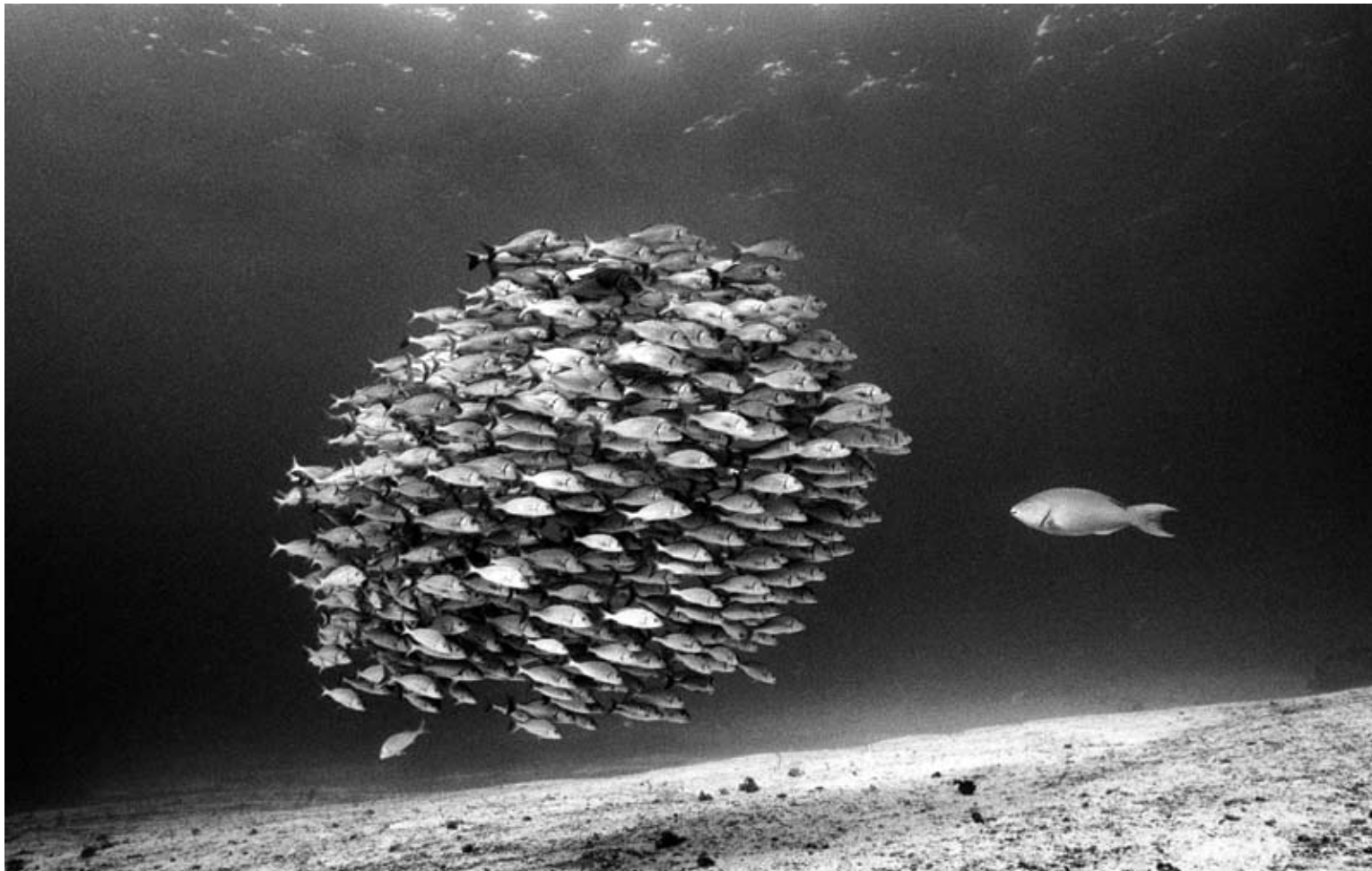
One global flavor

Thinking about International Financial Reporting Standards and how leading US companies are getting ready for them

By Raymond J. Beier

A US move to IFRS is inevitable. All companies should think strategically about this change and begin to understand the impact now.

