SECOND EDITION

International Financial Reporting Standards:

An Introduction

Belverd E. Needles, Jr.

Marian Powers

International Financial Reporting Standards: An Introduction

Belverd E. Needles, Jr.
DePaul University

Marian Powers
Northwestern University

SECOND EDITION

SOUTH-WESTERN
CENGAGE Learning™

Australia • Brazil • Japan • Korea • Mexico • Singapore • Spain • United Kingdom • United States

SOUTH-WESTERN
CENGAGE Learning™

International Financial Reporting Standards: An Introduction, Second Edition
Belverd E. Needles, Jr., and Marian Powers

Vice President of Editorial, Business: Jack W. Calhoun

Editor-in-Chief: Rob Dewey

Acquisitions Editor: Matt Filimonov

Developmental Editor: Julie Warwick

Reprint Buyer: Nancy Stamper

Production Manager: Jean Buttrom

Manufacturing Buyer: Doug Wike

Marketing Manager: Natalie Livingston

Content Project Manager: Sathyabama Kumaran (Pre-Press PMG)

Production House/Compositor: Pre-Press PMG

Senior Art Director: Stacy Shirley

Cover Designer: Lou Ann Thesing

Cover Image: © Getty Images/Photolibrary

Library of Congress Control Number: 2010922531
ISBN-13: 978-0-538-47680-5
ISBN-10: 0-538-47680-X

South-Western Cengage Learning
5191 Natorp Boulevard
Mason, OH 45040
USA

Cengage Learning products are represented in Canada by Nelson Education, Ltd.

Printed in the United States of America
1 2 3 4 5 6 7 13 12 11 10

TABLE OF CONTENTS

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) 1

The Global Momentum for IFRS 1
Using International Financial Reporting Standards (IFRS) in the Classroom 2
Acknowledgments.. 3

I. BACKGROUND OF IFRS 4

The Origin of International Accounting Standards (IAS) 4
The Road to IFRS in the United States.. 7
Bumps in the Road for IFRS in the United States.. 9
Conclusion 11

II. IFRS FRAMEWORK AND FINANCIAL STATEMENTS 13

Overview of IFRS 13
Framework for the Preparation and Presentation of Financial Statements 14
Example IFRS Financial Statements 18
Proposed Presentation of Financial Statements.. 23

III. KEY DIFFERENCES BETWEEN IFRS AND U.S. GAAP 34

Principles-Based vs. Rules-Based Standards 34
Income Measurement 34
Fair Value Measurements.. 35
Revenue Recognition 36
Provisions.. 38
Comprehensive Income and Recycling 38
Inventories 38
Property, Plant, and Equipment 39
Impairment.. 41
Research and Development Costs 42
Equity 43
Share-Based Payments.. 43
Consolidation 44

IV. IFRS FOR SMALL- AND MEDIUM-SIZED ENTITIES 47

IFRS for SMEs Defined and Described... 47
“Full IFRS” and “IFRS for SMEs” Compared and Contrasted 49
Summary, Resources, and Transition.. 50

V. THE CURRENT STATUS AND FUTURE OF IFRS 52

Remaining Differences Between U.S. GAAP and IFRS 53
Transitioning to IFRS 54

The Prospects for IFRS for SMEs 55
Implications for Accounting Education 55

APPENDIX A: COMMON ACRONYMS **57**

APPENDIX B: IFRS TIMELINE **58**

APPENDIX C: CURRENT IFRS AND IAS **59**

APPENDIX D: SELECTED WEBSITES WITH IFRS RESOURCES **60**

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

THE GLOBAL MOMENTUM FOR IFRS

For most of financial history, companies have issued financial statements based on the accounting standards of the country in which they are headquartered. As growth in the global economy expanded, companies operating worldwide became a powerful force behind efforts to achieve more uniformity in financial reporting. International Financial Reporting Standards (IFRS) are accounting standards set by the International Accounting Standards Board (IASB), headquartered in London. Worldwide, IFRS are now the most common basis of financial reporting. Over 15,000 companies outside of the United States currently use IFRS, and another 12,000 will likely adopt IFRS by 2012. Many foreign-based subsidiaries of U.S. multinationals operate in IFRS countries and thus prepare IFRS financial statements. With more of the world using IFRS, expectations are that the United States will follow.[1]

Through a process called *convergence*, the IASB is working with the U.S. Financial Accounting Standards Board (FASB) and other national bodies to achieve identical or nearly identical standards worldwide. The chair of the IASB predicts that by 2011 or 2012, U.S. standards and IFRS will have *converged*, that is, become much the same and that perhaps 170 countries in total will be using either U.S. standards or IFRS.[2]

An alternate approach to conversion where U.S. GAAP and IFRS gradually come together is *adoption,* under which the United States would adopt IFRS. This latter approach is the most common approach in other parts of the world[3] and one that the Securities and Exchange Commission (SEC) in the United States pushed forward in 2007–2008 in two major ways:

- First, the SEC voted in November 2007 to allow foreign registrants in the United States to file financial statements prepared in accordance with IFRS as issued by the IASB. This change means the SEC no longer requires foreign registrants using IFRS as issued by the IASB to reconcile the differences between their financial statements and their statements using U.S. GAAP. Approximately 10 percent of all publicly listed companies in the United States are potentially impacted.[4]
- Second, the SEC approved in August 2008 and released in December 2008 a "roadmap," or timetable, that may lead to mandated use of IFRS by U.S. companies. This timetable permitted selected large U.S. companies to voluntarily begin using IFRS in 2009. The roadmap stated that other companies would follow, if certain milestones were met, in stages beginning in 2014. In February 2010, the SEC confirmed the roadmap but extended the possible start date to 2015.[5]

[1] Common acronyms used in this publication are listed in Appendix A.

[2] David Tweedie, "Simplifying Global Accounting," *Journal of Accountancy,* July 2007.

[3] As will be seen in a later chapter, countries that "adopt" IFRS often make some exceptions to accommodate their country's practices.

[4] Securities and Exchange Commission, Concept Release on Acceptance from Foreign Private Issuers of Financial Statements Prepared with International Accounting standards without Reconciliation to U.S. GAAP (Corrected), August 7, 2007.

[5] Securities and Exchange Commission, Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by US Issuers, August 2008, revised February 2010.

