Institute of Internal Auditors Dallas Chapter – IFRS

Convergence of IFRS & US GAAP

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AC LORDI

Agenda

- Overview
- Developing and Managing an Adoption Plan
- Key differences between IFRS and GAAP

Overview

History

1973

Creation of International Accounting Standards Committee (IASC)

1993

"Comparability and Improvements Project" completed to develop common set of standards

2001

International Accounting Standards Board (IASB) replaces IASC

2002

"Norwalk Agreement" – IASB and FASB agree to remove differences and converge on high quality standards

2007

SEC eliminates requirement of foreign registrants to reconcile IFRS to US GAAP

Nov. 2008

SEC issues proposed roadmap for US adoption of IFRS

SEC's Proposed Adoption Roadmap

- Targeted mandatory adoption dates of IFRS for U.S. issuers
  - 2014: Large accelerated filers
  - 2015: Accelerated filers
  - 2016: Non-accelerated filers

- Initial filing via Form 10-K, with three years of audited financial statements

- Early adoption permitted in 2009 for certain companies
  - Must be among 20 largest global companies in an industry where IFRS is used more than any other GAAP

IFRS Today

- Required in all EU Countries (since 2005)
- Approximately 40% of Global Fortune 500 companies use IFRS
- Large countries, including Brazil, Canada and India, have announced required adoption.

Differences in Approach

IFRS

- "Principles-based" with limited application guidance
- Approximately 2,500 pages
  - 8 IFRSs
  - 29 IASs
  - 27 Interpretations

US GAAP

- "Rules-based"
  - 168 SFASs
  - 31 APBs
  - 51 Research Bulletins
  - 48 FINs
  - 506 EITFs
  - 55 FASB Staff Positions,
  - Technical Bulletins
  - SOPs
- More than 25,000 pages

Implementation Challenges

Education and Training

- Accountants
- Auditors
- Investors
- Rating agencies
- Analysts

Implementation

- Lack of specific industry guidance
- More judgment and fewer rules
- Moving target

Convergence Efforts by the FASB

- All Statements issued since SFAS 150 address convergence of US GAAP and IFRS
- Each Statement:
  - Provides general background on convergence project
  - Highlights how statement has contributed to convergence goal
  - Identifies significant differences that still exist
  - Indicates those IFRS statements that address the same topics as the FASB statements

IFRS 1

First-time Adoption of International Financial Reporting Standards

- Provides guidance for entities preparing financial statements under IFRS for the first time
- Full retrospective application – prepare financial statements as if the entity had always reported under IFRS
- Opening balance sheet at transition date to IFRS
  - Recognize assets and liabilities required under IFRS
  - Exclude assets and liabilities not allowed under IFRS
  - Classify assets, liabilities and equity components in accordance with IFRS
- Adoption is subject to certain mandatory exceptions and optional exemptions

IFRS 1

First-time Adoption of International Financial Reporting Standards

Optional Exemptions from Retrospective Application(14)

Examples:

- Share-based payments
- Cumulative translation adjustments
- Business combinations
- Leases

Mandatory Exceptions from Retrospective Application(5)

Examples:

- Estimates
- Hedging transactions
- Non-controlling interest

Developing and Managing an Adoption Plan

Project Based

- Preliminary Plan
- Conversion
- Implementation

Preliminary Plan

- What is impact to the financial statements?
  - Identify difficult areas
- What is the impact to other areas?
  - Examples
    - Systems
    - Income taxes
    - Internal controls
- What have our peers done?
- Preliminary report to management
- Begin to develop overall plan and timeline

Conversion

- Assess current policies and procedures
- More in depth analysis of IFRS/GAAP differences
- Finalize analysis of impact to other areas
- Finalize timeline and milestones
- Establish reporting structure
  - Champion
  - Steering committee
  - Project team
    - Project monitoring
    - Status reporting
    - Issue and risk management
- Communication with outside users of financial information
- Top-down approach
- Draft and approve new accounting policies
- Develop training and roll-out plans

Selecting Policies: IAS 8 Hierarchy

Existing IFRS Standards and Interpretations, Appendices & Implementation Guidance

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Management Judgement

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Similar Topics covered by IFRS

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IASB Framework

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Other Standard Setting Bodies

