

# GAAP and IFRS

## The Convergence and Transition of International Accounting Standards

by A. Bruce Bowden

**T**here are two principal accounting frameworks in use today: generally accepted accounting principles (GAAP), promulgated by the Financial Accounting Standards Board (FASB), which has long been the standard in the United States, and some iteration of the international financial reporting standards (IFRS), promulgated by the International Accounting Standards Board (IASB), which has been the standard in much of the rest of the world. While there are significant variations in IFRS from one country to the next, some form of IFRS is in use in more than 100 countries (and in mandatory use in nearly 30), and by more than 12,000 companies, representing one-third of global market capital.<sup>1</sup>

The accounting communities have recognized the need for the convergence of these standards for a number of years. While the consensus seems to be that uniform worldwide accounting standards are desirable, as always, the devil is in the details. Clearly, the review of financial statements, whether by a corporate development vice president, a general counsel, an investment banker, an analyst or a transactional lawyer, should be based on a common set of assumptions, so that financial statements truly are comparable. FASB and IASB have agreed on a plan to eliminate differences between GAAP and IFRS and move toward a single accounting standard in a 2002 memorandum of understanding, referred to as the Norwalk agreement (after the Connecticut city where it was reached).<sup>2</sup> Some progress has been made on both sides, and the current work plan for convergence continues through 2011, with extension of that date a possibility.

Multinational public companies registered with the U.S. Securities and Exchange Commission (SEC), whose accounts are prepared predominantly based on IFRS, are already allowed to file those accounts with the SEC without a GAAP reconciliation. There is now a roadmap intended to lead to the SEC's adoption of a modified version of IFRS for all U.S. reporting companies.<sup>3</sup> If the seven milestones set forth in the roadmap are achieved by

2011, U.S. reporting companies could be required to file IFRS-based statements with the SEC beginning in 2014. The SEC appears to have an open mind on the subject, but it has not committed to adopting IFRS.<sup>4</sup> In any event, transition will take time, since the financial reporting norm is to show the year just ended with the prior year or years on the same basis. Moreover, whatever accounting standard eventually is required of public or reporting companies, the accounting profession is likely to apply that standard to private companies as well.

### Why is Convergence Important?

The importance of convergence is best illustrated by way of examples. For instance, take a merger or joint venture involving a U.S. company that applies GAAP accounting, and a European Union company that applies IFRS. Whether each partner's share of the combined entity is based on its contribution to that entity of assets or of income, or earnings before interest, taxes, depreciation, and amortization (EBITDA), calculating those contributions on different assumptions could result in one partner receiving a disproportionately low or high share of the combined entity.

What about an employment policy that rewards managers of various profit centers in different countries with compensation based on their respective center's contributions to profitability? If profits are based on differing accounting standards, some managers may be overcompensated and others undercompensated.

What about a multinational company with businesses in both GAAP and IFRS countries, which is trying to monitor and manage the profitability of those businesses? Are the results reported to senior management really comparable? Does senior management really know which businesses are more profitable?

What about financing transactions in which the multinational borrower's covenants include covenants based on its financial statements, and breach of covenant is a default on

the loan? Whether or not these covenants are satisfied may vary, depending upon which accounting standard is applied to which part of the borrower's business.

And what about transactions or policies adopted under GAAP that then must play out under IFRS, such as a compensation plan driven by earnings per share, or return on assets or investment; an acquisition involving an earn-out; or a dividend policy based upon the adequacy of income or reserves? These are just a handful of the many issues raised by the use of two standards.

### **What Are the Differences Between GAAP and IFRS?**

At a broad, conceptual level, IFRS may be viewed as a 'principles-based' standard. GAAP, on the other hand, which has been in use longer than IFRS and is much more extensive and detailed, may be viewed as a 'rules-based' standard.

Turning from concept to detail, there are many differences between the two, which cannot be addressed in an article of this length. Some of the more significant differences, however, which affect income, asset value, or both, are identified here. While this discussion may be an oversimplification, the intent of this article is to flag issues rather than turn the reader into an accountant.

#### ***Inventory***

With respect to income and assets, GAAP recognizes the concept of 'last in, first out' (LIFO) accounting for inventory. Where a business purchases raw materials, LIFO assumes the last raw material purchased is the first one used in making a product. In a period of rising material costs (which, with the exception of microprocessors, is typical in recent years), the LIFO approach maximizes the cost of goods, which reduces both income and income taxes, and minimizes the value of raw material inventory on the balance sheet. IFRS does not recognize LIFO

accounting, but instead requires FIFO, or first in, first out, accounting for inventory.

If two companies in the same business are compared, one applying GAAP accounting and one applying IFRS accounting, the GAAP reporting company arguably could be said to be underreporting its income and assets, while the IFRS reporting company could be said to be overstating them. The GAAP-based company, however, is likely to pay lower income taxes on a comparable amount of business. Nonetheless, the income statements and balance sheets of the two will not be comparable.

