

Sage Fixed Assets



# The road toward International Financial Reporting Standards (IFRS)



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# The road toward International Financial Reporting Standards (IFRS)

With the globalization of business, it has become more important than ever to establish common standards for the preparation of financial statements. A universal standard would make it easier to evaluate company accounts and more accurately compare business health across international borders.

While companies in the United States do their financial reporting according to Generally Accepted Accounting Principles (GAAP), more than 100 countries are using International Financial Reporting Standards (IFRS). This presents problems for both shareholders and potential investors who are evaluating different companies. Plus, the marketplace has become much more complex with businesses' serving international customers and using suppliers from all over the world.

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have been meeting for many years now to work on a convergence of the two standards. Convergence is not the same as adoption. Convergence means a migration toward GAAP's becoming more closely aligned with IFRS. Adoption, on the other hand, would mean there was a complete acceptance of IFRS. Regardless, this is not an easy undertaking because, while they do share many of the same general principles, they also differ on some major issues.

In 2002, the boards issued a Memorandum of Understanding (MoU), commonly known as the Norwalk Agreement, in which they pledged to give their best efforts to converge U.S. GAAP and IFRS. In 2006, another MoU was released that outlined the major projects the two boards plan to complete and the steps they will take in their convergence attempt.

In 2008, the Security and Exchange Commission (SEC) issued a "Roadmap" for the potential use of IFRS in the preparation of financial statements by U.S. public companies. The SEC Roadmap includes a possible staged transition to IFRS beginning with large accelerated filers (that is, public companies with an aggregate worldwide market value of outstanding voting and nonvoting common equity held by nonaffiliates of \$700 million or more). The most recent progress report was released in February 2013, when they jointly issued a high-level update on the status and timeline of the remaining convergence projects. While the boards have been working diligently, there have been several delays.

Since fixed assets management is so important to so many companies, it is a concern as to how it will be affected by the inevitable changes a convergence will bring. This paper will focus on the challenges that are sure to ensue. Understanding how IFRS works is imperative for business executives as they prepare for the future of accounting.

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# Origins of GAAP

GAAP was established in 1930, when the American Institute of Accountants (AIA) saw a need to outline accounting principles following the stock market crash of 1929. A special committee organized by the AIA recommended several broad principles of accounting, which were approved by the AIA membership and intended to improve the practice of accounting.

The American Institute of Certified Public Accountants and the SEC gave the responsibility for establishing GAAP to the Financial Accounting Standards Board in 1973. They gave the FASB the task of developing accounting concepts and reporting standards that are both current and useful. This makes the FASB the primary source of GAAP.

U.S. GAAP is very detail oriented and contains specific guidance for certain industries. The public can access U.S. GAAP in a topically organized format through the most recent FASB Accounting Standards Codification. The FASB codification project consisted of a restructuring of the accounting standards to simplify their usability.

# Creation of IFRS

In 2001, the International Accounting Standards Committee (IASC), which was formed in 1973, was replaced by the IASB, an independent London-based accounting organization, which is the group currently responsible for creating IFRS. Unlike U.S. GAAP, IFRS consists of broad principles with few specific rules. Thus, instead of consisting of industry-specific guidelines and detailed instructions, IFRS is more open to interpretation.

Although IFRS is not fully established in America, the door for its implementation is steadily opening wider. In 2007, the SEC allowed foreign private issuers\* the option to choose not to report their financial results under U.S. GAAP and to use IFRS instead. Additionally, the AICPA made it possible for U.S. auditors to offer opinions on financial statements prepared under IFRS by officially recognizing the IASB as an international accounting standard setter in 2008.

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\*According to the SEC, "a foreign company will qualify as a foreign private issuer if 50% or less of its outstanding voting securities are held by U.S. residents; or if more than 50% of its outstanding voting securities are held by U.S. residents and none of the following three circumstances applies: the majority of its executive officers or directors are U.S. citizens or residents; more than 50% of the issuer's assets are located in the United States; or the issuer's business is administered principally in the United States."

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# Fixed asset accounting: IFRS versus GAAP

Let's look at some of the major issues that will affect fixed asset management if the convergence is successful.

## Depreciation

Like many areas, when comparing these two sets of standards and their treatment of depreciation, there are both similarities and differences.

### Here are some of the similarities:

- Accept same methods of depreciation
- Require depreciation on long-lived assets
- Depreciation begins when an asset is available for use
- Similar concept of useful lives
- No depreciation on land
- Stops depreciating an asset if it becomes temporarily idle
- Changes in depreciation lives and methods are handled prospectively

### Then there are the differences:

- Component depreciation: Although GAAP allows component depreciation to be used, IFRS requires individual components of fixed assets that have different economic lives to be individually recorded and depreciated.
- Salvage value and carrying value: Under IFRS, if the residual value (that is, salvage value) of an asset is higher than the asset's carrying amount, no depreciation is claimed until, and unless, the residual value decreases to be less than the asset's carrying value. For GAAP, salvage value generally reduces an asset's basis for depreciation, depending on the depreciation method used.