Globalization has changed nearly every aspect of how companies manage their business—sourcing, distribution, consumer pricing, raising of capital, and so much else. Financial reporting has also been greatly influenced by globalization. In fact, it is not an overstatement to say that a financial reporting revolution is now under way. Increasingly, International Financial Reporting Standards (IFRS) is how most of the world talks to investors and other stakeholders about corporate performance. Changing to IFRS alters how companies prepare and report their financial results and necessitates that investors understand any forthcoming changes. Anticipating that the US will soon join the rest of the world by allowing or mandating a move to IFRS, some leading US companies are already beginning to prepare for IFRS adoption. Even if your company is not yet ready to embrace IFRS, it makes sense for senior



management to take action so they can understand how a move to IFRS will impact reporting of financial performance, operations, and communications with investors.

IFRS: The world's new reporting framework

The message is clear: IFRS is becoming the global accounting language. Virtually all major territories other than the US use or are moving to IFRS. Approximately 12,000 public companies around the world already use IFRS in territories such as the European Union, Australia, Singapore, and Hong Kong. China, Canada, Japan, and South Korea have announced their intention to convert to IFRS in the not-too-distant future. Although IFRS only recently has made headlines in the US, the US standard setter, the Financial Accounting Standards Board (FASB), has been deeply involved with the London-based

International Accounting Standards Board (IASB) and with IFRS since their inception in 2001. In the past five years, the IASB and FASB have worked to improve and converge both US GAAP (Generally Accepted Accounting Principles) and IFRS, with an increasing focus on the end goal of achieving high-quality, globally understood reporting standards.

The year 2007 brought a new perspective to that goal for US constituents. Would adoption of IFRS in the US make sense? In a global economy, do the reasons for adoption outweigh the reasons for retaining our own US standards? And then this intriguing question: Would adoption of IFRS help to eliminate many of the difficulties in US GAAP, which in certain respects has come under increasing and well-taken criticism? The answers to these questions are now being weighed. The US Securities

and Exchange Commission (SEC) has already taken preliminary steps that history will almost certainly show to have been tipping points in the course of events:

- The SEC no longer requires foreign private issuers to reconcile their IFRS filings to US GAAP so long as they use IFRS as issued by the IASB.
- The Commission is studying whether US companies should have the option of reporting under IFRS rather than under US GAAP.

As early as spring 2008, the SEC may issue proposed rules that designate a date for optional and/or mandatory adoption of IFRS by US public companies. The speed with which a move to IFRS has progressed—from a mere possibility to inevitability—has landed this topic squarely on the radar screen of many multinational



companies and their boards. However, some pioneering US companies that recognize the inevitability of IFRS are not just talking about it—they are actively beginning the conversion process.

This article looks in broad terms at the shift from US GAAP to IFRS and at the emerging best practices of leading US companies that view IFRS reporting as not only inevitable, but also beneficial. These companies are aware of the challenging scope of implementation. They want to be ready to seize the advantages and make a smooth transition. And they want to control the costs of doing so.

Benefits of IFRS

From a macroeconomic perspective, the benefits of using one global financial reporting language are evident: increased comparability across global investment

options, fewer barriers of entry to non-US markets, and, potentially, a lower cost of capital. Moving to a single global accounting and reporting language also will reduce complexity—a welcome improvement for the companies that prepare financial reports and for the investors and other stakeholders who rely on them.

From a capital markets perspective, many multinational companies believe IFRS offers an opportunity to lower their cost of capital. Widespread acceptance of IFRS financial statements allows companies to seek capital across a broad base of global funding without having to incur additional financial-reporting costs based on the source of funding. Anticipating increased competition among global investors and financiers for attractive investments, strong companies expect their cost of capital to decrease. Because the conversion of major

capital markets to IFRS is relatively young, it is too soon to tell whether the anticipated decrease in cost of capital will prove out. However, due to the sheer size of most capital-raising efforts and the long-term nature of the payoff, even slight improvements in transaction terms such as interest rates can translate into significant dollar savings.

