Disclaimer and attribution

- Nothing in this presentation constitutes legal advice
- Some of the ideas expressed here did not originate with me
- Sources include Deloitte’s May 2008 Faculty Consortium and Todd Markus at Accretive Solutions
Presentation Objectives

- Review status of transition/harmonization efforts
- Provide overview of IASB and IFRS
- Highlight some U.S. GAAP – IFRS principles differences
- Highlight pros and cons
- IFRS-transition challenge: What to do now
40. It is neither possible nor desirable to provide unequivocal criteria to identify the functional currency of foreign entities under all possible facts and circumstances and still fulfill the objectives of foreign currency translation. Arbitrary rules that might dictate the identification of the functional currency in each case would accomplish a degree of superficial uniformity but, in the process, might diminish the relevance and reliability of the resulting information.
Status

- IFRS standards are required or accepted in most other countries
- Accepted, in “pure” form, in the U.S. for foreign private issuers without reconciliation
- SEC is looking to transition some domestic issuers voluntarily to IFRS starting with years ending after December 15, 2009; mandatory application likely between 2014-2016.
- Market developments – domestic political pressure against adoption
- New administration could appoint an SEC chairman who delays IFRS process, but it seems inevitable that it will happen
Structural Overview

- Standards (called IASs and IFRSs) are promulgated by the IASB.
- Currently, there are 41 IASs and 8 IFRSs.
- IASs and IFRSs are typically much shorter than FASB standards (IAS 39 = 72 pages; FASB 133 = 161 pages).
- Interpretations drafted by the IFRIC are ratified by the IASB before publication.
- IASB’s members (14) are appointed by trustees (22) of the IASC Foundation.
- Foundation is governed by its Constitution under which the trustees appoint IASB members and trustees according to a geo rubric: 6-6-6-4.
IFRS Overview

- The IFRS model is based on flexible transparency, not uniformity, “consistency,” or “comparability” across companies and industries.
- The transition to IFRS is not a mere technical accounting exercise.
- It requires a fundamental change in culture and mindset.
- Current U.S. model
  - focuses on technical compliance with bright lines that mathematically yield a single right but arbitrary answer (think operating vs. capital leases).
  - pathological attitude: “show me where it says I can’t do it”
IFRS Overview

In the IFRS “true and fair view” paradigm (found most faithfully in the U.K.), preparers and auditors ask whether a proposed accounting treatment is consistent with a foundational IFRS principle and fairly provides material information to users.
IFRS Overview

- The premium in the IFRS world is on transparency, critical thinking and the ability to explain why a chosen accounting treatment is consistent with principle.
- Finding the “right” answer buried in 25,000 pages of U.S.-GAAP (or another other) code should fade as a key skill set.
Comparisons

- True & Fair View vs. Rule 12b-20
- General valuation method (IAS 16)
- Revenue recognition
- Consolidation policy & method
- R&D
True & Fair View

In the extremely rare circumstances in which management concludes that compliance with a requirement in a Standard or an Interpretation would be so misleading that it would conflict with the objective of financial statements set out in the Framework, the entity shall depart from that requirement in the manner set out in paragraph 18 if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure. IAS 1, para. 17.
18. When an entity departs from a requirement of a Standard or an Interpretation in accordance with paragraph 17, it shall disclose:

(a) that management has concluded that the financial statements present fairly the entity’s financial position, financial performance and cash flows;

(b) that it has complied with applicable Standards and Interpretations, except that it has departed from a particular requirement to achieve a fair presentation;

(c) the title of the Standard or Interpretation from which the entity has departed, the nature of the departure, including the treatment that the Standard or Interpretation would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the Framework, and the treatment adopted;

and

(d) for each period presented, the financial impact of the departure on each item in the financial statements that would have been reported in complying with the requirement.
In addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading. SEC Rule 12b-20 (1965).
TFV example: Société Générale & Jerome Kerviel

