

IFRS vs. GAAP: Convergence Or Collision Course?

By Tammy Whitehouse

Are U.S. accounting rules ready to stand shoulder-to-shoulder in the capital markets alongside international accounting standards?

The Securities and Exchange Commission, under pressure to end the requirement that non-U.S. companies reconcile their financial statements to U.S. Generally Accepted Accounting Principles, has promised movement on the contentious issue by this summer. Not only will the SEC propose dropping the reconciliation requirement (as widely expected), but the Commission has also promised to consider allowing foreign and domestic companies alike the option to report under either set of rules.

That has accounting experts wondering whether the pace of convergence between GAAP and International Financial Reporting Standards is moving quickly enough. The U.S. Financial Accounting Standards Board and the International Accounting Standards Board have made big progress since they penned a landmark agreement in 2002 promising to make U.S. GAAP and International Financial Reporting Standards more alike. But will they be enough alike by 2009—the targeted date for SEC’s halt on reconciliation—to give investors comparable, transparent financial information?

The differences between the two systems are still deep and significant, accounting experts say.

“The primary difference right now between U.S. GAAP and IFRS is the level of specificity,” says Brian Markley, managing director for CFO services firm SolomonEdwardsGroup. “IFRS is a principles-based set of standards. U.S. GAAP has become a very rules-based body of standards that is generally viewed as more complex and more onerous than IFRS. Because IFRS is principles based, it may provide a preparer with a little more leeway in how to account and report specific transactions.”

The rules vs. principles approach to accounting rules has been debated endlessly as FASB and IASB work through differences in their standards. Markley says U.S. GAAP became rule-intensive at the demand of U.S. companies and accountants,

who want the protection of detailed rules and guidance to justify their positions when SEC staffers dissect financial reports.

According to D.J. Gannon, a partner with the national office for Deloitte & Touche and leader of the firm’s IFRS Center of Excellence for the Americas, the differences between IFRS and GAAP fall into three major categories: the requirements of the standards, the choic-



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es companies can make, and the levels of detail they must go into.

In terms of accounting requirements, Gannon says significant differences still exist in areas such as consolidation—when companies fold in results from subsidiaries or other entities where a company may not have full control or ownership. Differences in consolidation requirements are “most pervasive in terms of the effect on financials,” he says. He also sees big differences in requirements related to asset impairment, liability recognition, and intangible assets.

Revenue recognition is another area with significant differences, says Tony

Lopez, a director at FTI Consulting and a former associate chief accountant at the SEC. “In the United States, we have hundreds of standards and interpretations related to revenue recognition,” he says. “In [International Accounting Standards], we have IAS 18. In the U.S., we have very stringent rules on software revenue. In IAS, there are two sentences about software revenue.”

Bruce Pounder, president of accounting education firm Leveraged Logic, says IFRS relies more heavily on measurement concepts like fair value for reporting assets and liabilities than GAAP does. In the United States, companies are just getting the option to use more fair value, but it’s focused on financial assets and financial liabilities.

Pounder says IFRS also provides fewer allowances for reducing volatility, leading to more volatile earnings. And IFRS prohibits certain accounting methods allowed under GAAP that tend to distort the financial statements, he says, such as the last in, first out (LIFO) calculations for inventory.

Each set of accounting rules provides different choices companies can make, Gannon says, although he acknowledges some of those choices have disappeared in recent years. “Depending on the choice a company makes, it will make a difference in the financial outcome,” he adds. For example, companies have different options about how to format the income statement under IFRS or GAAP.

The Details Creep Up

Many of the differences between IFRS and GAAP reside in the significant level of detail that defines GAAP compared with IFRS, experts say. The rules may start out in roughly the same place, but subsequent detailed guidance often sets GAAP apart from IFRS. That’s the case with revenue recognition, for example, and with accounting for complex financial instruments like derivatives, Markley says.

As Gannon sees it, the bottom line is not how the rules compare, but how the numbers compare when the rules are applied. “When we talk about differences, we’re talking about different accounting outcomes,” he says. “You may have dif-

ferent principles and standards that may come to the same accounting outcome.”

Lopez says regulators are focused more on differences in the rules, not outcomes.

“If I take a transaction—whether it’s a revenue transaction, an asset impairment, whatever it may be—and I run it through a GAAP model and an IAS model, if I get a materially different answer as a result of applying both models, to me there’s a difference,” Lopez says. “Even if the models are similar, they may yield a materially different answer.”