The SEC enthusiasm for this approach cooled somewhat in early 2009 under the new administration; but by the end of the year, the Chair of the SEC was again talking positively about the "goal of a global set of high-quality accounting standards."[6] Further, the leaders of the Group of 20, or G-20 (the leading economies of the world including the United States and countries such as Brazil, India, Russia, and China), urged international accounting setters "to redouble their efforts to achieve a single set of high-quality, global accounting standards through independent standard-setting process and complete their convergence project by June 2011."[7]

Even if one concludes that the IASB chair's convergence prediction and the SEC roadmap are overly optimistic, IFRS are now permitted in the United States for privately-held companies. In May 2008, the governing council of the American Institute of Certified Public Accounts (AICPA) amended its Code of Professional Conduct to recognize the IASB as issuing high-quality standards on par with the FASB.[8] The result is that privately-held companies may now choose IFRS as the basis for preparing financial statements. Further, the newly issued and scaled-down IFRS for small- and medium-sized entities (SMEs) provide an attractive option currently for privately held U.S. companies.

USING INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) IN THE CLASSROOM

Over the next few years, IFRS will likely increase in importance in both the United States and globally. Therefore, all business and accounting professionals must be knowledgeable about IFRS and their potential impact.[9] In a joint effort, KPMG and AAA surveyed members of the American Accounting Association.[10] The 500 professors who responded expressed an urgency for getting IFRS into the curriculum:

- 75 percent think IFRS should immediately be incorporated into curriculum.
- 70 percent said their most significant challenge in teaching IFRS is making room for it in the curriculum.
- 79 percent believe U.S. GAAP should be taught over the next 3–5 years, progressively increasing IFRS coverage.
- 40 percent believe the first class of IFRS-ready students will be 2015.

Our objective of this introduction to *International Financial Reporting Standards (IFRS): An Introduction* is to address this need through the following topic chapters:

1. The history and background of IFRS, including perceived benefits and shortcomings
2. The framework of IFRS, their general relationship to U.S. GAAP, annotated IFRS financial statements for a real company, and the proposed future structure of financial statements

[6] Quoted in *Accountancy Age,* October 9, 2009.

[7] KPMG, Department of Professional Practice, "G-20 Leaders Call For A Single Set of High-Quality Global Accounting Standards by 2011," *Defining Issues*, September 2009.

[8] American Institute of CPAs, "AICPA Council Votes to Recognize the International Accounting Standards Board as a Designated Standard Setter," News Release, May 18, 2008.

[9] Refer to Appendix B for a timeline of past and projected developments of IFRS since the formation of the IASB.

[10] "Accounting Professors Urge IFRS Education", *WebCPA*, September 22, 2009.

3. Key technical differences between U.S. GAAP and IFRS
4. IFRS for small- and medium-sized companies (SMEs)
5. The current status of IFRS

International Financial Reporting Standards (IFRS): An Introduction provides business students—who will graduate into an IFRS world—with a sufficient awareness of the key issues and differences between U.S. GAAP and IFRS. Further, it provides accounting students with sufficient knowledge of IFRS to accomplish two important goals:

- To be *IFRS-ready* for internships and full-time position with accounting firms
- To be *CPA Exam–ready* for the CPA Examination, which will contain IFRS questions as of 2011

International Financial Reporting Standards (IFRS): An Introduction is intended to be used with any textbook in beginning or intermediate accounting courses or in any other course in which the instructor wants students to have more than a superficial knowledge of IFRS. We recommend choosing one of the following two strategies:

Strategy 1: IFRS as an instructional unit of one to two weeks toward the end of the course. This strategy is not difficult to implement because it does not disrupt traditional coverage, and is perhaps easier to assess.

Strategy 2: Integrate IFRS topics at appropriate points throughout the course. This strategy facilitates the transition to IFRS, promotes discussion of issues, and reflects the convergence underway, but is takes more effort to implement.

> Assign Chapter 1 and 2 in one class toward the beginning of the course and integrate the topics in Chapter 3 and 4 as they are covered in the course. Cover Chapter 5 as a wrap-up.

For classroom use, we provide solutions to the assignments as well as a PowerPoint slide presentation.

In light of the constant change in and the development of IFRS taking place, we view this publication as a *living* document subject to frequent revision. As a result, we welcome user feedback about its content and usefulness. Please direct your suggestions to the authors.

ACKNOWLEDGMENTS

We are very appreciative of the tremendously positive feedback from numerous accounting educators who have read and used this booklet and who have attended our IFRS seminars and workshops. Thanks to those who have offered constructive suggestions. Thanks also to our colleagues at DePaul University for their encouragement and the Illinois CPA Society for its support of IFRS education for academics through the Education Summit. We appreciate the support without hesitation by our editors at Cengage Learning, South-Western. Finally, we acknowledge our assistant, Sunjin Park, for his valuable aid in researching and producing the manuscript. We also thank Daniel Li and Abigail Needles for their assistance in preparation of the instructor resources.

I. BACKGROUND OF IFRS

The goal of converging U.S. accounting standards and international standards is not of recent origin. The history of IFRS, the movement toward convergence of U.S. GAAP and IFRS, and the arguments for and against the adoption of IFRS for public companies in the United States are explored in this chapter.

THE ORIGIN OF INTERNATIONAL ACCOUNTING STANDARDS (IAS)

International Accounting Standards (IAS) stem from the establishment of the **International Accounting Standard Committee Board (IASC)** in 1973 by the professional accountancy bodies of Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and Ireland, and the United States. These bodies were members of the **International Federation of Accountants (IFAC)**, which by 1997 had 119 members from 88 countries. The IASC members were part-time and paid by the member bodies. The IASC's objectives were:

- To formulate and publish in the public interest standards to be observed in the presentation of financial statements and to promote worldwide acceptance and observance
- To work generally for the improvement and harmonization of regulation, accounting standards and procedures relating to the presentation of financial statements[1]

The IASC issued about forty standards and worked for their acceptance. However, IAS was criticized as permitting too many alternative treatments intended to satisfy the great variation in accounting practices among all the members. In fact, the IASC clearly stated that it "endeavors not to make the International Accounting Standards so complex that they cannot be applied effectively on a worldwide basis." And that the standards are not created to "override the local regulations . . . governing the preparation of financial statements in a particular country."[2] In response to criticism, the IASC began work on revising the current standards into a set of "core" standards that allow fewer alternatives.

