SOUTHEAST
AUDIT COMMITTEE NETWORK
VantagePoint

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# International Financial Reporting Standards

## Introduction

The Southeast Audit Committee Network held its 11th meeting on September 9, 2008, to discuss enterprise risk[1] and International Financial Reporting Standards (IFRS). This document is a synthesis of insights and comments from the discussion of IFRS, presented in a question-and-answer format and centered around three main topics:

- **Practical differences between IFRS and U.S. GAAP** *(page 2)*
- **The nuts and bolts of conversion** *(page 4)*
- **Public policy issues** *(page 8)*

Collectively, members of the network in attendance at the September meeting sit on the boards of more than 25 large-, mid-, and small-cap public companies. Audit committee chairs attending were:

- Eddie Adair, Tech Data
- Denny Beresford, Kimberly-Clark and Legg Mason
- Kerm Campbell, SPX
- John Farrell, Fidelity National Financial
- Renée Hornbaker, Eastman Chemical Company
- Sherrill Hudson, Publix Super Markets
- Claude Lilly, FairPoint Communications
- Dean O'Hare, HJ Heinz
- Jim Robbins, DSW
- Erik van der Kaay, RF Micro Devices
- Edwina Woodbury, R. H. Donnelley

Also participating in the meeting from Ernst & Young were:

- Edwin Bennett, Southeast Area AABS Managing Partner
- Tom Hough, Vice Chairman and Southeast Area Managing Partner
- Chuck Seets, Southeast Area Partner
- Ron Weissman, Partner, Financial Services Practice

*VantagePoint* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals or corporations. However, Mr. Weissman has permitted his comments to be attributed. Members' remarks appear in italicized quotes.

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[1] See Southeast Audit Committee Network, "Enterprise risk," *VantagePoint,* September, 2008. Available at http://www.tapestrynetworks.com.

As directors are increasingly aware, over the past several weeks, the U.S. Securities and Exchange Commission (SEC) has taken initial steps that could begin the process of moving U.S. companies away from reporting financial information in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP) and toward the use of IFRS. On August 27, 2008, the SEC announced it will publish a proposed Roadmap to IFRS. It announced that it "would make a decision in 2011 on whether adoption of IFRS is in the public interest and would benefit investors. The proposed multi-year plan sets out several milestones that, if achieved, could lead to the use of IFRS by U.S. issuers in their filings with the Commission."[2]

In explaining the SEC's support for a transition to IFRS, SEC chairman Christopher Cox noted that over the past several years, "we have seen the emergence of IFRS as a high quality, increasingly globally accepted set of financial standards. Over 100 countries and all of Europe currently require or permit IFRS reporting, with approximately 85 of those countries requiring IFRS reporting for all domestic, listed companies. The market capitalization of exchanges within those 85 countries requiring IFRS represented approximately 35 percent of global market capitalization as of the end of July [2008]. That number exceeds the 28 percent share of global market capitalization held by United States exchanges. And the share of global market capitalization represented by IFRS markets will grow still larger with the inclusion of the additional countries that have decided to adopt IFRS by 2011."[3]

## Practical differences between IFRS and U.S. GAAP

While it would appear that a principles-based system such as IFRS and a rules-based system such as U.S. GAAP are fundamentally different, a recent Ernst & Young study concluded "although the US and international standards do contain differences, the general principles, conceptual framework, and accounting results between them are often the same or similar, even though the areas of divergence seem to have disproportionately overshadowed these similarities. We believe that any discussion of this topic should not lose sight of the fact that the two sets of standards are generally more alike than different for most commonly encountered transactions, with IFRS being largely, but not entirely, grounded in the same basic principles as US GAAP."[4] In fact, much of IFRS will be familiar to financial staff and audit committee members, Mr. Weissman remarked.