Application of Final Policies

- Quantify the necessary adjustments
- Create IFRS Financial Statement Templates
- Provide for dual reporting and reconciliation
- Prepare the IFRS statements

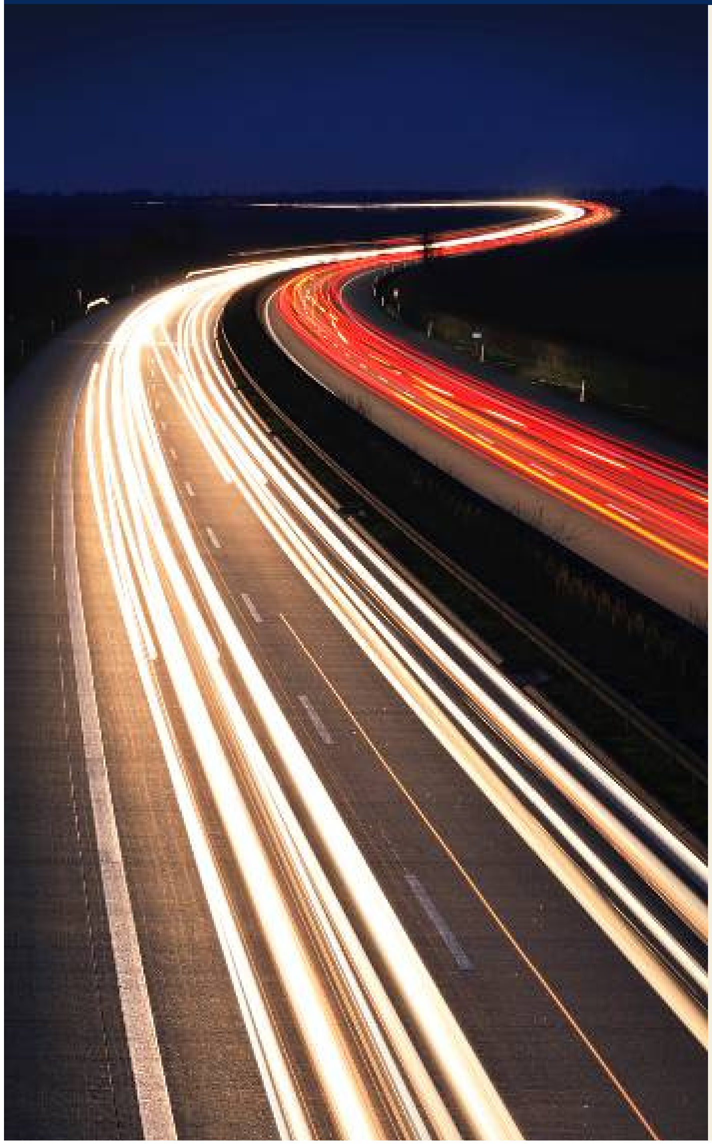
Other Key Elements

- Systems
- Business Processes
- Operational Considerations
  - Internal and External Agreements
- Internal Controls
- Need for Specialists
  - Tax
  - Systems
  - Valuation

Implementation

- Processes must be repeatable and sustainable
- Ensure there is an audit trail
- Address:
  - Management reporting
  - Budgeting and forecasting
  - Regulatory reporting
  - Tax reporting
  - SOX documentation