- “Rogue” trader scored derivatives gains of €1.471B prior to end of 2007
- Incurred losses of €6.382B in January 2008
- SocGen discovered and measured losses prior to issuance of calendar 2007 financials
- SocGen invoked TFV to record Kerviel’s gains & losses in 2007 financials after getting OK from AMF & two big four firms (see Note 40, p. 107)
- SocGen had previously fully disclosed the entire Kerviel affair
- U.S. & U.K. commentators went nuts, Brits screamed “foul”
SocGen takeaways

- Disclosure transparency is the key
- IFRS means different things to different people
- Different companies and regulators will apply IFRS differently just as they, today, apply national accounting standards differently
- Users need to quit playing “gotcha”; preparers need to quit playing “show me why I can’t do it”
General valuation method

- IAS 16 & 38 permit companies to use historical cost or fair value for property, plant & equipment & intangibles on a class-by-class basis
- U.S. GAAP requires HC except for impairments
- IASs require disclosure of valuation methods for each class
MEASUREMENT AFTER RECOGNITION

29. An entity shall choose either the cost model in paragraph 30 or the revaluation model in paragraph 31 as its accounting policy and shall apply that policy to an entire class of property, plant and equipment.

Revaluation Model

31. After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.

32. The fair value of land and buildings is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified valuers. The fair value of items of plant and equipment is usually their market value determined by appraisal.

39. If an asset’s carrying amount is increased as a result of a revaluation, the increase shall be credited directly to equity under the heading of revaluation surplus. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.

40. If an asset’s carrying amount is decreased as a result of a revaluation, the decrease shall be recognised in profit or loss. However, the decrease shall be debited directly to equity under the heading of revaluation surplus to the extent of any credit balance existing in the revaluation surplus in respect of that asset.
Revenue Recognition

- **Starting points**
  - IAS 18 (37 paragraphs long)
  - FASB [nada]; SAB 104; SOP 97-02; EITF 00-21, etc.

- IASB and FASB began their “joint revenue recognition project” in 2002 to develop a “fair value” model

- Fair value has proven elusive

- Fighting broke out among IASB members over “measurement” and “customer consideration” models
SALE OF GOODS

14. Revenue from the sale of goods should be recognised when all the following conditions have been satisfied:

(a) the enterprise has transferred to the buyer the significant risks and rewards of ownership of the goods;

(b) the enterprise retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;

(c) the amount of revenue can be measured reliably;

(d) it is probable that the economic benefits associated with the transaction will flow to the enterprise; and

(e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.  

(See page 147 of 2007 EU print.)
Coca-Cola Gallon Pushing

CCJC  1996-1999  Coca-Cola Bottlers’ Inventories +62%

Sales of Finished Products to Retailers +11%
A worldwide concentrate inventory reduction is planned during the first half of the year 2000. The inventory reduction will be accomplished by Coca-Cola’s operating divisions, including CCJC, ceasing to sell concentrate to bottlers until bottlers naturally reduced their inventory to optimum levels.

Throughout the past several months, we have worked with bottlers around the world to determine the optimum level of bottler inventory. Coca-Cola’s management and our bottlers, including bottlers in Japan, have jointly determined that opportunities exist to reduce concentrate inventory carried by bottlers. Some bottlers, including those in Japan, have indicated that they intend to reduce their inventory levels during the first half of the year 2000.
Section 13(a) of the Exchange Act requires issuers to file periodic reports with the Commission containing such information as the Commission prescribes by rule. Exchange Act Rules 13a-1, 13a-11, and 13a-13 require, respectively, issuers to file Forms 10-K, 8-K, and 10-Q. Under Exchange Act Rule 12b-20, the reports must contain, in addition to disclosures expressly required by statute and rules, such other information as is necessary to ensure that the statements made are not, under the circumstances, materially misleading. The obligation to file reports includes the requirement that the reports be true and correct. United States v. Bilzerian, 926 F.2d 1285, 1298 (2d Cir. 1991). The reporting provisions are violated if false and misleading reports are filed. SEC v. Falstaff Brewing Corp., 629 F.2d 62, 67 (D.C. Cir. 1980). Scienter is not an element of a Section 13(a) violation. SEC v. Savoy Indus., Inc., 587 F.2d 1149,1167 (D.C. Cir. 1978).
Sections 17(a)(2) and 17(a)(3) of the Securities Act prohibit making untrue statements of fact and misleading omissions of facts in the offer or sale of a security. Section 17(a)(2) specifically proscribes obtaining “money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.” Section 17(a)(3) specifically proscribes engaging “in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.” To constitute a violation of Sections 17(a)(2) and 17(a)(3), the alleged untrue statements or omitted facts must be material. Information is deemed material upon a showing of a substantial likelihood that the misrepresented or omitted facts would have assumed significance in the investment deliberations of a reasonable investor. Basic, Inc. v. Levinson, 485 U.S. 224 (1988). Establishing violations of Sections 17(a)(2) and 17(a)(3) does not require a showing of scienter; negligence is sufficient. Aaron v. SEC, 446 U.S. 680 (1980); SEC v. Hughes Capital Corp., 124 F.3d 449, 453-54 (3d Cir. 1997).
Consolidation policy