Within individual companies, the ability to centralize and streamline accounting functions and move financial personnel freely around the world will lower costs and strengthen internal controls. Today, multinational corporations with numerous statutory filing requirements around the world need to employ staff with expertise in each national GAAP to prepare filings and then translate financial statements from national GAAPs to the parent-company reporting GAAP. Use of IFRS globally will reduce these reporting efforts and related costs and decrease the risk of errors.

Challenges of many kinds

Although the benefits at both the macro and micro levels are attainable, the associated challenges are meaningful and need to be addressed. Key for companies is understanding how their financial reporting will change under IFRS and what those changes will mean to investors and other financial statement users. Managing and communicating the impact of these changes appropriately are defining points in a successful conversion plan.

Perhaps the most immediate hurdle US companies will face in a conversion to IFRS is a limited pool of IFRS-knowledgeable resources. Companies need to determine if they already have the right skill sets in-house to manage the change, and, if not, whether individuals who possess those skills should be hired. Learning IFRS is a challenge for the US at all levels, from colleges and universities educating future

accounting professionals to retraining for current financial executives, auditors, analysts, and professional investors.

Beyond learning the principles of IFRS, preparers, users of financial reporting, and educators will need to change how they think about and practice their disciplines. The needed changes are broad in scope: cultural, behavioral, and institutional. Unlike US GAAP, IFRS is intentionally light on interpretive guidance. Principles and a minimum of necessary rules require accountants to make more professional judgments about the nature of transactions when determining how to account for them. The principles are generally consistent with those in US GAAP or closely similar, but much greater exercise of judgment is needed in a framework that deliberately doesn't carry the same weight of detailed rules, bright lines, safe harbors, and exceptions.

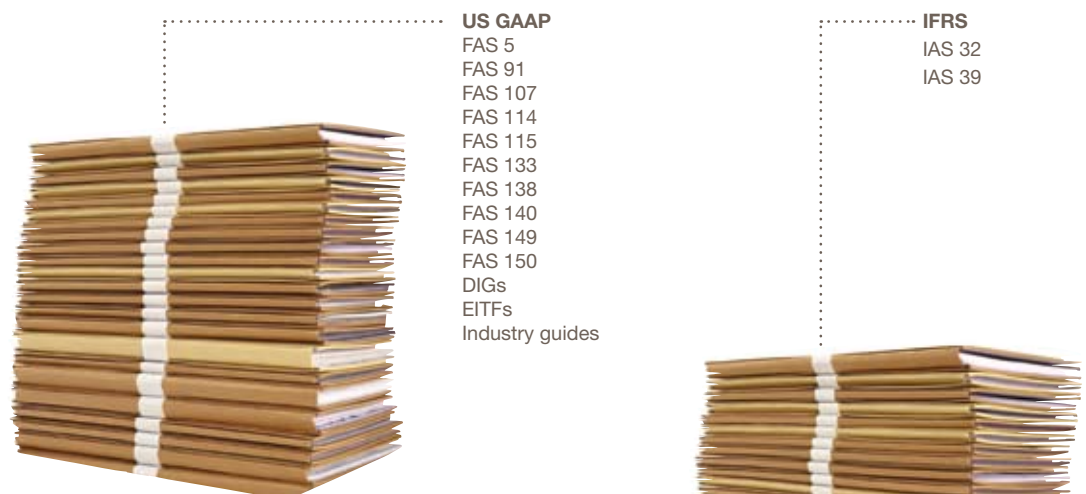
This point is dramatically illustrated by comparing the modest number of IFRS accounting standards that address the accounting for financial instruments with the mass of US GAAP literature on the same topic. (See Figure 1.) The IFRS literature isn't weak or incomplete. It clearly states the principles, avoids unnecessary rule-making, and relies on preparers—CFOs, controllers, and others—to exercise professional judgment. Undoubtedly, many Americans will initially find it challenging and uncomfortable to navigate without prescriptive guidance and to set aside time-honored practices.

Here is an issue worth considering more closely. The principles underlying IFRS are in fact designed to narrow the acceptable alternatives. US GAAP is similarly based on fundamental accounting principles, but it has become laden with so many rules

and other detail over the years that the process of applying it has become cumbersome and complex.