#### ***Revenue Recognition***

Revenue recognition also is not the same under GAAP and IFRS. A GAAP-compliant client's earnings can appear to the business lawyer to be considerably understated. A good illustration in this regard is a medical device, including hardware, software and a year of free warranty service. Under GAAP, the manufacturer/seller may be unable to recognize any income on the product sale until the warranty period has expired. IFRS, on the other hand, adopts a more practical and realistic approach, looking at whether: 1) significant risks and rewards of ownership have been transferred to the buyer, 2) any economic benefits of the transaction will flow to the customer, 3) the seller retains any management or control over the goods sold, and 4) the price and costs of the transaction can be reliably measured—looking more to the substance of the transaction rather than simply relying on detailed rules and a strict checklist.

#### ***Leases***

IFRS accounting for leases, whether they are treated as operating leases or capital leases, similarly relates to the overall substance of the transaction. Under GAAP, there is a rules-based test based on ownership transfer, lease term relative to actual economic life of the

asset, present value of minimum lease payments compared to actual value of the asset, etc. The more substance-oriented IFRS approach may allow greater flexibility in treating a lease as operating, with lease payments treated as expense that reduces income.

#### ***Research and Development***

Research and development costs related to a company's ongoing operations are generally expensed as incurred under GAAP. While IFRS also treats research costs as expense, development costs generally are capitalized. Comparing similar companies under GAAP and IFRS, the GAAP-reporting company will charge more of research and development to expense, and thus report somewhat lower earnings than the IFRS-reporting company.

#### ***Equity Compensation***

Equity compensation (option grants, share grants subject to deferred vesting, etc.) can be treated differently under IFRS accounting than under GAAP accounting. The rules are complex, but, in general IFRS offers more flexibility in accounting for share-based compensation.

#### ***Investment Property***

Under GAAP, property held for investment must be carried on the company's books at its historical cost. IFRS offers historical cost as one basis for reporting. It also provides the alternative of reporting the asset at its fair value. As fair value changes from time to time, the IFRS reporting company will charge gains and losses to its income statement. Thus, there will be some volatility in the IFRS reporting company's income statement, which a comparable GAAP company would not experience.

#### ***Equipment***

Under GAAP, property, plant and equipment used in the ongoing business of a company, once acquired and val-

ued, will be depreciated over the estimated useful lives of the various items. IFRS recognizes different useful lives for various components of a single asset (for example, the structure of a building and its roof, which may have a shorter life than the structure). In some circumstances, IFRS may permit reevaluation of a depreciable asset during its life, which is not permitted under GAAP.

### **Impairment**

When the value of an asset is less than the amount at which it is carried on the balance sheet, the asset is said to be impaired. Impairment may occur either as a result in a change in the market for the asset, or from the asset ceasing to be used in the company's ongoing business and being held for sale. While both GAAP and IFRS anticipate that impairment will be tested from time to time, valuation under IFRS can move up and down. Under GAAP, impairment, once recognized, cannot be decreased. Thus, in circumstances in which markets, and hence asset values, recover, the amount attributed to the asset on the balance sheet will stay more aligned with market value under IFRS than under GAAP. Stated differently, impairment can increase and net value of an asset can decrease under GAAP, but net value under IFRS can either increase or decrease as market forces dictate.

### **Conclusion**

Lawyers must be prepared to advise clients and draft agreements and plans with the understanding that IFRS could come along at some future time—as early as two years from now, and before the plans and agreements on which the lawyer is working have been fully performed, changing some of the basic assumptions under which the plans and agreements were prepared and approved. Agreeing on the effect the adoption of IFRS will have on a plan or agreement now is preferable to arguing

about it in the future. This advice is especially timely for U.S.-reporting, multinational clients electing to make the change to IFRS earlier, as the SEC, in some cases, permits.

To further complicate the issue, tax accounting is often inconsistent with financial accounting, and it is by no means certain that if IFRS becomes the world financial accounting standard, which of the many taxing bodies in the world will follow IFRS principles. The codification of GAAP accounting standards, recently issued and effective with respect to financial statements for periods ending after Sept. 15, 2009, provides an additional reason for addressing accounting issues with clients sooner rather than later. ☞

### **Endnotes**

1. Speech by SEC Chairman Christopher Cox, Proposing a Roadmap Toward IFRS, Washington, D.C., Aug. 27, 2008, [www.sec.gov/news/speech/2008/spch082708cc\\_ifrs.htm](http://www.sec.gov/news/speech/2008/spch082708cc_ifrs.htm).
2. Memorandum of understanding (the Norwalk agreement) [www.fasb.org/news/memorandum.pdf](http://www.fasb.org/news/memorandum.pdf).
3. [www.sec.gov/rules/proposed/2008/33-8982.pdf](http://www.sec.gov/rules/proposed/2008/33-8982.pdf).
4. Cox speech, see endnote 1.

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