University Honors Capstone Project

2014: U.S. GAAP Transition to IFRS

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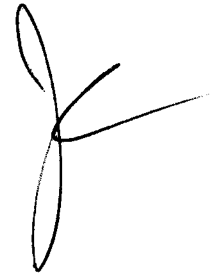

I thought I have submitted the paper work for Kenichiro Azumaya.
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>>> Sara Matthies-Long 9/14/2010 1:55 PM >>>
Last spring,Kenichiro Azumaya handed in to us a copy of his Capstone Paper. He said we would be receiving a signature page from you indicating acceptance of the paper by you. As of this date we have not received a signature page. If this paper is satisfactory, could you please submit to us a statement to that affect. Thank you.

sami

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Purpose of Report

The main purpose of this report is to answer the following questions:

1. What are the key differences between IFRS and U.S. GAAP?
2. How should U.S. companies approach this issue for a successful transition?
3. Currently (in 2010), how ready are U.S. companies in making the transition?

Introduction

The U.S. GAAP to IFRS conversion declared by the SEC in recent years will bring drastic differences to America as how the Sarbanes Oxley Act did in 2002. In terms of financial statements, mandatory conversion is not predicted to begin till 2014; however, many of the top globally recognized domestic companies have already made its first step in this historical transition this year. Currently, there are 110 companies in the U.S. that are potentially "capable" of initiating the IFRS transition (Jefferson Wells, 2009). Companies, however, are hesitant of making the transition because of the inevitable additional costs that they must incur in terms of internal/external professional IFRS assistance, as well as IT reforms and renewals.

However, U.S. companies will face much greater challenges if they stagger. Already, more than 100 countries around the world have either permitted or required the use of IFRS, making the financial reporting standard the most popular in the world. This includes many European countries such as Russia, France, Germany, and the United Kingdom. The adaptation rate continues to grow around the world, having Asian countries such as Japan to inquire new accounting rules, or countries like China to basically converge its country's accounting standards to IFRS (PricewaterhouseCoopers, 2010). America is one of the last major countries in the world faced with the IFRS conversion, and by being left out in this transition will cause an enormous damage to its international commerce. Overall, the main purpose of this IFRS conversion is to raise the transparency and continuity of the financial statements around the globe for better international business practices.

Current accounting practitioners, as well as potential CPA candidates are also affected during these times of change. The AICPA has announced that CPA examinees will be required to be tested on IFRS concepts in addition to the current exam questions. The IFRS component will

be included in the CPA exam starting January 1, 2011. The bigger problem is the learning environment that must be created for current CPAs and practitioners to allow them to inquire the new knowledge. Companies and current CPAs may be forced to allot a great deal of time and money.

Background

Key Accounting Differences

According to Feeley and Driscoll, P.C., a public accounting firm, there are three major differences between U.S. GAAP and IFRS in terms of accounting procedures (Feeley and Driscoll, 2009):

1. Inventory
2. Carrying Value of Assets
3. Income Taxes

First, LIFO is prohibited under IFRS. LIFO is very popular among U.S. companies with lower tax incentives. This is especially true in industries such as the automobile industry, where higher COGS is expected. However, this has not been the case in 2009. Because automobile production declined at an incredible rate last year, 200 out of 220 car dealers in the suburbs of Illinois were forced to use the inventory acquired earlier in the year to determine COGS, which caused a much higher taxable income than they expected (Thompson, 2010). President Obama has announced the LIFO repeal, in other words the disallowance for companies to use the LIFO method. U.S. companies seem to be going towards the direction of losing LIFO as an option, but professionals argue that the mandatory use of FIFO will "...increase a company's tax burden,

lowering its global competitiveness, increasing cash flow problems and decreasing working capital (Busch, 2009)."

Second, IFRS permits a one-time option of the revaluation of assets to fair market value. Although devaluation of asset is permitted under U.S. GAAP, bringing the asset's value upward is not permitted. An article by Grant Thornton questions when and for which assets the method should be applied to. Fixed assets such as land that tend to increase its value over the years should be revaluated, while many will question the significance it will have on assets such as automobiles or machineries. The revaluation method also raises the risk of fraud. By giving management the power to, "use their assumptions, their choice of valuators," when determining the fair market value price, overestimation of the assets can be a possibility (Lafleche, 2008).