The FASB in the United States first formally expressed interest in international standards when it issued a plan for a global focus on standard setting in 1991. Prior to this time, consideration of accounting standards in other countries was not a focus of the FASB. The FASB began to collaborate with the IASC and became a founding member of the G4+1. The G4+1 was a working group consisting of standard setters in the United Kingdom, Canada, the United States, and Australia, plus the IASC. Working outside the standard setting process, the G4+1 issued policy papers related to global accounting standards. By 1998, a set of core standards had been generally agreed upon. Nevertheless, the core standards were still widely considered too broad with little specificity to various cultures. The G4+1 believed that the IASC required a full-time independent board. Consequently, among the most important policy papers by the G4+1 is one that urged the restructuring of the IASC to make it more independent of the member bodies.[3]

---

[1] International Accounting Standards Committee (IASC), *International Accounting Standards Explained* (West Sussex, UK: John Wiley & Sons, 2000), 5.

[2] IASC *Constitution* (1992).

[3] Donna L. Street, "The Impact in the United States of Global Adoption of IFRS," *Australian Accounting Review* 18, no 3 (2008), 200.

The initiative of the G4+1 led eventually to formation of the IASB in 2001. The IASB chair emphasized the historical importance of cooperation in the formation of the IASB in the following statement:

> [T]he SEC and the FASB were deeply involved in the establishment of the restructured IASB, and the structure, governance, and independence of the IASB are largely modeled on the FASB's.[4]

The International Accounting Standards Board (IASB) is an independent standard-setting board and does not represent any particular country, and is not part of any other international bodies such as IFAC.[5] The structure and oversight of the IASB is shown in Figure 1–1. Members of the IASB work full-time and must give up affiliations to other organizations. Its organization is illustrated in Figure 1–1. The goal of the IASB is "to provide the world's integrating capital markets with a common language for financial reporting." Its output is intended to be high quality, enforceable, global standards.[6]

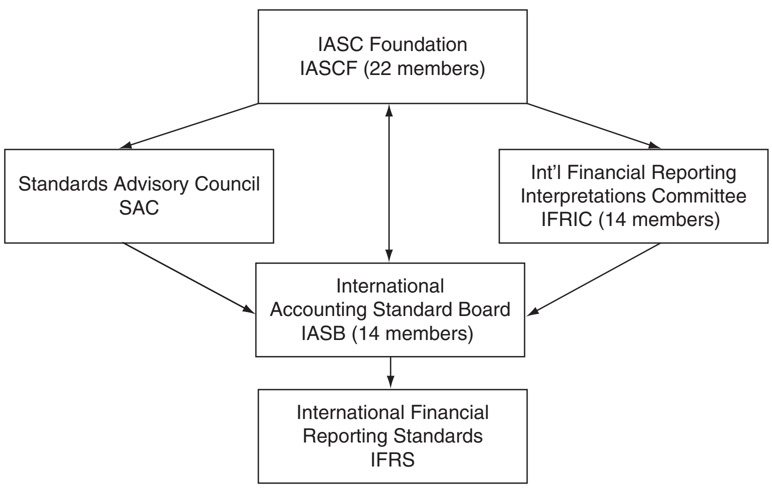

Figure 1–1: Structure and Oversight of the IASB

Appointing and overseeing the IASB is the **IASC Foundation (IASCF)**, a not-for-profit, private sector body consisting of a geographically and professionally diverse group of twenty-two trustees who are accountable to the public interest. To support the IASB's budget of about $24 million in 2008, the IASCF raises funds from thousands of professional bodies who benefit from the standards and by mandatory levies for listed and non-listed companies in many countries. It also receives official support from relevant regulatory authorities. Further, the IASCF also appoints support committees to the IASB, such as the **International Financial Reporting Interpretation Committee (IFRIC)** and the **Standards Advisory Council (SAC)**. The IFRIC issues interpretations of IFRS, using due process, when divergent practices have

[4] David Tweedie, "Simplifying Global Accounting," *Journal of Accountancy,* July 2007.

[5] This section is development from information on the International Accounting Standards Board website, http://www.IASB.org/.

[6] International Accounting Standards Board (IASB), *Preface to International Financial Reporting Standards* (http://www.eIFRS.org).

emerged regarding the accounting for particular transactions or circumstance or when there is doubt about the appropriate accounting treatment. The SAC, which consists of a wide range of representatives from user groups, financial analysts, academics, auditors, regulators, and professional accounting bodies, advises the IFRS on a broad range of issues, including the IASB's agenda and work program. The SAC also reports to the IASC Foundation on its work and its evaluation of the IASC.

IFRS are developed through the due process illustrated in Figure 1–2. Steps followed in achieving due process are as follows:

1. The IASB and staff set an agenda of possible issues to be addressed by IFRS.
2. Once an issue is deemed worthy of study, the project is planned including deciding if it will be a joint project with other bodies such as the FASB.
3. After research and discussion by the IASB and staff, a discussion paper (DP) is prepared for public discussion.
4. After considering all comments and additional proposals to its DP, the board may issue an exposure draft (ED) for further public consideration, as in step 1.
5. These further comments are considered. IASB may at this point publish a final IFRS to be considered for adoption in the various jurisdictions.
6. After two years, a post-implementation review of the IFRS is conducted by the board.

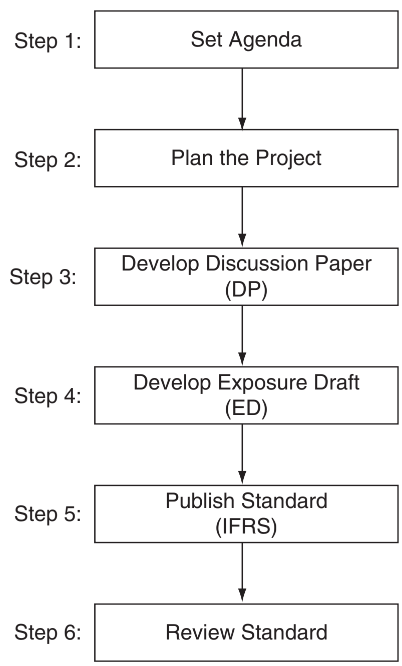

Figure 1–2: Due Process

This thorough, open, and transparent process led to widespread acceptance of IFRS throughout the world. The European Union mandated use of IFRS for companies engaged in international markets beginning with 2005 financial statements. Germany's adherence was deferred until 2007. Also, by 2007, Australia, Brazil, Canada, Chile, India, Korea, and New Zealand, among others, have adopted IFRS or issued timelines to adopt or converge with IFRS. In a landmark decision, Japan adopted a "roadmap" or timeline that permits early adoption of IFRS by listed companies for fiscal years beginning April 1, 2009. The roadmap mandates adoption of IFRS from 2016, subject to a final decision being taken by 2012.[7] Today, more than 100 countries require or permit the use of IFRS. The United States is the only major country to not formally commit to the adoption of IFRS.