- **U.S. GAAP**
  - Primary authority is FASB 94
  - Focus is on legal control of voting shares except for anomalies dealt with in EITF 96-16 & and FIN 46

- **IFRS 27 & 31**
  - Default is legal control of voting shares, however, . . .
  - Focus is on effective control by whatever means
  - An effectively controlled investee is a subsidiary

- **Both**
  - All subsidiaries – except in bankruptcy or acquired with a view toward early disposition to an identified buyer – must be fully consolidated
Consolidation Method

- **U.S. GAAP**
  - Full, line-by-line consolidation for subsidiaries
  - Equity-method for significant influence
  - No official rule for joint ventures; equity method is fall-back

- **IFRS**
  - Full, line-by-line consolidation for subsidiaries
  - Equity-method for significant influence
  - IAS 31 requires proportionate consolidation or equity method for joint ventures
R&D

- U.S. GAAP expenses all R&D (except in limited cases)
- IFRS distinguishes between Research & Development
  - Expenses research
  - Capitalizes development
  - Capitalizes acquired in-process development
Acquired in-process R&D

(a) In accordance with this Standard and IFRS 3 (as revised in 2008), an acquirer recognises at the acquisition date, separately from goodwill, an intangible asset of the acquiree, irrespective of whether the asset had been recognised by the acquiree before the business combination. This means that the acquirer recognises as an asset separately from goodwill an in-process research and development project of the acquiree if the project meets the definition of an intangible asset. 

IAS 38
What the IFRS critics say

- Too many options, too few bright lines
- Too much judgment required
- Insufficient consistency & comparability
- Implementation costs
- Quality of reporting concerns
- IASB too opaque and political
- Who’s going to enforce the rules?
IFRS Proponents respond

- U.S. GAAP has too many bright lines, not enough options
- U.S. GAAP requires too little judgment
- Consistency & comparability are only skin deep anyway (e.g., FASB 52’s functional currency)
- U.S. GAAP is too detailed, too oriented toward accounting academics
- U.S. GAAP-setting process involves too few constituents
- U.S. GAAP has big gaps, slow development process
- IFRS can result in better, more transparent financial reporting – true and fair view
- Current system has multiple sets of accounting standards with no single regulator or enforcer; narrowing it down to one set of standards is a step in the right direction
Making the transition

- Way more than a technical accounting exercise
- Also includes
  - Big shift in culture
  - Major IT ramp-up
  - External relationship issues
  - HR issues
  - Governance issues
Transition Issues

- Accounting policies & procedures; income tax provision
- Application software
- Forecasting & investor relations
- Contracts & loan covenants
- Bonuses, commissions & stock-based compensation
- Internal audit, ERM, board education
What companies should do

- Hold board and C-level discussions now to chart an implementation strategy
- Begin acclimating both accounting and systems staff to IFRS
- Example: Can IT system separately track research and development?
- Can system parallel process in order to deliver three years of financial information in first year of IFRS adoption in public reports?
Additional Sources of Information

- IASPlus.com
- IASB.org
- FASB.org
- SEC’s Office of International Affairs
  - http://www.sec.gov/about/offices/oia.htm
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