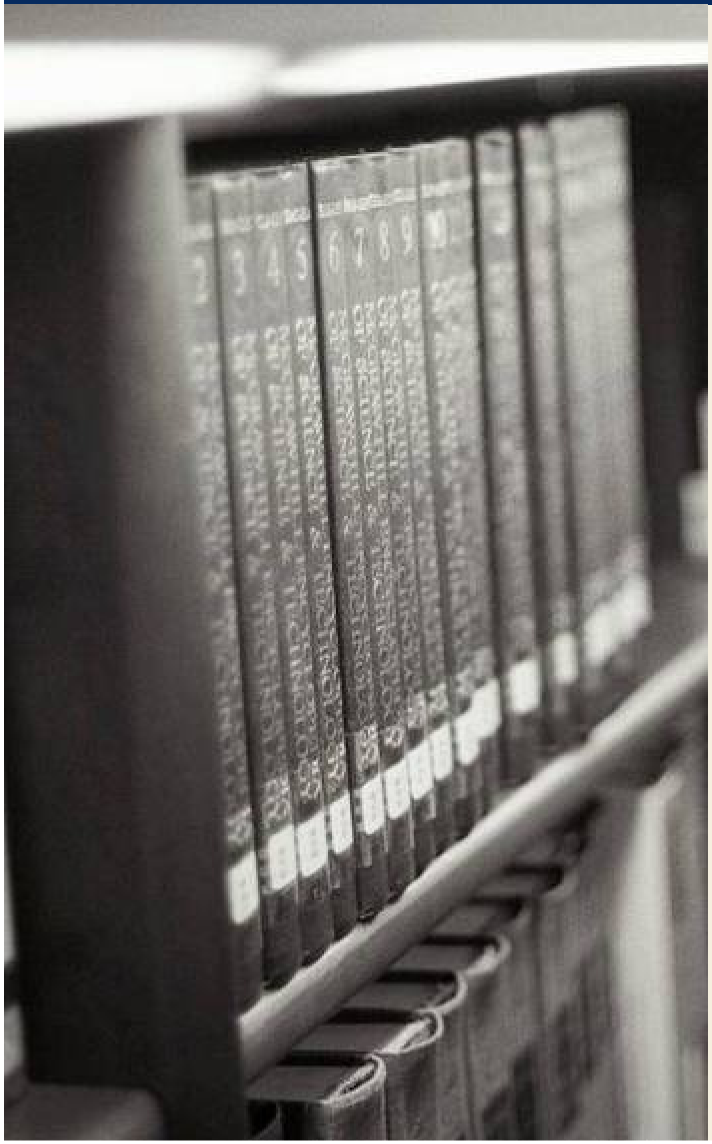
Internal Audit's Role in Convergence



- Member of Steering Committee
- Evaluating impact or controls
- System/process changes
- SOX-404

Key Differences Between IFRS and GAAP

Significant Differences between US GAAP & IFRS



- Financial statement presentation
- Revenue recognition
- Stock based compensation
- Capitalization of development costs
- Inventory accounting
- Business combinations
- Impairment assessments
- Provisions/Contingencies
- Leases
- Convertible instruments
- Accounting for Joint Ventures

Financial Statement Presentation-
Balance Sheet

IFRS	US GAAP
• No reclassification of LT debt subsequently refinanced	• LT debt subsequently refinanced may be classified as ST

Financial Statement Presentation- Income Statement

IFRS	US GAAP
• Can be presented on a functional basis or based on the nature of the expense • No set format	• Can be presented as a single step or multi-step format • SEC requires expense classification on a functional basis

Financial Statement Presentation-
Statement of Cash Flows

IFRS	US GAAP
• Bank overdrafts may be included in cash and cash equivalents • Interest and dividends paid or received are classified as Operating or Financing • Taxes paid usually Operating • Policy election	• Bank overdrafts not classified as cash and cash equivalents. Changes reflected in Financing activities • Dividends paid must be classified in Financing activities. Interest paid, interest received, dividends received, taxes paid classified in Operating

Revenue Recognition

- Multiple element arrangements
- Upfront non-refundable fees
- General right of return
- Contract Accounting
- Sales of Services

Revenue Recognition – Core Criteria

IAS Concepts

- Significant risks/rewards of ownership transferred to buyer
- No continuing involvement with ownership
- Amount of revenue can be measured reliably
- Probable that economic benefits from transaction will flow to enterprise
- Costs incurred or stage of completion can be measured reliably

US GAAP Concepts

- Persuasive evidence of an arrangement exists
- Delivery has occurred or services have been rendered
- Seller's price to buyer is fixed or determinable
- Collectability is reasonably assured

Multiple Element Arrangements

IFRS	US GAAP
• No detailed guidance- however, allocation using relative fair values is acceptable • Amount recognized for each component should not include any amounts contingent on future delivery of additional goods or services • Amount should not exceed amount that seller is contractually entitled to receive • Allows reverse residual method in rare circumstances	• Requires relative fair value approach for allocating consideration to elements of an arrangement when fair values of each element are objectively determinable • Permits residual value method when only fair values of undelivered elements are known

Upfront Non-refundable Fees

IFRS	US GAAP
• An upfront service fee is recognized as revenue when there is no significant uncertainty as to its collection and the entity has no further performance obligations that are linked to the fee	• An upfront fee is not recognized as revenue unless it meets requirements to be treated as a separate unit of accounting in a multiple element transaction

General Right of Return

- Under IFRS, a right of return may not necessarily mean the seller has retained significant risks associated with the products.
  - A seller offering refunds or other general rights of returns would recognize revenue – net of a liability for expected refunds – at the point of sale **provided the seller could make a reliable estimate of future returns based on prior experience**.
  - The amount of the liability recorded would reduce the gross sales revenues reported.