Conversions to IFRS by companies in other countries, particularly in the European Union and Australia, lay excellent groundwork for US companies to follow. With different national GAAPs as starting points, it's true that each country's conversion to IFRS varied in its challenges and level of difficulty. Due to the long-standing global influence of US GAAP and the convergence agenda between the FASB and the IASB, many IFRS standards issued in recent years are based on principles that are fairly consistent with existing US GAAP standards. This should translate into fewer accounting differences for US companies that are converting to IFRS as compared with many of the other countries that have already done so.

Figure 1: Financial instruments Key differences between US GAAP and IFRS



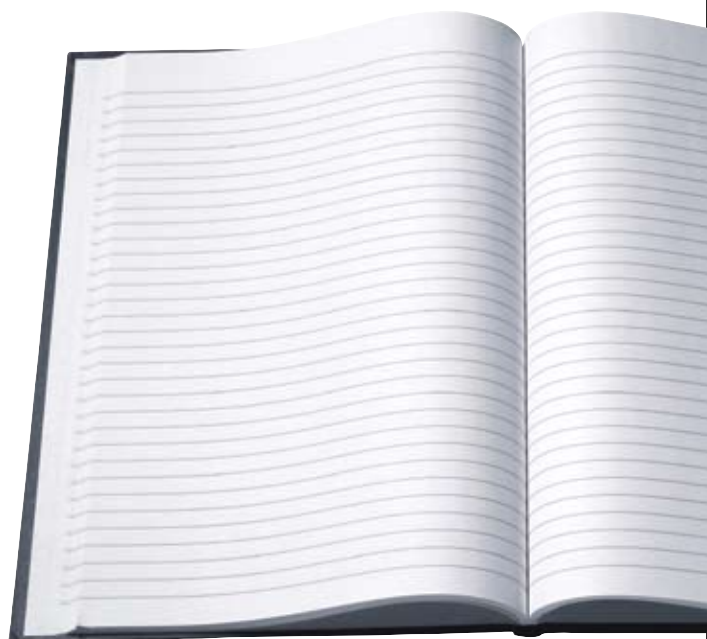
Differences between IFRS and US GAAP

Despite the large number of parallel principles underlying IFRS and US GAAP, the devil is in the details, and differences can be significant for certain industries and types of transactions. The following examples of key differences are somewhat technical in nature, but readers familiar with accounting and reporting will see at a glance the primary implications.

	IFRS	US GAAP	Implications
Asset write offs	Impairment assessment of long-lived assets is a one-step process based on discounted cash flows. Under certain circumstances, previously recognized impairments are reversed.	Impairment analysis is a two-step process based first on undiscounted cash flows. Reversal of impairments is prohibited under US GAAP.	Impairment charges may be recognized more frequently, earlier, and for different amounts under IFRS. Combined with the ability to reverse impairments, the result is greater potential earnings volatility.
Fair value accounting	Greater use of fair value, and certain assets, such as property, plant, and equipment; intangible assets; and investment property can be carried and remeasured to fair value each period.	Requires historical cost valuation of such assets.	The result is a very different balance sheet and a clearer view for investors of the unrealized appreciation in certain major asset categories.
Development costs	Development portion of research and development costs is capitalized if certain criteria are met.	Both research and development costs are expensed.	Development costs do not hit the bottom line immediately but, rather, are expensed over an estimated life, typically as the associated revenues from the development activities are earned.
Liability versus equity classification	Classification of an instrument as a financial liability versus equity is stricter and based on the substance of the instrument rather than on its legal form. Compound instruments must be bifurcated between the liability and equity components.	Instruments with both liability and equity characteristics can often qualify for treatment as mezzanine equity and are not marked to fair value.	The result is an increase in interest expense, greater volatility in the income statement, and less equity on the balance sheet than under US GAAP.
Pension accounting	Recognition of pension expense may be accelerated: Companies can elect to recognize actuarial gains and losses immediately rather than deferring for a period of time, and prior-service cost is recognized over the vesting period.	Requires actuarial gains and losses to be amortized over life expectancy, and prior-service cost is amortized over the remaining service period.	The cost of providing pension benefits is not deferred as far into the future under IFRS as it is under US GAAP.