THE ROAD TO IFRS IN THE UNITED STATES

As noted in the introduction, two approaches have emerged for the use of IFRS by public companies in the United States: convergence or adoption. Under *convergence*, the FASB and IASB commit to work in tandem to achieve compatibility of U.S. GAAP and IFRS. The FASB remains the standard setter for U.S. public companies and over time the U.S. GAAP and IFRS move closer to each other. Convergence will not necessarily result in identical standards since each board is issuing its own standards. Under *adoption*, the SEC mandates that U.S. companies must begin using IFRS as issued by the IASB as of a certain date. As a result, the IASB becomes the principal standard setter for U.S. public companies. Unless specific exceptions are made, U.S. companies will use the same standards as used in other countries.

The FASB and the IASB have worked diligently toward convergence. They mutually issued a **Memorandum of Understanding (MOU)** in 2002 that laid out a joint commitment of cooperation:

- To make their existing financial reporting standards fully compatible as soon as is practical
- To coordinate future work programs to ensure that once achieved, compatibility is maintained[8]

The two bodies reaffirmed their commitment to convergence in 2005. Also, in that year the SEC joined with the **European Commission (EC)** with a similar goal by producing a *Roadmap to Convergence* agreement. The roadmap specified the steps needed before the requirement for foreign registrants reporting to reconcile their statements' net income and stockholders' equity to U.S. GAAP could be eliminated. A New York City report suggested the city may lose its world financial center status within ten years without a major shift in policy and regulation, including recognition by the SEC of IFRS without the reconciliation for foreign SEC registrants and the promoting of global converge of accounting standards.[9] This action eliminates unnecessary costs and removes a barrier for foreign issuers. Companies, investors, rating agencies, accounting firms, and others echoed these sentiments leading to the SEC decision in November 2007 to drop the reconciliation requirement for foreign registrants that used IFRS.[10]

Consideration of IFRS by the SEC has focused on adoption of IFRS. Since March 2007, the SEC has held three roundtables to examine IFRS. In August 2008, the SEC voted to publish for public comment a proposed *Roadmap* that could lead to the adoption of IFRS by U.S. issuers beginning in 2014, with all public companies required to comply by 2016. The decision whether to mandate IFRS for U.S. public companies is expected in 2011. The SEC believes that a common

[7] "Japan Approves Roadmap for IFRS Adoption," Press Release, International Accounting Standards Board, June 17, 2009.

[8] Memorandum of Understanding between the FASB and the IASB, September 2002.

[9] Charles Schumer and Michael Bloomberg, "Sustaining New York's and The US' Global Financial Services Leadership," 2007, http://www.senate.gov/schumer.

[10] Donna L. Street, "The Impact in the United States of Global Adoption of IFRS," *Australian Accounting Review*,18, no 3 (2008), 200–201.

accounting language around the world could give investors greater comparability and greater confidence in the transparency of financial reporting worldwide.[11] A common accounting language may potentially lower the cost of capital and avoid the cost of preparing statements on multiple accounting standards. The roadmap sets out a series of milestones that, if achieved, could lead to the positive decision, as follows:

- Improvements in accounting standards
- Accountability and funding of the IFSC Foundation
- Improvement in the ability to use interactive data for IFRS reporting
- Education and training in the United States relating to IFRS
- The anticipated timing of future rulemaking by the commission
- Potential implementation of the mandatory use of IFRS, including considerations relating to whether any mandatory use of IFRS should be staged or sequenced among groups of companies based on their market capitalization

The IASB and FASB reaffirmed their commitment to the MOU in November 2009 with a joint statement describing their milestone targets for completing the major MOU projects in 2011.[12]

Most arguments supporting use of IFRS by U.S. public companies favor large global companies and large CPA firms, as follows:[13]

1. IFRS would enhance transparency and comparability among companies globally, thus, enabling investors and other users to more readily assess performance and to make comparisons among companies, especially in such industries as banking, insurance, motor vehicles, pharmaceuticals, and telecommunications. A survey of 200 CFOs of global companies found strong support for IFRS. The survey concluded that IFRS would transform the finance function and create value for companies by:
   - Mitigating financial reporting risk
   - Decreasing financial transparency risk
   - Creating operational efficiencies[14]
2. IFRS present opportunities for global U.S. companies to lower costs through standardization of financial reporting, centralization of processes, improved controls, and better cash management.
3. Research would appear to show that U.S. companies would benefit financially from adoption of IFRS. It shows that adoption of IFRS result in *improvements* in liquidity, valuation and cost of capital for companies in countries with relatively strict enforcement regimes and where the institutional environment provides incentives for more transparent earnings, such as you would find in the United States. In countries with weak enforcements and poor reporting incentives, the introduction of IFRS has no effect.[15]

---

[11] Securities and Exchange Commission, "SEC Proposes Roadmap toward Global Accounting Standards to Help Investors Compare Financial Information More Easily," SEC press release, 2008, 184.

[12] IASB, "IASB and FASB Reaffirm Commitment to Memorandum of Understanding," press release, November 10, 2009.

[13] Donna L. Street, "The Impact in the United States of Global Adoption of IFRS," *Australian Accounting Review* 18, no 3 (2008), 199–208.

[14] Survey reported by Accenture, March 31, 2009.

[15] Holger Daske, Luzi Hail, Christian Leuz, and Rodrigo Verdi, "Mandatory IFRS Reporting around the World: Early Evidence on the Economic Consequences." *Journal of Accounting Research* 46, no. 5 (2008): 1085–1142.