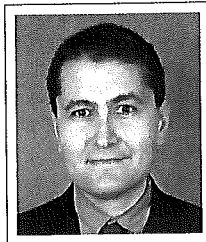
The resulting lack of comparability concerns investors and investor advocates, says Mary Morris, an investment officer for the California Public Employees’ Retirement System. CalPERS is supportive of SEC’s intended direction, yet also questions whether the systems will produce comparable outcomes.

Morris says CalPERS is placing faith in the continued development of eXtensible Business Reporting Language, or XBRL, to resolve comparability problems. A favorite project of SEC Chairman Christopher Cox, XBRL is an evolving computer language for financial reporting that establishes uniform line-item definitions and eases data exchange.

Neri Buckspan, managing director and chief accountant at Standard & Poor’s Credit Market Services, says comparability is already a problem even within GAAP, so it shouldn’t be seen as an obstacle to allowing companies to report side-by-side in either system.

“Given that accounting differences have always existed and will always exist, an important issue is how robust the disclosures are,” he says. “As long as the market has an understanding of what is in the number and how you arrived at the number, it will provide sufficient transparency. It will sustain minor differences for a while with the broad objective of achieving harmony over time.”

For the latest news on IFRS usage, please go to www.complianceweek.com and enter **Print Reference Code: 060713**.



Lopez

SPEECH

Below is a recent speech from John White, the SEC’s director of corporation finance division, on the convergence of U.S. GAAP and IFRS. To see a complete text, please go to www.complianceweek.com and enter **Print Reference Code: 060713**.

The chorus of voices calling for the U.S. to recognize and accept financial reports filed with IFRS has become louder and louder in recent months. Such a move was one of the eight recommendations of the report that Mayor Michael Bloomberg of New York City and Senator Charles Schumer of New York commissioned and released recently. If you attended (or watched on C-Span, like I did) the conference on U.S. competitiveness that Secretary Paulson hosted at Georgetown recently, you also heard a number of people including John Thain from the NYSE and former Federal Reserve Chairman Paul Volcker call for the acceptance of IFRS without reconciliation. Chairman Cox has spoken of his goals on this front as well. I would say that you can add to those voices the ones that we heard at the Roundtable. And while that is true, what was in some ways more striking to me is that many (if not all) of the people behind those voices are already ahead of us. The various players and participants in our capital markets, whether intermediaries or investors, already accept IFRS. Foreign private issuers would like reconciliation to end; U.S. domestic issuers also seem ready for that, at least in the case of large companies with multinational operations. In fact, those U.S. issuers want IFRS for themselves and already use IFRS in many cases for various purposes.

I will be the first to acknowledge (or the first to second some of the sound thinking we heard at the Roundtable) that reconciliation cannot be ended carelessly, nor overnight. I have heard concerns about the sustainability of funding for the IASB (without which, what would happen to the care and maintenance of IFRS?), and other steps or considerations laid out in the roadmap that cannot yet be confidently checked off. For the reasons I heard at the investors panel, I think we must remain focused on the convergence process and on the robustness and strength of IFRS. At the same time, I believe that reconciliation should end for the benefit of investors as well as other participants in our capital markets as soon as we pass the remaining mile markers. And the discussion at the Roundtable bears witness to tremendous support for passing those markers with alacrity. It might also be useful to consider some sort of phase-in, whereby certain issuers could be relieved of the reconciliation requirement on a trial basis even before the roadmap’s conditions have been fully achieved ...

I believe that the staff of the Commission needs to work in earnest to analyze and address the question of allowing U.S. issuers to report in IFRS rather than U.S. GAAP. That issue also has competitive angles, in our markets as well as for U.S. companies operating overseas, and it seems to me an essential piece of the larger pictures. There are also hidden landmines in this one, I suspect, and we must walk forward deliberately. For example, I was surprised to learn that colleges in the U.S. do not today generally teach IFRS to accounting students. So, while we might allow U.S. companies to report in IFRS, there would seem to be a large learning curve before there would be sufficient accountants to prepare those financial statements, or to audit them for that matter ...

Obviously there are a lot of questions and a lot of exciting ideas that came out of (or were repeated at) the Roundtable. I would like for the Commission to get more public input from yet more affected parties and the public on these topics and then to consider moving forward expeditiously ... By formally entering the discussion, the Commission could express its views on the roadmap and ending reconciliation in its own voice rather than just being a staff position. I believe that could be a powerful signal of the seriousness with which we take these matters and a good next step down the road of aligning the Commission’s rules with a world in which those who file their financial statements in IFRS, as promulgated by the IASB, do not need to provide a U.S. GAAP reconciliation.

Source: Securities and Exchange Commission (March 23, 2007).