## Assets' carrying basis

A major difference between GAAP and IFRS is how an asset is recorded. GAAP, of course, uses historical cost for an asset's basis. Generally, IFRS also uses historical cost, at least initially, but then allows for a revaluation to the asset's fair value. This can result in a significant difference when comparing balance sheets prepared under GAAP versus IFRS.

### When an asset is revalued according to IFRS rules, its accumulated depreciation is handled in one of two ways:

- 1) Accumulated depreciation may be restated proportionately with the change in the gross carrying amount of the asset so that the asset's carrying amount then equals the revalued amount.
- 2) Accumulated depreciation may be eliminated against the gross carrying amount of the asset so that the asset's net amount is restated to the revalued amount. This second approach is often used for buildings.

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If borrowing funds to acquire assets, borrowing costs under IFRS include exchange rate differences from foreign currency loans. This is **not** the case under GAAP.

Yet another difference when computing basis involves “investment property,” which IFRS (IAS 40) defines as land and buildings held either for rental income or appreciation (or, for both). IFRS allows such property to be valued either at historical cost or at fair value. If the fair value is used, any change is recognized as a gain or loss on the income statement, and the carrying amount is not depreciated. However, if the cost model is used, the investment property must be depreciated (IAS 16, Property, Plant, and Equipment). Furthermore, any owner-occupied property is not considered investment property. Under GAAP, rental real estate and other investment-type property is valued at historical cost, and there are no specific provisions for it.

Biological assets are accounted for separately under IFRS (IAS 41) but not under GAAP. Such property consists of farm animals and growing plants. (Once slaughtered or harvested, they are considered agricultural produce.) Such property must be reported at fair value for IFRS and historical cost for GAAP.

#### Impairment of assets

Under both GAAP and IFRS, an asset is written down for impairment when it is probable a loss has occurred. That said, the term “probable” is interpreted differently under the two sets of standards. GAAP interprets probable as “likely to occur,” with a threshold of just over 50%. Under IFRS, probable is defined as “more likely than not” to occur, with a threshold of any level more than 50%. (This also should give the reader an idea of the issues the two boards must face to achieve a successful convergence of the two sets of standards.)

According to GAAP, intangible assets with indefinite lives (including goodwill) must be analyzed at least annually (or more often if needed) for impairment. **GAAP uses a two-step approach for assessing impairment losses whereby:**

- **Step #1:** The carrying value of the asset is compared to the undiscounted cash flows it expects to generate. If the carrying value is lower, no impairment loss is recognized. If the carrying value is more, the amount of impairment loss must then be determined.
- **Step #2:** To determine the amount of the impairment loss, calculate the difference between the asset’s carrying amount and its fair value.

According to IFRS, all intangible assets are amortized over their useful lives. If no useful life can be determined, the asset should be tested for impairment. Furthermore, if impairment is indicated on an asset, an impairment loss may be recognized. However, unlike GAAP, a subsequent reversal of an impairment loss for all assets other than goodwill must be recognized if certain criteria are met. This is never the case with GAAP.

Impairment write-downs are completed in a single-step method under IFRS, making write-downs easier and more likely. According to IFRS and IAS 36, Impairment of Assets, assessing an impairment loss is a one-step process. The carrying amount of the asset is compared with its recoverable amount, and, when the carrying amount is more, the asset must be revalued to its lower recoverable amount. **The “recoverable amount” is the greater of:**

- The asset’s fair value less the cost to sell the asset.
- The asset’s value-in-use (VIU)\*

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\*VIU is equal to the present value of the future cash flows expected to be derived from the asset or cash-generating unit (CGU). The “CGU” is the smallest identifiable group of assets generating cash inflows that are independent of cash inflows from other groups of assets. A CGU can range from an individual asset to the business as a whole.

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When grouping assets for assessing impairment losses under GAAP, intangible assets without a finite life can only be grouped with other such intangible assets; they cannot be grouped with either goodwill or assets that have determinable lives. There is no such rule under IFRS.

Under IFRS, impairment losses are measured at the individual asset level. If that cannot be done, then it is done at the cash-generating unit level. As stated, a CGU is the smallest identifiable group of assets generating independent cash flows.

### Asset retirement obligation

Under GAAP, an asset retirement obligation (ARO) is the estimated cost of eventually retiring the associated asset and may include the cost of dismantling and removing the asset, as well as the cost of restoring the site. This is per ASC 410-20, Asset Retirement Obligations (formerly FAS 143). An ARO is recorded when a long-lived tangible asset is acquired if, and when, the fair value can reasonably be estimated or, if not, a present value technique is used. The ARO's value is adjusted over time as the amount of the liability changes.