4. All SEC registrants would provide the IFRS option, not just foreign filers, thus, increasing U.S. companies' competitiveness in global capital markets and lowering their cost of capital.[16]
5. Adoption of IFRS by the SEC would give public companies the same option that private, nonpublic companies now have since the AICPA approved their use. Small- and medium-sized companies (SMEs), outnumber public companies in the United States by a factor of 200 to 1. The recent issuance of a condensed set of IFRS for SMEs by the IASB (see Chapter 4) made IFRS even more attractive for use by nonpublic U.S. companies.

BUMPS IN THE ROAD FOR IFRS IN THE UNITED STATES

The momentum for convergence or adoption of IFRS in the United States faces some barriers. For example, after moving aggressively under the previous administration in support of the roadmap, the SEC under the current administration appeared more tentative on the issue to use IFRS in the United States. In her first statement on IFRS in January 2009, Mary Schapiro, the new head of the SEC, stated:

> "American investors deserve and expect high standards of financial reporting, transparency and disclosure—along with a standard setter that is free from political interference and that has resources to be a strong watchdog. At this time, it is not apparent that the IASB meets those criteria, and I am not prepared to delegate standard setting or oversight responsibility to the IASB."[17]

By October 2009, Schapiro position had moderated:

> "We must not lose sight of the fact that the purpose of accounting standards is to provide a clear and accurate picture of the company's financial condition for investors . . . I remain committed to the goal of a global set of high quality accounting standards."[18]

The support for adoption of IFRS in the United States (as opposed to convergence or doing nothing) is not unanimous. For example, the **National Association of State Boards of Accountancy (NASBA)**, which tends to be represented by smaller CPA firms, urged the SEC to withdraw the roadmap, supporting the effort toward convergence of U.S. GAAP with IFRS. It argues that the FASB is broadly applicable to both public and private companies, whereas the IASB is concerned only with public companies. It also notes the subjectivity in the application of IFRS. Further, it objects because the IASB depends on funding from large accounting firms among others.[19]

---

[16] Not all authorities agree with this statement. For instance, the former head of the Public Company Accounting Oversight Board (PCAOB), Charles Niemeieir, questions why the United States should even consider IFRS. He says, the United States has "the lowest cost of capital in the world. Do we really want to give that up?"—from a speech to the New York State Society of CPAs (NYSSCPA), September 8, 2008.

[17] Quoted from Congressional testimony, *Web CPA*, January 27, 2009.

[18] Quoted in *Accountancy Age*, October 9, 2009.

[19] Comment letter to the SEC, www.nasba.org, February 19, 2009.

The **New York State Society of CPAs (NYSSCPA)** also takes issue with the SEC roadmap in a comment letter[20] that states:

> "The SEC roadmap does not present, in sufficient detail, the methodology and criteria expected to be applied . . . . in assessing the adequacy of IFRS."

In the comment letter, the NYSSCPA maintains that comparability of financial statements prepared under IFRS may be overstated due to the lack of consistency from country to country and judgments that are influenced by former country standards. Further, the NYSSCPA asserts that the IASB succumbed to pressure from the EC to allow companies to "cherry pick" assets with significant losses and remove them from income calculations. This point is echoed by Robert Herz, chairman of the FASB, when he says, "The IASB's ability to resist undue European pressure will be a critical issue as [the] U.S. decides whether to adopt global accounting rules."[21]

In spite of these misgivings about IFRS in the United States, the momentum is clearly moving toward either convergence or adoption of IFRS. The SEC continues to study this important policy issue:

> "As with any important policy question, we are proceeding deliberately and thoughtfully. We are working diligently to make sure we understand the advantages and disadvantages. At this stage in the process, I expect we will likely consider further action sometime in early 2010."[22]

Some of the practical considerations by the SEC of U.S. readiness for IFRS include:

- The ability of U.S. investors to understand IFRS
- IASB progress in developing IFRS
- The impact of the regulatory environment
- The ability of U.S. companies to adapt their human resources, IT and accounting systems, contractual agreements, governance and litigations contingencies

Little doubt exists that challenges remain for the convergence or adoption of IFRS in the U.S. Among these are:[23]

1. Differences between IFRS and U.S. GAAP are significant. U.S. GAAP has a longer history and is more comprehensive than IFRS. Joint IASB–FASB projects may take years to complete. Also, IFRS does not cover many areas existing in U.S. GAAP. For example, the SEC will need a plan for industries where U.S. GAAP provides industry-specific standards. A significant body of research shows that, if anything, the differences in financial results between U.S. companies using U.S. GAAP and foreign companies using IFRS have increased.[24]

---

[20] Comment letter to the SEC, NYSSCPA, March 2009

[21] Quoted in *Accountancy Age*, October 15, 2009.

[22] Elaine B. Walter, SEC Commissioner, quoted in the *Journal of Accountancy*, December 9, 2009.

[23] These sections are based on Donna L. Street, "The Impact in the United States of Global Adoption of IFRS," *Australian Accounting Review* 18, no 3 (2008), 199–208.

[24] Donna L. Street, "The Impact in the United States of Global Adoption of IFRS," *Australian Accounting Review* 18, no 3 (2008), (pp. 202–203). According to Street, one study showed that net income under IFRS was higher than under U.S. GAAP and that the difference IFRS and U.S. GAAP net income significantly exceed the difference between European GAAP and U.S. GAAP net income. Further, a survey by a major bank yielded similar results. On average, IFRS net income was 23 percent higher than U.S. GAAP net income.