Of course differences do exist. One of the challenges companies face is that those differences vary depending on industry or even company. It is impossible, therefore, to say how international standards will impact all companies. However, Ernst & Young did examine a number of differences between the two accounting standards relating to inventory reporting and revenue recognition reporting, and those are set out below.[5]

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[2] Securities and Exchange Commission, "SEC Proposes Roadmap Toward Global Accounting Standards to Help Investors Compare Financial Information More Easily," press release, August 27, 2008. Available at http://www.sec.gov/news/press/2008/2008-184.htm.

[3] Christopher Cox, "Proposing a Roadmap Toward IFRS." Speech at an open meeting of the SEC, Washington, DC, August 27, 2008. Available at http://sec.gov/news/speech/2008/spch082708cc_ifrs.htm.

[4] Ernst & Young, *US GAAP vs. IFRS: The basics* (New York: Ernst & Young, 2008), 2. Available at http://www.ey.com/Global/assets.nsf/US/Assurance_US_GAAP_v_IFRS/$file/US_GAAP_v_IFRS.pdf.

[5] The summary of the differences in inventory reporting and revenue recognition reporting are drawn from Ernst & Young, "Are You Ready for IFRS? What US Audit Committees Need to Know about IFRS," *BoardMatters Quarterly,* April 2008, 9–11.

**What are the differences in inventory reporting?**

- **Costing methods.** Under U.S. GAAP, LIFO (last in, first out) is an acceptable costing method, and a constant cost formula for all inventories of a similar nature is not explicitly required. Under IFRS, LIFO is prohibited; FIFO (first in, first out) must be used, and the same cost formula must be applied to all inventories of a similar nature or use to the entity.
- **Measurement.** Under U.S. GAAP, inventory is carried at the lower of cost or market. *Market* is defined as "current replacement cost" as long as market is not greater than net realizable value (estimated selling price minus reasonable cost of completion and sale) and is not less than net realizable value reduced by normal sales margin. Under IFRS, inventory is carried at the lower of cost or net realizable value (best estimate of the amount inventories are expected to realize, taking into consideration the purpose for which the inventory is held; this amount may or may not equal fair value).
- **Reversal of inventory write-downs.** Under U.S. GAAP, any write-downs of inventory to the lower of cost or market create a new cost basis that subsequently cannot be reversed. Under IFRS, previously recognized impairment losses are reversed up to the amount of the original impairment loss when the reasons for the impairment no longer exist.

**What are the differences in revenue recognition reporting?**

- **Sale of goods.** Under U.S. GAAP, public companies must follow SAB 104, Revenue Recognition, which requires that delivery has taken place (the risks and rewards of ownership have been transferred), that there is persuasive evidence of the sale, and that the fee is fixed or determinable and reasonably certain to be collected. Under IFRS, revenue is recognized only when the risks and rewards of ownership have been transferred, the buyer has control of the goods, revenues can be measured reliably, and it is probable that economic benefits will flow to the company.
- **Rendering services.** Under U.S. GAAP, certain types of service revenue, primarily relating to services sold with software, are addressed separately. All other service revenue must follow SAB 104. Application of long-term contract accounting (SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts) is not permitted for non-construction services. Under IFRS, revenue can be recognized in accordance with long-term contract accounting – including considering the stage of completion – whenever revenues and costs can be measured reliably and it is probable that economic benefits will flow to the company.
- **Multiple elements.** Under U.S. GAAP, specific criteria are required for each element to be a separate unit of accounting; delivered elements must have stand-alone value, and undelivered elements must have reliable and objective evidence of fair value. If those criteria are met, revenue for each element of the transaction can be recognized when the element is complete. Under IFRS, IAS 18 requires recognition of revenue on an element of a transaction if that element has commercial substance on its own; otherwise the separate elements must be linked and accounted for as a single transaction. IAS 18 does not provide specific criteria for making a determination; the

IASB is currently developing guidelines for identifying separable components within revenue contracts.

- **Construction contracts.** Under U.S. GAAP, construction contracts are accounted for using the percentage-of-completion method if certain criteria are met; otherwise the completed-contract method is used. Under IFRS, construction contracts are accounted for using the percentage-of-completion method if certain criteria are met; otherwise revenue recognition is limited to recoverable costs incurred. The completed-contract method is not permitted. Additionally, under U.S. GAAP, construction contracts may be, but are not required to be, combined or segmented if certain criteria are met. Under IFRS, construction contracts are combined or segmented if certain criteria are met. The criteria under IFRS differ from those under U.S. GAAP.