Third, income tax is probably one of the most complicated areas in the transition to IFRS. This is because of the relationship between book and tax numbers. With many book accounting methods changing, the tax methods must accommodate those changes as well. Also, after everything is finally settled on the federal tax level, everything on the state and local levels must change as well (Bernard, 2008). FASB Interpretation 48 (FIN 48) was created for guidance purposes for uncertain tax issues. According to the CPA Journal, the FIN 48 has a two step process to determine how to deal with these uncertain tax issues (Alltizer, 2008). First, if the uncertain tax area is "more than likely" (over 50%) to impact financial statements, further investigation must be taken. The determining factors of whether it is more than likely is 1) an expert fully knowledgeable about the topic determines the uncertainty material to financial statements and 2) all authorities of tax laws are used to determine its validness. The second and final step is to determine its impact numerically on the financial statements under consideration

of all facts and circumstances Thus, FIN 48 should play a huge role in helping future accountants determine the uncertainties that the IFRS conversion should cause.

Overall, the main difference between IFRS and U.S. GAAP is the level of disclosure. For example, if an auditor were to determine the amount of depreciation for a machinery, he/she would need to figure out the depreciable amount for each part of the machinery. It is said that while the IFRS manual is only 2 inches thick when compiled as a document, the U.S. GAAP standards is over 9 inches (BKD, 2010). IFRS is principle based, and requires the auditor to use more of his judgments based on knowledge and experience, rather than following specific accounting rules.

Key Financial Statement Differences

As of April 2004, FASB (Financial Accounting Standards Board) and IASB (International Accounting Standards Board) have been working on a joint project in order to bring together the financial statement presentation styles. The goal of this project is to create a common form that will help investors and other users better understand the financial statements. According to an article by Guy McClain of the Journal of Accountancy, this project has been conducted in three different phases (McLelland, 2008).

The first phase was in December 2005. The IASB presented a financial statement of version IAS 1, which helped align the income statement standards. The IASB also proposed that a complete set of financial statements will include an income statement, a balance sheet, a statement of changes in equity, and a statement of cash flows.

The second phase in June 2008 addressed the financial statement differences on the line-item level. Another words, it specified which line item should be placed under certain

categories. For example, in terms of the balance sheet, assets and liabilities are not categorized under two distinct sections. Instead, you can observe in the Hutch Manufacturing Co. example that the asset and liability items are put under "Business – Operating Assets and Liabilities" and categorized on whether they are short or long term material. These presentation style differences have been made on the income statement and statement of cash flows as well.

Short term assets (ex. Receivables) is listed under the same category as short term liabilities (ex. Accounts payable)

--McLelland , 2008

Exhibit 2 Hutch Manufacturing Co. Consolidated Balance Sheets

	2007	2006
BUSINESS		
Operating assets and liabilities		
Short term		
Receivables	$68,000	$54,000
Less: Allowance for bad debts	(2,000)	(1,000)
Inventories	26,000	20,000
Prepaid expenses	19,000	24,000
Short-term assets	111,000	97,000
Accounts payable	(19,000)	(16,000)
Accrued liabilities and other	(56,000)	(74,000)
Short-term liabilities	(75,000)	(90,000)
Long term		
Property, plant, and equipment	34,000	24,000
Less: Accumulated depreciation	(9,000)	(6,000)
Goodwill	20,000	25,000
Intangibles	82,000	82,000
Less: Accumulated amortization	(21,000)	(14,000)
Other assets and liabilities, net	(5,000)	(3,000)
Net long-term assets	101,000	108,000
Net operating assets	$137,000	$115,000
Investing assets and liabilities		
Long term		
Available-for-sale securities	2,000	3,000
Investment in affiliate – equity method	6,000	5,000
Total investing assets	$8,000	$8,000
Net business assets	$145,000	$123,000

The third phase did not occur yet at the point this article was written in 2008. Currently, the third phase is still in the process of completion. The most recent meeting between FASB and IASB was on March 11, 2010. In this meeting, the two organizations finalized the decision that a complete set of financial statements will include the four mentioned in the first phase plus notes that list significant accounting policies. As for the comparative periods that the IASB requires, they have finalized their decision that only one comparative period is necessary (FASB, 2010).