2. Some U.S. standards that differ from IFRS may be difficult to change. For example, IFRS do not allow use of the *last-in, first-out* (LIFO) *method*. This is a method of accounting for inventories used by many U.S. companies. A mandated change to other inventory methods by these companies would cause significant tax and cash flow consequences that only an act of Congress could mitigate.
3. IASB needs strengthening as an independent, global standard setter. It needs stability of funding and staffing as well as the means to enforce compliance in countries where IFRS are adopted only as they suit local reporting traditions. Enhanced lobbying may limit the IASB's ability to maintain IFRS' status as "principles-based" and thus, prevent the desired move from the current U.S. approach of providing extensive guidance. The IASB has a short history. As it matures and becomes more powerful, strong forces will inevitably demand the IASB address more specific issues of implementation. If it does not, then a wide variety of practices will develop around the world and the goal to comparability motivate the switch to IFRS will be lost.
4. Continued existence of European IFRS undermines global comparability. Research has shown that European countries that adopt IFRS tend to place their own interpretations on them. Since IFRS are "principles-based" and do not provide great detail, there is room for each country to apply them in their own way. At times, European regulators simply ignore aspects of IFRS. For example, French regulators do not follow IFRS in accounting for financial instruments. If companies using IFRS from different European countries produce financial statements that lack comparability, why would adoption by the United States achieve the goal of more comparability? Also, some companies fear that efforts of the IASB working with the FASB in Europe will greatly influence U.S. practices.
5. Significant changes to the U.S. reporting infrastructure are needed. Among these are to (1) train and educate issuers, regulators, auditors, and investors about IFRS; (2) transition auditing standards; (3) adjust regulatory and contractual arrangements; and (4) assess impact on nonpublic companies, not-for-profit organizations, and specialized industry reporting. It will take years to accomplish these changes.
6. U.S. accountants and educators need to adapt to IFRS. Unprecedented changes in curriculums at colleges and universities and a substantial increase in continuing professional education for those already in practice are required.
7. Finally, elimination of U.S. GAAP for U.S. companies contradicts the general sentiment in the United States that by maintaining control of setting accounting standards, the influence of the FASB, SEC, and other U.S. organizations would be limited or nonexistent. Many are unwilling to give ultimate power in financial reporting to a non-U.S. entity in a foreign country. What if the IASB fails to act on an issue vital to U.S. interests? How would such conflicts be resolved?

CONCLUSION

Thus, will the IFRS live up to their promise? The answer is "maybe." Will the SEC roadmap be achieved? The answer is also "maybe." Certainly, the movements to switch to IFRS have support from powerful organizations and have momentum. However, challenges remain and the economic crisis or other roadblocks may delay completion of the roadmap. The convergence project of the FASB and IASB is continuing under the MOU while the IASB works to improve IFRS for adoption in the United States. Further, the SEC continues to consider the costs and benefits of adoption, as well as the steps needed to improve comparability under IFRS.

ASSIGNMENTS

1. What international organization began the movement toward international accounting standards and when and how did the United States become involved?
2. What is the IASB, when was it formed, and why is its structure important?
3. Briefly, what is the process followed by the IASB for issuing an IFRS?
4. Why is each of the following important and how does each relate to the concepts of convergence and adoption?
   a. Memorandum of Understanding (MOU) between the FASB and the IASB
   b. The SEC Roadmap
5. What conditions must the IASB meet in order for adoption of IFRS by the United States in 2011? List one or two conditions that will be the most difficult to accomplish.
6. In your opinion, what are the two most important arguments in favor of allowing IFRS for U.S. public companies?
7. In your opinion, what are the two most important arguments against allowing IFRS for public U.S. companies?
8. *Exercise*: State the name of each of the organizations represented by the acronyms listed below and give a brief statement to the organization's importance to IFRS:

a. IASC	d. IASCF
b. IAS	e. IFRIC
c. IFAC	f. SAC

9. *Class or group discussion*: Should the SEC require U.S. public companies to use IFRS?
10. *Case*: Off-Shore Jewelry, Inc. is a relatively small, but fast-growing U.S. based private company. It designs, manufacturers, and distributes fine jewelry in the United States. To reduce costs, it has manufacturing facilities in several countries including Malaysia and Mexico. Off-Shore Jewelry, Inc. also maintains relations with global banks and has considered a merger with a large jewelry company in Europe. A member of the Audit Committee of the company's board of directors has asked you, as CFO of the company, to report to board on whether the company should adopt IFRS. Develop a recommendation to the board, including reasons to support your recommendation, and discuss possible downsides.

II. IFRS FRAMEWORK AND FINANCIAL STATEMENTS

This chapter summarizes the conceptual framework underlying IFRS and the implications for financial reporting. It also illustrates actual and proposed IFRS financial statements.

OVERVIEW OF IFRS

The IASB achieves its objectives primarily by developing and publishing IFRS and promoting the use of those standards in general purpose financial statements and other financial reporting. IFRS typically require like transactions and events to be accounted for and reported, similarly and unlike transactions and events to be accounted for and reported differently, both within an entity over time and among entities. Although some choices currently exist, the IASB intends not to permit choices in accounting treatment.

IFRS are designed to apply to all profit-oriented entities. Profit-oriented entities include those engaged in commercial, industrial, financial and similar activities, whether organized in corporate or in other forms. A complete set of financial statements includes the following:

- Balance sheet
- Income statement
- Statement showing either all changes in equity or changes in equity other than those arising from capital transactions with owners and distributions to owners
- Cash flow statement
- Accounting policies and explanatory notes

These financial statements are directed toward the common information needs of a wide range of users such as shareholders, creditors, employees, and the public at large.

Financial statements must not be described as complying with IFRS unless they comply with *all* the requirements of IFRS. Mandatory IFRS comprise the following and are listed in Appendix C:

- IFRS issued by the IASB currently consist of nine standards issued since the formation of the IASB in 2001.
- IAS issued by the IASC from its beginning in 1971 that have not been superseded by IFRS. Currently of the original forty-one IAS, twenty-nine are still in effect.
- Interpretations originated by the IFRIC or its predecessor, the SIC. Currently, sixteen IFRIC and eleven SIC are still in effect.

Downloadable, searchable electronic educational versions of IFRS are available to both faculty and students of the **International Association for Accounting Education and Research (IAAER)** for a nominal membership fee. IAAER is the global association of academic accountants (see http://www.iaaer.org/ for more information).

FRAMEWORK FOR THE PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS[1]

To aid in the development of future IAS and in the review of existing IAS, the IASC issued the *Framework for the Preparation and Presentation of Financial Statements* for external users. The IASB continues to rely on the framework in setting IFRS. The purpose of the framework is to set forth the basic concepts that underlie financial statements. Thus it provides guidance to the IASB when setting forth the international accounting standards that guide preparers in interpreting and applying IFRS. Importantly, the framework is not an IAS or IFRS, and for that reason, does not define standards for any particular measurement or disclosure issue. The concepts and elements for the financial statements are the core basis for these standards as shown in Figure 2–1. Any exceptions, interpretations, rules and guidance, which are intended to be few in number, do not change the underlying core concepts and elements. Nothing in the framework overrides any specific standard. The framework is currently under revision by the IASB.