As the option to use IFRS becomes available in the United States and companies decide to adopt, each company will need to undertake an extensive review of financial policies to determine the impact of these and many other differences between the two frameworks.

A clean-sheet-of-paper approach will be beneficial for many companies; some may be tempted to try to force their historical US GAAP policies to fit into IFRS as a means of simplifying the conversion process.



Preparing for the move to IFRS

Because IFRS appears inevitable, companies need to begin actively assessing what such a move will mean to their operations, financial statements, and stakeholders. The European conversion to IFRS taught us that companies that take the initiative now will benefit by enjoying a smoother transition with fewer fire drills.

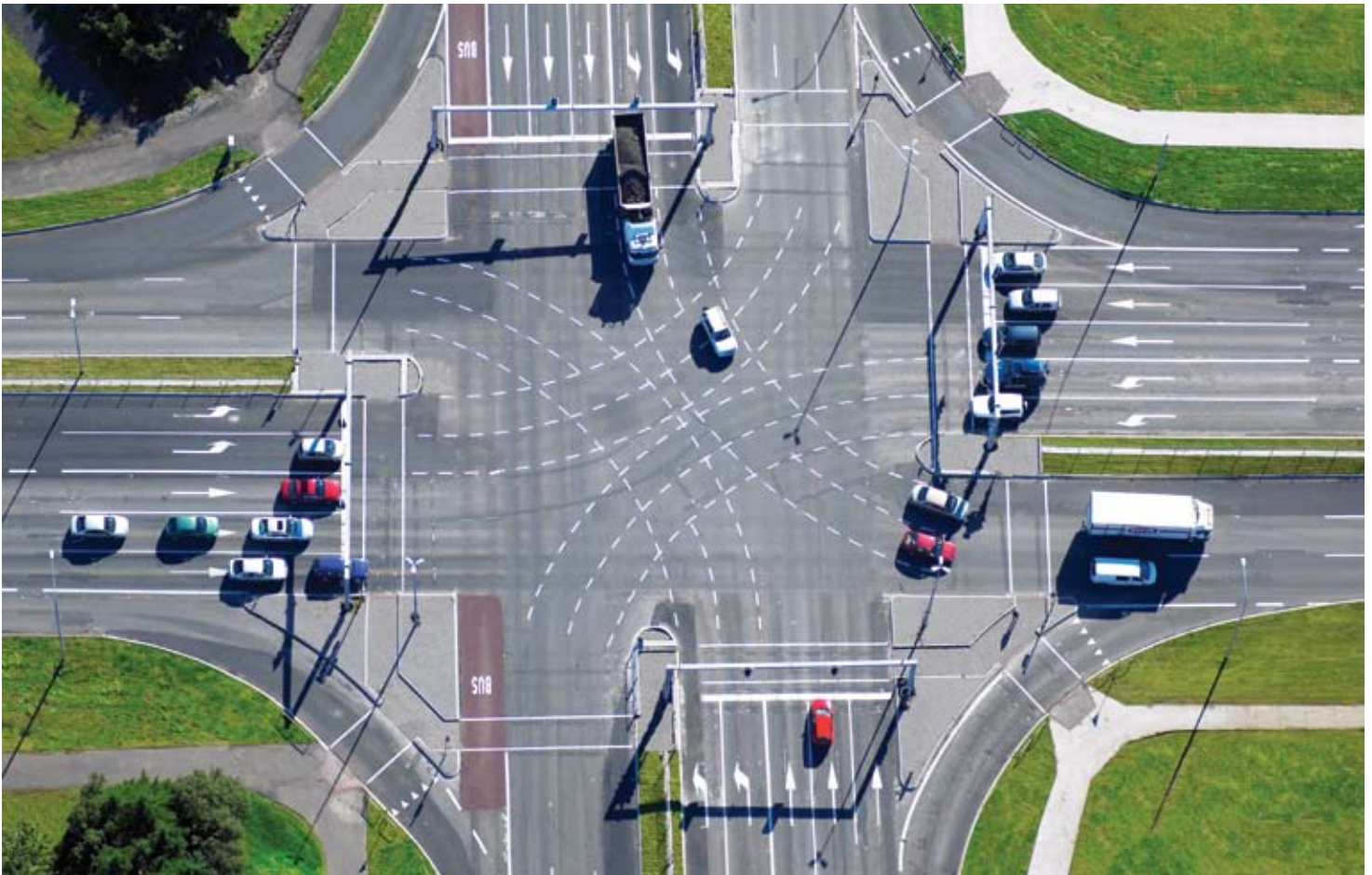
Other key lessons learned include:

Selecting new IFRS accounting policies
A clean-sheet-of-paper approach will be beneficial for many companies; some may be tempted to try to force their historical US GAAP policies to fit into IFRS as a means of simplifying the conversion process. But conversion to IFRS is a rare, onetime opportunity to comprehensively reassess all accounting policies. IFRS may offer alternatives that US GAAP did not—alternatives that may better reflect the economic substance of transactions and positions. Benchmarking against global peers and competitors that have already adopted IFRS will provide valuable insight into what is acceptable in the marketplace.

Involving the whole company New financial-reporting principles can impact nearly every aspect of a company's operations—from

customer and vendor contracts and employee compensation arrangements to planning for M&A activity and income tax structures. The involvement of key company expertise—legal and risk management, treasury, sales, tax, human resources and investor relations—at the right stage is essential to a successful conversion.

Planning the IFRS conversion project
Conversion projects can vary in length, difficulty, and cost depending on the level of complexity in a company's transactions, operational structure, and regulatory environment. Another lesson to be learned from Europe's mass adoption in 2005 is that conversion will take longer than expected. US companies that have started the process—mostly large multinational companies—estimate that it will take at least two to three years and significant resources—both internal and external—to complete a quality conversion project.



Integrating the change Integrating IFRS principles into operations from the ground up is a necessity. Companies that left their IFRS conversions to the last minute often tried to complete the transition by making top-side adjustments to their existing practices. IFRS is not a bolt-on solution to be layered on top of old conventions. Companies that do so will strain internal controls over financial reporting and increase their risk of reporting errors.

Each company's road map to IFRS will be unique, but the following steps provide an approach and key considerations for a well-orchestrated conversion plan.

Impact analysis

To scope a conversion project effectively, companies need to understand the multiple moving parts and wide-ranging impacts that a move to IFRS will bring. An impact analysis helps identify the depth and breadth of necessary changes, how long they could take to implement, what resources are needed to bring them to fruition, and what impact they could have on the companies' stakeholders. Some facets of an impact analysis include:

Understanding what is affected Conversion to IFRS will change the way certain transactions are accounted for. A thorough review of the financial statements, with detailed identification of differences between current accounting and IFRS, will help a company assess the dimensions of the conversion and the scope of the information needs.

A company's legal contracts represent another layer of impact for consideration. A change to IFRS may result in a dramatically different balance sheet and changes in earnings projections, key performance indicators, and financial ratios. In response, debt agreements and specific covenants may need to be modified. Changes in accounting policies and disclosure requirements may necessitate new information needs. Customer and vendor contracts may need to be revised and compensation agreements restructured.

The impact on accounting and reporting processes, controls, and IT systems needs to be considered. A move to IFRS can create new information needs and impact how controls are designed or implemented, how consolidations are achieved, and how financial systems record and report information. Changes in these areas need to be vetted and will eventually need to be documented and tested.

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Understanding resource needs and timelines Assessment of the quantitative and qualitative levels of resources needed, coupled with decisions on whether to train internal resources (and what amount of training is necessary) or hire external resources, is critical and frequently underestimated. Decisions on resources also play a key role in budgeting the cost of a conversion project.

Although milestones and timelines at this early stage of a conversion project are tentative, having them in place is key to scoping the project, assessing the correct level of urgency of various tasks, and keeping all participants focused on the many moving pieces of the project.

Project management reminder: A formally established and executive-sponsored project with a dedicated project team is needed in most cases to manage successfully through completion.

Final thoughts

As the move to International Financial Reporting Standards gains momentum, more and more forward-thinking companies are preparing for a move to IFRS. They are identifying the benefits they expect to realize and the challenges they will face along the way. At a minimum, all companies should consider undertaking an impact analysis now so that they have an accurate appreciation of what IFRS will mean to their business when it arrives on US shores.



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