Expert's Advice on How to Make the Transition

Currently, it may be a difficult time for many U.S. companies to devote any time to think about the IFRS transition. The economic crisis has wearied U.S. business morals. While they are trying to minimize overall cost and expenses as much as possible, the fact that the IFRS implementation will cause them to incur more cost is probably a huge headache for CEOs and chief accountants. As a result, this may be an issue that corporations will push off until the laws make it a requirement. However, when the companies finally decide to make the transition, it is necessary that they make the correct first step. Following the right advices to successfully make it through the conversion is essential.

"Start now, treat it as an opportunity, and make sure your entire organization is invested in the change." This is what a Vice President of a foreign multibillion manufacturer who has already experienced the IFRS conversion has to say to U.S. CEOs. These foreign corporations who have successfully gone through the IFRS conversions should be role models for U.S. companies. Hence, we should take a look at some of the advices these companies have (IFRS, 2009).

Foreign professionals claim that it is the worst idea to completely take care of this business at the top level (IFRS, 2009). A fully engaged organization is necessary to make it through, which means every department should be aware of the change in accounting standards. However, this does not necessarily mean having one knowledgeable person in each department is enough. The best option is to have a core IFRS project team that can distribute their knowledge to every department and level of the company.

Auditors are indeed important in making this change happen, however, companies should learn as much as possible before asking for a third party's help. Companies should learn what will become affected and what will stay the same. This way, companies will be able to talk professionally on the same level with auditors, thus eliminate unnecessary audit fees for elementary questions and concerns.

The foreign professionals took the IFRS change as an opportunity, and not just a compliance issue. They state that the convergence is like starting on a new sheet of white paper. It gives companies time to think about the current accounting standards and how the change may benefit their companies.

Minimizing the Transition Cost

Following the steps of the ones who have already been there is probably the best option. However, as stated before, cost minimization is a crucial goal for many companies. Deloitte recommends companies to follow its guidelines to plan out the transition to IFRS. Companies who are prepared for the transition can negate such costs that are made from errors or premium fees for hiring IFRS specialists at the last minute, (Deloitte, 2009).

It is important to understand which costs can be anticipated to change. In terms of company resources, IFRS implementation will demand the need for internal human resource experts, as well as external experts (i.e. Deloitte's IFRS advisors), and also costs incurred to upgrade current IT systems. The need for internal and external professional assistance was noted in the previous passage by the foreign experts. When developing a budget, it is important that these costs are included. The IT systems, specifically the accounting and financial reporting systems, will probably need to be modified to meet IFRS standards. Current accounting systems are designed to automate numbers, schedules and statements based on GAAP rulings. With IFRS coming up, accountants should work with members of the IT branch to resolve potential disputes that may occur. However, it is important to note the degree of change the system necessitates. Some systems may only require slight upgrades, while others may need a whole renewal. This is a huge factor for the company's budget.

According to an electricity supplying company in Ontario, these are some elements that may need to be considered to be IFRS ready (McCann 2010):

- Disclosures – IFRS has fewer rules than GAAP, however it requires more disclosure in the footnotes which necessitate explanations of how some numbers were derived. Systems may need to be reconfigured to display this information.
- Accounting Measurement – Such rules as the asset retirement obligations differ between U.S. GAAP and IFRS. IFRS allows assets to be written back up to its fair value. The system would need to understand that this is an allowable process.
- Interface – Financial statement presentation style differences must be accommodated as well.

Training for IFRS

The need for internal and external expertise to get through this IFRS transition has been continually noted through this report. Although the level of external expertise can only be determined by how much the company is willing to pay, internal expertise can be developed in many ways. A well-educated IFRS professional can be a valuable asset for companies.

Companies should first identify who is capable of learning IFRS standards and can become the IFRS specialists for the company. Ideally, companies should choose employees who already have a good grasp of the company's accounting policies, or employees who are currently traveling abroad and have direct experience with IFRS. Companies with subsidiaries scattered internationally are capable of bringing in IFRS expertise from these subsidiaries and teach the rest of the employees at the U.S. location. While that is taking place, the company can send a group of employees to the foreign subsidiary for them to bring back IFRS knowledge as well (Robert Half, 2009).