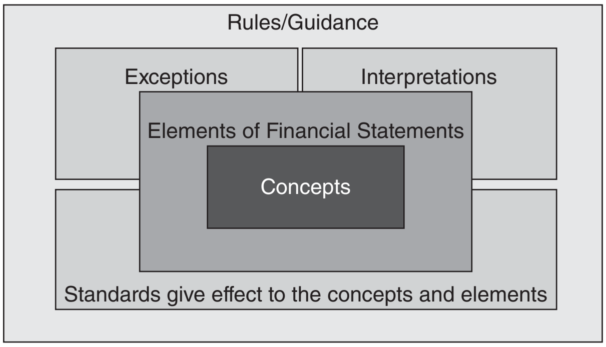

Figure 2–1: Structure of IFRS
Source: Adopted from Michael Wells, IASB, June 2009.

The framework defines the following concepts:

- Objective and underlying assumptions of financial statements
- Qualitative characteristics
- Definition, recognition, and measurement of the elements from which financial statements are constructed.

Financial statements are frequently described as showing a true and fair view of, or as presenting fairly, the financial position, performance, and changes in financial position of an entity. The framework does not deal directly with such concepts, but the application of the concepts in this framework to the accounting standards is intended to result in financial statements that convey what is generally understood as a true and fair view of, or as presenting fairly, such information.

[1] This section is based on IASB, *Framework for the Preparation and Presentation of Financial Statements*, October 2008, http://www iasb.org/.

OBJECTIVE OF FINANCIAL STATEMENTS

The **objective of financial statements** is to provide information about the financial position, performance, and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. The objective is not to provide all information necessary to make economic decisions. Financial statements, for example, are based on past information and do not normally provide projections of future information or nonfinancial information. Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it.

Two assumptions underlying financial statements are **accrual accounting** and **going concern**. Accrual accounting assumes that information is most useful when the effects of transactions and other events are recognized when they occur (and not as cash or its equivalent is received or paid) and that they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash, but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. The going concern assumption presumes that the company will continue in operation for the foreseeable future, thus allowing judgments to be made about the future on which the financial statements are based.

QUALITATIVE CHARACTERISTICS

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are as follows:

- ***Understandability***: Information has the quality of understandability if users readily understand it. Users are assumed to have a reasonable knowledge of business, economic activities, and accounting as well as a willingness to study the information with reasonable diligence. However, relevant information about complex matters should not be excluded merely on the grounds that it may be too difficult for certain users to understand.
- ***Relevance***: Information has the quality of relevance when it influences users' economic decisions, aiding their evaluation of past, present or future events, or confirming or correcting their past evaluations. In some cases, the *nature* of information alone is sufficient to determine its relevance, such as the reporting of a new segment. In other cases, *materiality* is important. Information is **material** if its omission or misstatement could influence the user's economic decisions taken on the basis of the financial statements. Materiality is related to the size of an item or misstatement and provides a threshold or cut-off point rather than being a primary qualitative characteristic.
- ***Reliability***: Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent. Reliability does not imply precise measurements of the elements of financial statements, but it is a complex concept that implies the following:
  - *Faithful representation*: Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This risk is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those

transactions and events. Where possible, the risk of error surrounding recognition and measurement of items should be disclosed.

  - *Substance over form*: If information is to represent the transactions and other events that it purports to represent faithfully, it is necessary that these transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.
  - *Neutrality*: To be neutral, the information contained in financial statements must be free from bias. There must be no deliberate slanting or misstatement of information.
  - *Prudence*: To be prudent, a degree of caution in the exercise of the judgments is needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, would not have the quality of reliability.

- ***Comparability***: Information has the quality of comparability if users may compare the financial statements of an entity through time in order to identify trends and also compare the financial statements of different entities in order to evaluate their relative financial position, performance, and changes in financial position. This quality implies that like transactions and other events are carried out consistently throughout an entity and over time for that entity and for different entities. Lack of consistency should be disclosed to the users.

In achieving a balance among the qualities, the overriding consideration is how best to satisfy the economic decision-making needs of users. Trade-offs may be acceptable. The aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment. For example, *timeliness* relates to the trade-off between waiting until information is highly reliable at the expense of relevance. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. Also, *cost-benefit* refers to the need for benefits derived from information to exceed the cost of providing it. Although it is difficult to apply a cost-benefit test in any particular case, standard-setters, preparers, and users of financial statements should be aware of this constraint.

ELEMENTS OF FINANCIAL STATEMENTS

The IFRS Framework defines the principal elements or components of financial statements. The elements directly related to the **measurement of financial position** are assets, liabilities, and equity. These are defined as follows:

- ***Asset***: An economic resource of a company that are expected to benefit the company's future operations.
- ***Liability***: A business's present obligations to pay cash, transfer assets, or provide services to other entities in the future.
- ***Equity***: Represents the claims of the owners of a corporation to the assets of the business.

The elements of the income statement consists of income and expenses. These are defined as follows:

- ***Income***: The increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants. This definition encompasses both revenues and gains.
- ***Expenses***: Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants. This definition encompasses both losses and expenses that arise in the ordinary course of business.

Most entities adopt a financial concept of **capital** in preparing their financial statements. Under this concept, such as invested money or invested purchasing power, capital is synonymous with the **net assets** or **equity of the entity**. Under an alternative physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the entity based on, for example, units of output per day.

Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the following criteria for recognition:

- It is probable that any future economic benefit associated with the item will flow to or from the entity; and
- The item has a cost or value that can be measured with reliability.

Conversely, **derecognition** *is* the removal of a previously recognized asset or liability from an entity's statement of financial position. An entity shall derecognize an item of property, plant, and equipment on disposal or when no future economic benefits are expected from its use or disposal.

Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognized and carried in the balance sheet and income statement. This involves the selection of the particular basis of measurement. Measurement can include any of the following bases: historical cost, current cost, realizable (settlement) value, and present value. However, fair value, discussed in the next section, is the most common measurement under IFRS.