**How is risk disclosure handled under IFRS?**

IFRS and U.S. GAAP also differ in how they treat disclosures. IFRS 7 (Financial Instruments: Disclosures) requires detailed information on various financial risks (including financial instruments that are off-balance-sheet) and how the risks are being managed.[6] Mr. Weissman noted that "with IFRS, the risks come out of the 10-K and are placed into the footnotes of the financial statement." Because they are in the financial statement, these items must be audited by the independent auditor."

## The nuts and bolts of conversion

As noted in the *New York Times*, some large American companies will be permitted to begin using international accounting standards as early as 2009: "Under the proposal, a small group of large companies, which the S.E.C. estimated at about 110 firms, would be allowed to use the international rules in financial statements issued after Dec. 15, 2009. This means companies on a calendar-year basis could use the international rules for their 2009 annual reports. To be allowed to do that, the company would have to be among the 20 largest companies in its industry around the world, and a large number of its competitors would have to already be using the international standards. The commission said it would consider requiring large American companies to move to the international standards for their 2014 financial statements, with smaller ones required to make the move in 2015 and the smallest – but largest number – allowed to delay until 2016. Under the plan, a final decision on those companies would be made in 2011."[7]

While the SEC says it is using the early adoption period to look at examples of how well companies are converting, Mr. Weissman says it's worth noting that there are already "plenty of examples. It's called Europe." Mr. Weissman believes that "early adoption in 2009 will be a very rare thing … Not many companies will be ready to provide three to four years of retrospective data." Then too, the boards of some companies that believe themselves to be eligible aren't in any rush to convert. One member remarked, *"We don't know enough to intelligently move forward. We want to identify complex areas. We talked to BP – it took them three years and $30 million [to move to IFRS]. We don't want to be out in front."*

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[6] A technical summary can be found at http://www.iasb.org/NR/rdonlyres/8177F9A2-EB2F-45A3-BBF3-3DE7DCB13E1A/0/IFRS7.pdf.

[7] Floyd Norris, "U.S. Moves Toward International Accounting Rules," *New York Times*, August 28, 2008. Available at http://www.nytimes.com/2008/08/28/business/worldbusiness/28audit.html.

The SEC retains the option to expand in 2011 the list of companies that will be permitted to adopt IFRS early. If it does choose to expand the list, companies that might be included on that expanded list will need to have their IT systems in place, comparative data collected, and be ready to execute at that time if they want to take advantage of the opportunity.

**If we're not planning on converting early, do we need to be doing anything about IFRS now?**

Companies that do not choose early adoption may be well advised to consider "early understanding." Prior to the SEC's recent announcement, many audit committee chairs were holding off on detailed discussions with their finance staffs or full boards: *"It's premature to go whole hog unless you're an early adopter,"* one member noted. But the announcement, in particular its proposed timeline, should spur audit committee members to start learning about international standards and what filing under a more principles-based system will mean for their company and their industry.

Mr. Weissman said that if he were a CFO, "I would want to sit down and analyze the differences between U.S. GAAP and IFRS as it relates to me. There are implications for a number of areas, including systems implications, debt, employee benefits, and tax. How do you do a conversion? How do you educate your people and drive it into the organization? For the most part, this was not done in Europe due to short turn around times… a lot of companies have had to go back and redo this."

All companies should be thinking about how they collect financial data and how their IT systems handle that data. "If you start too late, the problem is the data," Mr. Weissman said. "You're behind, you have to re-create information, and you'll be fortunate if it can even be re-created. Consider the data needs early so you can make an informed decision [about adoption], and the systems are ready to go when you have to start the process." One person who has spent time looking at this issue agreed that *"IT is a big problem"* for many companies during conversion. Mr. Weissman remarked, "There are a lot of decisions to be made on the first day. You have to be ready on January 1, 2012, and have the data ready to do that – you may not have that data."