Unlike GAAP, according to IFRS, the liability is not measured at its estimated fair value but rather at the estimated value of the present obligation at the time of the asset's initial acquisition. Furthermore, IFRS uses a more-likely-than-not approach (see the discussion of impairments above for an explanation of this threshold) to discern if an obligation exists and should be recorded, using a pretax discount rate. If changes to the measurement of the liability under IFRS occur over time, the carrying value of the associated asset is adjusted.

### Capitalization of software development costs

Generally, GAAP does not allow the costs of software development to be capitalized in the initial phase of development. In fact, research and development costs are expensed as incurred.

Under IFRS, while research costs are usually expensed, development costs are capitalized for intangible assets if technical and economic feasibility of a project can be demonstrated.

Finally, guidance under GAAP differs depending on whether the software is to be used internally or held for sale, but there is no such distinction under IFRS.

# Implications of convergence

Although there certainly are a number of similarities between the two sets of standards, as you can see just from the discussion of fixed assets management, there are also many significant differences. In addition to the ones already mentioned, for example, there is a prohibition by IFRS of the last-in-first-out (LIFO) method of inventory valuation, as well as the completed contract method of accounting used so widely in the U.S. construction industry. Major differences obviously exist.

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One of the principal differences between the two sets of standards is that while GAAP contains detailed guidance, some of which is industry-specific, IFRS is very general with no mention at all of specific industries. GAAP is so much more detail-oriented because it exists within the United States' highly regulated environment. IFRS, on the other hand, requires the use of more judgment because the companies are only following a set of basic principles. In fact, IFRS has been referred to as "principle-based" while GAAP has been said to be "rule-based."

According to IFRS 1, First-Time Adoption of International Financial Reporting Standards, reconciliation with previous financial statements prepared according to GAAP would be a necessity. In fact, IFRS requires at least one year of comparative prior period financial information be presented. Some recommend that accounting records be maintained according to both GAAP and IFRS for the first year of IFRS reporting.

When you consider a suggestion made by the AICPA to the SEC to make the adoption of IFRS optional, you can easily see how complicated this could become. And, no surprise, the AICPA favors a continuing role for the Financial Accounting Standards Board so that it might approve future accounting rules for U.S. companies. The FASB has always been the standards setter for U.S. GAAP. In fact, as other countries have adopted IFRS, many have chosen to retain their own version of a local standards setter.

Multinational companies need to closely monitor their foreign-based subsidiaries because if they decide to adopt IFRS for local reporting purposes, the action cannot easily be undone. Once adopted, IFRS must continue to be applied unless a change would provide more accurate financial statements. In addition, consider the difficulty in using IFRS for one subsidiary and GAAP for another.

If the convergence of these two standards does occur, it may be necessary to budget for a significant cost outlay for the training of staff, as well as collecting and entering new and additional data into a company's accounting system. Accounting software can certainly assist in the transition if convergence occurs. In addition, companies will have to update shareholder communication and invest in education efforts due to the need to explain the unpredictability of financial results as the new rules are instituted.

## Perspectives on IFRS adoption

Many company executives and accounting regulators see the need for a single accounting standard. Until the adoption of IFRS, every country had its own accounting standards. Different accounting practices make it challenging to compare the performance of businesses across national boundaries. Thus, a single set of rules could provide more global transparency and disclosure. It would also ease accounting preparation for multinational companies that currently have to prepare multiple books, leading to cost savings.

If the U.S. adopts IFRS, exchanges with international companies could become more competitive by eradicating accounting differences. Standardization has also been proven to increase efficiency and the implementation of common measures adds value to the information.

Although the transition would affect many levels of business practice, ranging from business school texts and courses to retraining finance employees to reeducating investors, those who are in favor see the added benefit of global IFRS adoption as worth the effort.

Under the SEC's current proposal, large companies would make the transition first, which would result in a period where companies of the same industry would be using different accounting practices. However, not only would IFRS adoption help make U.S. businesses more competitive in the international arena, it could provide better control of accounting practices. It also makes international movement of accountants and auditors simpler.

IFRS is dependent upon business ethics and corporate governance. A principles system has the potential to both limit unethical behavior and provide those who are trying to do the right thing with added protection. Accountants who may have accidentally made an error when applying accounting principles they thought applied to the situation could disclose their thought process and motivations as a defense. This would mean the law would have to account for more ambiguities in order to facilitate accurate reporting.

## Conclusion

As the number of non-U.S. companies that adopt IFRS increases, there will be added pressure for American companies to do the same in order to ease the comparison of financial results. In fact, preparing for IFRS is becoming more of a requirement than an option for U.S. companies as the global business arena continues to implement the standard.

Because a complete adoption of IFRS at this time would be extremely difficult, an initial convergence of the two sets of standards will undoubtedly occur. Although the cost of implementation could be high for many companies, multinational businesses could realize significant cost savings from being able to apply the same standards across all companies.

Although the boards still have significant hurdles to overcome before convergence of the two sets of standards is achieved, many feel the project can be completed in another four to five years.

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