Big 4 firms like PWC and KPMG in European countries have set up seminars for their clients and other professionals with backgrounds in finance or having the responsibility of accounting or reporting areas. These seminars are called IFRS Master Classes, and are designed for professionals who are looking to file their financial statements under IFRS rules. PWC, for instance, has trained members known as the PWC Accounting and Valuation Advisory Service teaching these seminars, who use IFRS standards on a daily basis to assist their clients. This Master Class in Amsterdam is set up in eight modules (four hours each), which starts in May 2010 and ends in November 2010. The seminars mainly deal with the accounting differences that are present between their own country's GAAP and IFRS (PWC, 2010).

Research

Interviews were conducted with credible professionals who work in the field of accountancy in order to gain direct insight of how ready U.S. companies are in making the transition to IFRS. Another words, the objective of this section is to gain first-hand information on how companies are currently dealing with IFRS in 2010.

Research Methodology

With the background knowledge the author gained from the individual research assistedby Dr. Lee, he was able to come up with ten interview questions. The questions are designed to better understand the current status of the interviewee and their clients on how ready they are to transition to IFRS. The project topic and interview questions were reviewed and approved by the Institutional Review of Research (IRB). The application submitted to the IRB also included information such as: purpose of study, participant demographics, estimated number of participants, insurance of confidentiality, and how the data retrieved will be stored. The data collected from the interviewees will be shredded upon completion of this report.

In total, the author was able to conduct seven interviews for this report. The author and the interviewees from Firm A, B and C had a professional relationship before this report initially began. Firm D and E and Company A and B were introduced to the author interviewees of Firm A, B and C. Out of the five accounting firms and two companies interviewed, four of the firms had started preparing for IFRS. The author conducted face to face interviews with Firm B and C. Firm A, D, and E and Company A and B were asked to answer the interview questions via e-mail.

Interviewee Description

Interview responses included in research:

Code Name	Description	Interviewee Position
Firm A	Big Four Firm; Japanese Service Group Division (JSG)	Manager
Firm B	Big Twelve Firm; Mainly U.S. clients	Audit Assistant
Firm C	Large firm; Both U.S. and foreign subsidiary clients	Audit Assistant
Firm D	Mid-sized; Specializes in Japanese foreign subsidiaries	Partner

Interview responses not included in research:

Code Name	Description	Interviewee Position
Firm E	Small-sized: Clients mainly small business owners	President
Company A	Fortune 500 Food Production Company	Financial Assistant
Company B	Japanese Foreign Subsidiary	Chief Accountant

**Note: Responses from Firm E, Company A, and Company B were not included in this research because the interviewees were not able to provide adequate responses to the author's IFRS related questions. A detailed explanation can be found in the Results section.

Results

Firm A and B, representative of a Big Four and Ten accounting firm respectively, seems to be the most IFRS ready. Also, its clients understand the IFRS situation the best among the firms I interviewed. Firm A seems to have the most international experience because of its size and focus on Japanese entities. Along the same lines, Firm B's clients already have established businesses on a multi-national scale as well. Its clients, however, are from countries such as Germany, where IFRS is already mandated. According to Firm C, its clients are usually Small Medium Entities (SMEs), and most of them had very little knowledge on the IFRS subject. Currently, Firm C is trying to develop its client's knowledge on the topic of IFRS by encouraging them to attend seminars. The Partner in Charge (PIC) interviewed from Firm D completely devotes his time to provide service for Japanese foreign subsidiaries. Many of his clients have parent companies in Japan that are publically traded, and are among the top corporations in the country. He claims that most of his clients loyally follow its parent company's instructions on such topics like accounting procedures, and his role is mainly to determine whether the J-GAAP translation to U.S. GAAP is successfully converted.

As indicated before, these firms' clients seem to be in the introductory stage of converting to IFRS. Financially, none of the firms have observed their clients set aside a budget for the sole purpose of being IFRS ready. Firm A has noted that its clients in the automobile industry are having trouble dealing with current financial problems. Overall, it seems all of the firms' clients are afraid of additional audit fees that they may need to incur. Firm B and C have remarked that their client's expenses (such as supplies expense) have gone down. Firm C has even witnessed their clients minimizing the audit fees. Many of their clients have requested reviews instead of audits these past few years. Firm D predicts that U.S. private companies will

probably not convert to IFRS since it will not be mandatory for them. Though internationally active private companies may benefit from filing under IFRS, the inevitable extra audit fees and procedures will probably cause them to stay with U.S. GAAP.