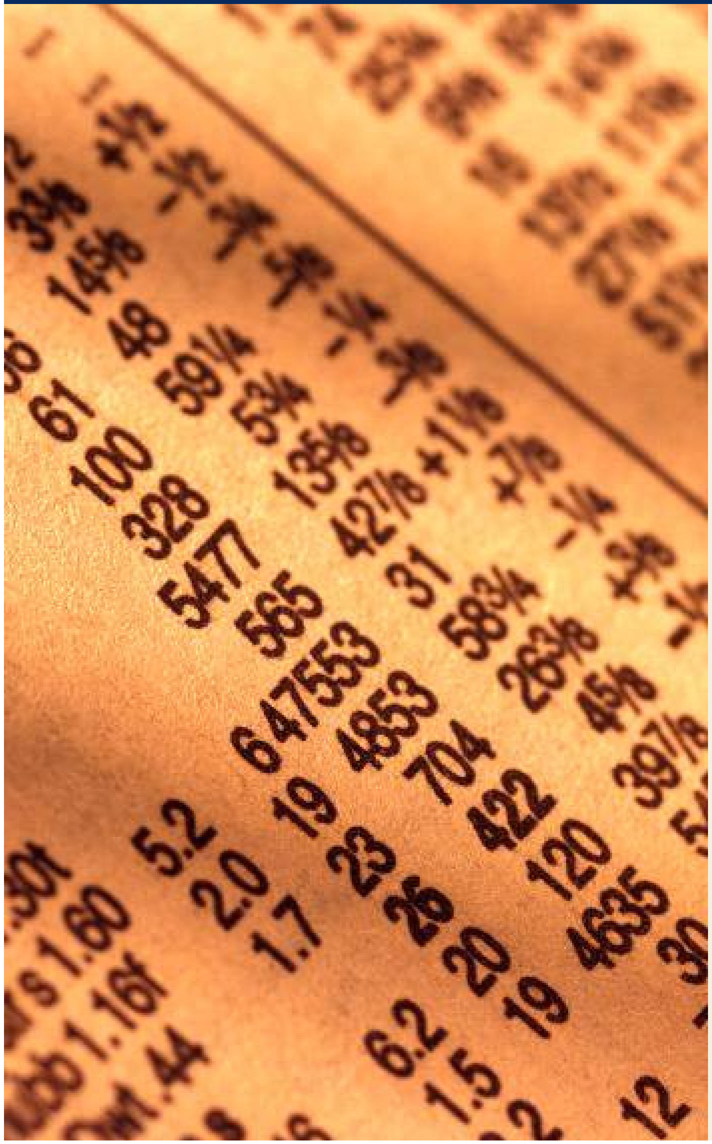
Construction Contracts

IFRS	US GAAP
• Not limited to specific industries • Completed-contract method prohibited • If estimates are unreliable, utilize -0- profit method	• Limited to specific industries • Percentage-of-completion method is preferable • Completed-contract-method is permitted where reliable estimates toward completion can not be made

Sales of Services

IFRS	US GAAP
• Generally requires use of the percentage-of-completion method • When no reliable measure of the outcome, may use zero profit method	• Generally percentage-of-completion method prohibited • Measured under the proportional-performance model or the completed-performance model

Stock Based Compensation



- Front loading of expenses – graded vesting
- Payroll taxes
- Deferred taxes
- Non-employee awards

Capitalized R&D

IFRS	US GAAP
• Development costs must be capitalized (if they qualify for capitalization) and subsequently amortized • Research costs are expensed as incurred	• Both research and development costs must be charged to expense as incurred

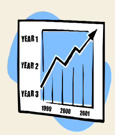
Capitalized R&D

Capitalize development expenditures if, and only if, entity can demonstrate all of the following:

– Technical feasibility

– Intention to complete

– Ability to use or sell



– Probable future economic benefits

– Available resources

– Ability to measure

Inventory

- LIFO
- Reversal of writedowns

LIFO

IFRS	US GAAP
• Use of LIFO is prohibited	• A variety of inventory costing methodologies, such as LIFO, FIFO, and weighted average cost are permitted • For companies using LIFO for US income tax purposes, the book/tax conformity rules also require use of LIFO for book accounting/reporting purposes

Reversals of Write-downs

IFRS	US GAAP
• Reversals of inventory write-downs (limited to the amount of the original write-down) are required for subsequent recoveries	• Reversals of inventory write-downs are prohibited

Business Combinations

- Restructuring provisions
- IPR&D
- Assets and liabilities arising from contingencies

Restructuring Provisions

	IFRS	US GAAP
Previous Guidance	Recognized as part of acquisition only if acquiree has an existing liability at acquisition date.	Recognized as part of acquisition only if specified criteria are met.
Revised Guidance	No change.	Such costs of the acquiree should be recognized if, from acquirer’s perspective, an obligation existed as of the acquisition date under FAS 146.

IPR&D

	IFRS	US GAAP
Previous Guidance	IPR&D recognized if it meets definition of intangible asset and fair value is reliably measurable.	IPR&D expensed immediately unless it has an alternative future use.
Revised Guidance	No change	IPR&D projects are capitalized at fair value, regardless of whether those assets have alternative future use.

Assets and Liabilities Arising from Contingencies

IFRS 3R Guidance

- Recognize <u>contingent liabilities</u> if fair value can be measured reliably
- If not within the scope of IAS 39, measure subsequently at higher of amount initially recognized and best estimate of amount required to settle (under IAS 37)
- <u>Contingent assets</u> are not recognized

FAS 141 R Guidance

- Liabilities and assets subject to contractual contingencies are recognized at fair value
- Other contingencies recognized only if it is more likely than not the definition of an asset/liability is met
- Subsequent measurement of contingent liabilities and contingent assets

Impact

Significant recognition and measurement differences at acquisition date and with respect to subsequent measurement

Impairment

- Cash generating unit vs. reporting unit
- Recoverable amount vs. fair value
- Step approach
- Undiscounted cash flows
- Revaluation
- Reversal

Provisions/Contingencies

- Probability and the recognition of provisions
- Measurement of provisions

Probability and Recognition of Provisions/Contingencies

IFRS	US GAAP
• A contingent liability becomes a provision when three criteria are met: a present obligation from a past event exists, the obligation is probable, and a reliable estimate can be made • Probable means that the outcome is more likely than not to occur (**greater than 50%**).	• An accrual for a loss contingency is required when a present obligation from a past event is probable and reasonably estimable • Probable describes a situation when the outcome is likely to occur (**75% or greater** likelihood of occurrence).

Measurement of Provisions

IFRS

- Amount recognized should be the best estimate of expenditure required
- When there is a continuous range of possible outcomes and each point in that range is as likely as any other, the **midpoint** of the range is used

US GAAP

- Amount recognized should be the best estimate of expenditure required
- When there is a continuous range of possible outcomes and each point in that range is as likely as any other, the **low end** of the range is accrued

Leases-Capital vs. Operating

IFRS	US GAAP
• Focus on the overall substance of the transaction • No bright line tests	• Capital vs. Operating based on the results of 4 part test • Specific thresholds

Leases-Sales Leaseback

IFRS	US GAAP
• If the lease is an operating lease executed at FMV, the full gain would be recognized • No different rules related to real estate	• Generally gain is recognized over the lease term or in proportion to the amortization of the underlying asset in a capital lease • More onerous rules related to real estate sales leaseback

Convertible Instruments

IFRS

- Fixed cash for fixed shares, requires bifurcation with no subsequent re-measurement
- If not fixed cash for fixed shares, considered to be embedded derivative with re-measurement changes recognized through the P&L

US GAAP

- Not bifurcated unless it falls under FSP APB 14-1 or SFAS 133

Accounting for Joint Ventures

IFRS	US GAAP
• Proportionate consolidation OR • Equity method	• Evaluated under FIN 46R • Equity method

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