**As audit committee chairs, what questions should we be asking management about IFRS?**

Weissman told the group that "as far as the audit committee is concerned, I'd be interested in knowing the impact of IFRS and how ready the company is." In the new publication *IFRS for audit committees and boards of directors: important questions for your consideration,*[8] Ernst & Young outlines 16 questions directors should be asking about IFRS:

[8] Ernst & Young, *IFRS for audit committees and boards of directors: important questions for your consideration* (Ernst & Young, 2008). See also the Ernst & Young publication "Are You Ready for IFRS? What US Audit Committees Need to Know about IFRS," *BoardMatters Quarterly,* April 2008, which includes additional questions and issues for the audit committee to bring up in starting a dialogue with financial management and the external auditor.

**Initial considerations**

- Should we be a first mover?
- How can our organization take advantage of the opportunities presented by the conversion to IFRS?
- What are the most significant risks associated with converting to IFRS?
- How will converting to IFRS affect our stakeholders, and what should be done to manage the expectations of capital markets?

**Financial reporting considerations**

- What are the high-level differences in accounting and disclosures, and what are the estimated effects on the income statement and balance sheet?
- What will be the effect on management reporting?
- How will management address the need for financial information prepared under both U.S. GAAP and IFRS during the period of transition?
- How will IFRS affect accounting for income taxes and tax filings?
- Have any of our subsidiaries already adopted IFRS for local statutory or regulatory reporting? If so, what will management do to ensure consistency in the selection of accounting policies? If not, will they be required to convert in the future, or be permitted to convert?

**Conversion project considerations**

- How do we plan to approach the conversion to IFRS, and how ready are we to do this?
- What are the key areas that need to be addressed during the conversion?
- What is the timeline for our IFRS conversion project, what resources will be required, and how much will it cost?
- What can we learn from the conversion experiences of other countries, including Canada and the EU countries?

**Nonfinancial reporting considerations**

- Other than financial reporting, which other business areas will be affected by the conversion?
- Can our current IT systems handle the business' revised data collection requirements under IFRS?
- Other than financial reporting integrity, what are the other implications for boards of directors?

### Where can we find internal expertise?

Mr. Weissman noted that "parts of the world are knee-deep in this. People are getting exposure in London, Europe, and Australia. You know more [about IFRS] than you think you do." Directors at multinational corporations can often draw on experience and knowledge in IFRS-compliant subsidiaries. Mr. Weissman said, "It's important that someone like the chief accounting officer is driving the effort, but not serving as the project manager." He also cautioned against having the project lead be a subsidiary CFO with experience working in an IFRS-compliant entity as they would not have enough experience at higher levels of the global enterprise.

**Can we use our independent auditor for help with the IFRS conversion?**

"There are independence issues, but they're not crippling," said Mr. Weissman. Each company will need to review the portfolio of work currently provided by the auditor and decide if IFRS work would qualify as audit-related services. "There's no pat answer. Ultimately, the board should invite the auditor in and see if you like the team they bring." The audit committee should look for a team that has good working chemistry and represents a range of skills and experiences. Elements to look for on the team include accounting backgrounds, information technology skills, tax expertise, project management abilities, and experience with a previous IFRS conversion.

Boards may invite their external auditor firm in to give a presentation on IFRS or ask them to start a diagnostic procedure. Weissman notes that most diagnostics cover "significant accounting changes, an analysis of the differences between GAAP and IFRS and what that means for the company, and the impact the conversion will have on financial reports, IT systems, debt covenants, legal contracts, tax, employee benefits, management reporting, and other areas. It also includes an educational plan and a communications plan. It's pretty extensive."

Certain restrictions do apply, however. The independent auditor is not allowed to run the project management office, oversee the project, or act as a systems implementer for a client.

**Who else can help?**

A number of members suggested seeking assistance from software companies and ERP vendors who might be developing IFRS solutions. Several members said they were concerned that *"today's ERP spend could be going down the tubes"* if it isn't IFRS compatible.