Some problems these firms anticipate are procedural accounting differences, IT upgrades, and the risk of errors and fraud to occur. All four firms have answered that the number one difficulty accounting wise in this transition to IFRS is the income tax computation. Tax rates and temporary/permanent difference configurations are among the many problems that the auditors will need to learn. Firm C and D have noted that almost all of their clients use the FIFO inventory method, so there should not be a problem there, while Firm A and B believe they will struggle to convince some of their clients LIFO will no longer be an option. Also, the clients of Firm C and D should not have a problem upgrading their IT systems, while Firm B may have some trouble. Many of Firm C and D's clients use general accounting software such as Quickbook, which is updated every year. Because much of their accounting work is simple, they do not have to have an established accounting system specifically designed for the company. Some of Firm B's clients, on the other hand, have accounting systems that must be upgraded to be IFRS ready. Firm B believes this should not have such a burden on these companies, but it still should not be ignored when setting their budget. Finally, all the firms believe that both auditors and company accountants should anticipate errors in the beginning. However, as Firm D has stated, auditors must be able to distinguish between an error and a potential fraud. This is a critical reason why Firm D predicts the demand for CPAs will continually grow.

It is a good sign, though, that all four of the firms the author interviewed has had some degree of training received or offered. These preliminary steps show that these firms are anticipating 2014. It seems these firms have optional seminars they can attend; however,

considering it is busy season for them, mandatory attendance will probably not be required till the summer. Firm D has plans on sending one of their professionals abroad and gain IFRS knowledge. They have also held IFRS sessions in both English and Japanese and plan on running more for their clients in 2010.

Firm E, a small-sized accounting firm whose clients are mainly private business owners, is the fifth firm I interviewed for this report. The reason why the author did not list the firm in the interview response sheet is because the interviewee, who was the president of the firm, was not knowledgeable about IFRS. At this point, his accountants received zero training on IFRS as well. Firm E states that clients that small-sized accounting firms such as his only have to file financial information that is necessitated by the end user. This is probably the reason why private companies and their auditors will not be affected by IFRS in the beginning.

In addition to the accounting firms the author interviewed, he also had representatives of two companies answer the questions as well. These two companies had completely different backgrounds: 1) Fortune 500 food manufacturing company and 2) Japanese foreign subsidiary of a publically held parent company in Japan. From the interview conducted with the Financial Assistant, the author was not able to retrieve any information regarding IFRS changes made in the company. However, the interviewee noted that the U.S. unit for who he currently works for is the only unit that is not IFRS ready, and that all the other foreign units are either filing under IFRS right now or preparing for the changes. The foreign subsidiary at this point listens attentively to its auditor and contributes the information required to pass the audits. The interviewee was not knowledgeable about the topic, and suggested it was something its parent company or auditor will notify when necessary.

Conclusion

Currently, in the United States, the IFRS conversion in 2014 is an issue that is mostly discussed at the:

- Federal level (SEC)
- Accounting Organizations (FASB, AICPA)
- Partner level in Accounting Firms
  - Whose clients include foreign subsidiaries, or
  - Large sized accounting firms who have publically traded clients
- Upper level management in Corporations
  - Fortune 500 Companies, or
  - Foreign subsidiaries whose parent companies already have mandatory IFRS obligations

Accounting organizations, such as FASB and IASB, have steadily brought together IFRS and U.S. GAAP standards. At this time, the conversion is not perfect yet, and it will probably not be even in the year 2014. Publically traded companies will be mandated to switch to IFRS; however, the accounting standards for private companies will probably still need more refinement.

The interview responses show that four out of the seven interviewees have entered the preliminary stages for the transition. The author notes that the responses by the manager and partner included more long term goals, while the audit assistants understood the general background of the situation. Thus, the availability of information for each firm was influenced by the interviewee's position. Also, three out of the four firm's responses that were included in this research were to a degree affiliated with Japanese foreign subsidiaries. The author did not intend to collect data from firms with specialized foreign services. Therefore, this report incorporates a better understanding of how well prepared these specialized firms are, in contrast to status of the general American accounting firms.

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