**Will conversion be considered a risk factor for disclosure?**

Members asked, *"[Are] companies … starting to list IFRS conversion as a risk factor?"* Mr. Weissman said that he had not seen that occur, but several members felt it might become an issue. *"There's a recent focus on the risks of conversion. Conversion will have a company-wide impact, and that's something we don't really have our hands around."*

## Public policy issues

The public policy issues surrounding conversion to IFRS include, first and foremost, the milestones that must be reached before IFRS conversion will be mandated. The outcome of the U.S. presidential election will also have a significant effect on the conversion process.

**What are the milestones that need to be met prior to SEC's mandating of IFRS?**

When announcing its proposal for a Roadmap on U.S. adoption of IFRS for public comment, the SEC articulated several milestones that must be met by 2011 in order to proceed with mandating the use of IFRS for U.S. issuers. SEC commission Elisse Walter readily admitted that the milestones represent "significant hurdles to overcome over the next three years in order for the [SEC] to determine to accept IFRS reporting from U.S. issuers."[9] These milestones include:

- **Improvements in accounting standards, based on the IASB's and the FASB's convergence work.** Mr. Weissman noted that "even on joint opinions, there are still significant differences."
- **Accountability and funding of the International Accounting Standards Committee Foundation (IASCF).** The SEC would like to see IASCF securely established as a stand-alone, private-sector organization. "There are IASB financing issues," Mr. Weissman noted. "The SEC wants those issues addressed."
- **Improvements in the use of interactive data (eXtensible Business Reporting Language, or XBRL[10]) for IFRS.**
- **Improvements in IFRS education and training.** This is a concern for both businesses and business schools: "Business schools are spending time on IFRS," Mr. Weissman said. "[Education is] impossible with two systems. At the same time, the Big Four firms are focusing on IFRS."
- **Successful limited early use of IFRS by qualified U.S. companies.**[11]

If the SEC judges these milestones have been reached by 2011, it will proceed with the phased introduction of IFRS described earlier.

**Could the Roadmap be impacted by the 2008 U.S. Presidential election?**

"There are concerns about the Roadmap becoming a piece of the political debate on globalization," Mr. Weissman said. It is also widely believed that Chairman Cox will stand down early next year, which means that his successor will be chosen by the new administration. Mr. Weissman noted that the new chairman "will have a big impact on [the Roadmap]." One member likened the situation to the failure of the United States to adopt the metric system – a reasonable course of action derailed by politics.[12]

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[9] Elisse Walter, "Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards from U.S. Issuers." Speech at an open meeting of the SEC, Washington, DC, August 27, 2008. Available at http://sec.gov/news/speech/2008/spch082708ebw.htm.

[10] The consortium that developed XBRL describes it as "a language for the electronic communication of business and financial data which is revolutionising business reporting around the world … it is one of a family of 'XML' languages which is becoming a standard means of communicating information between businesses and on the internet." More information is available at the consortium's website, http://www.xbrl.org/Home/.

[11] The summary of the milestones is drawn from Ernst & Young, "SEC proposes Roadmap for IFRS adoption in the US," *Hot Topic* 20, 27 August 2008. Available at http://www.securitization.net/pdf/EY/RoadmapIFRS_27Aug08.pdf.

[12] As of September 2008, the metric system is used everywhere in the world except Burma, Liberia, and the United States.

### Can we comment on, or influence, the Roadmap's development and implementation?

When the SEC releases its proposal for a Roadmap to the public, it will invite comments from interested parties. The Roadmap will be available online at the SEC website,[13] and comment letters will be due to the SEC within 60 days of publication. "The comment letters are important," Weissman said. "When [the proposal is] issued, read it carefully and comment on it. The SEC needs to hear feedback from the marketplace."

## About this document

The Southeast Audit Committee Network is a group of audit committee chairs drawn from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit committee environment.

*VantagePoint* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *VantagePoint* may share it with those in their own network. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.



[13] http://www.sec.gov