APPLICATION OF CONCEPTUAL FRAMEWORK TO FAIR VALUE

Fair value underlies the measurement of all items under IFRS. Fair value is defined as an exit value or selling price in a ready market. It is thus the amount for which an asset could be exchanged, or a liability settled, between knowledgeable parties in an arm's length transaction. One former member of the IASB states that fair values:

- Are *relevant* because they reflect conditions relating to economic resources and obligations, under which financial statement users will make decisions.
- Have *predictive value* because they help predict future cash flows of interest to investors in valuing equity.
- Can be *faithful representations* of assets and liabilities because they reflect risk and probability-weighted assessments of expected future cash flows.
- Are *neutral* because they are unbiased.
- Are *timely* because they reflect changes in economic conditions.

- Are *comparable* because fair value depends only on the characteristics of the asset or liability being measured, not on the characteristics of the entity holding the asset or liability or when it was acquired.
- Enhance *consistency*, a dimension of comparability, because they reflect the same type of information every period.[2]

When there is a measurement change in the fair value of an asset or liability, there is an income or expense that results in a change in equity or capital that must be recognized (or derecognized) in the accounts.

EXAMPLE IFRS FINANCIAL STATEMENTS

European Union (EU) companies have used IFRS since 2005 and thus provide examples for IFRS in practice. Exhibit 2–1 through 2–4 present the financial statements for GlaxoSmithKilne (GSK), the large UK-based pharmaceutical, biological, and healthcare company. These financial statements are representative but it important to remember that IFRS allow considerable variation in the form of financial statements. The call-out boxes in the exhibits highlight some of the similarities and difference between IFRS and U.S. statements.[3] The following sections place the exhibits in context.

IFRS INCOME STATEMENT (EXHIBIT 2–1)

It is important to note that IFRS specify minimal information income statement. Only six lines are required:

- Revenue
- Finance costs
- Share of profit and loss from equity method
- Tax expense
- Discontinued operations
- Profit or loss

IFRS do require, however, a presentation that adheres to the concepts underlying reliability such as faithful representation in showing the effects of transactions. As a result, IFRS income statements, as does GSK, tend to resemble the multiple-step format that is common in the United States. The format and headings are similar but IFRS require only two years of data as opposed to three years in the United States. Terminology in the statements is not always the same as in the United States either. For example, the term "turnover" is used to indicate revenues or net sales and use of the word profit is used where the word net income or earnings is traditionally used. IFRS allow presentation of expenses according to nature or function, as is done in the United States and similarly require financing costs to be shown separately. In a major difference from U.S. GAAP, IFRS do not allow presentation of extraordinary items or gains and losses as separate elements of the income statement.

[2] Barth, 1165.

[3] The annotations of GSK's financial statements in Exhibit 1 through 3 are adapted with permission from Jo Lynne Koehn and Sandra Walter Shelton, "Using Annotated Financial Statements Teaching Aide," *Accounting Instructors' Report* (Winter 2010).

1: IFRS Income Statement

102 Gsk Annual Report 2008
Financial statements

4A: GSK's statements are for a consolidated group.

3A: Title of income statement similar to US GAAP titling.

2A: No income statement format is prescribed. GSK's resembles a multiple step format.

1A: IFRS requires current year and prior year be presented.

6A: This income statement presented in pounds (thousands).

CONSOLIDATED INCOME STATEMENT
for the year ended 31st December 2008

5A: Day of month given before name of month.

7A: Revenue is labeled as "turnover".

	Notes	2008 Results before major restructuring	2008 Major restructuring	2008 **Total £m**	2007 Results before major restructuring	2007 Major restructuring	2007 Total £m	Total £m
Turnover	6	24,352	–	**24,352**	22,716	–	22,716	23,225
Cost of sales		(5,776)	(639)	**(6,415)**	(5,206)	(111)	(5,317)	(5,010)
Gross Profit		18,576	(639)	**17,937**	17,510	(111)	17,399	18,215
Selling, general and administration		(7,352)	(304)	**(7,656)**	(6,817)	(137)	(6,954)	(7,257)
Research and development		(3,506)	(175)	**(3,681)**	(3,237)	(90)	(3,327)	(3,457)
Other operating income	8	541	–	**541**	475	–	475	307
Operating profit	9,10	8,259	(1,118)	**7,141**	7,931	(338)	7,593	7,808
Finance income	11	313	–	**313**	262	–	262	287
Finance costs	12	(838)	(5)	**(843)**	(453)	–	(453)	(352)
Share of after tax profits of and joint ventures	13	48	–	**48**	50	–	50	56
Profit before taxation		7,782	(1,123)	**6,659**	7,790	(338)	7,452	7,799
Taxation	14	(2,231)	284	**(1,947)**	(2,219)	77	(2,142)	(2,301)
Profit after taxation for the year		5,551	(839)	**4,712**	5,571	(261)	5,310	5,498
Profit attributable to minority interests		110	–	**110**	96	–	96	109
Profit attributable to shareholders		5,441	(839)	**4,602**	5,475	(261)	5,214	5,389
		5,551	(839)	**4,712**	5,571	(261)	5,310	5,498
Basic earnings per share (pence)	15			**88.6p**			94.4p	95.5p
Diluted earnings per share (pence)	15			**88.1p**			93.7p	94.5p

8A: IFRS allows expense classification by function: here operating or related to financing.

9A: Note cross-referencing to related footnotes.

The calculation of 'Results before major restructuring' is described in Note 1,'Presentation of the financial statements'

12A: IFRS prohibits its reporting of extraordinary items.

11A: Net income is labeled here as "Profit after taxation for the year." IFRS allows such labeling and also the presentation of alternate performance measures.

10A: Basic and diluted EPS are provided.

IFRS BALANCE SHEET OR STATEMENT OF FINANCIAL POSITION (EXHIBIT 2–2)

IFRS state a preference for the title "statement of financial position" over balance sheet. The IASB feels this titling most fully reflects the function of this statement. However, the board allows reporting entities to use titles other than those that are recommended. IFRS do not prescribe a format for the statement of financial position may be presented in a variety of formats. GSK chooses Assets – Liabilities = Equity. Other entities using IFRS may choose Assets = Liabilities + Equity. Another possible format is Fixed assets + Current assets – Short-term payables = Long-term debt + Equity. IFRS requires the separation of current and noncurrent assets, and current and noncurrent liabilities and that they be listed in order of liquidity. In contrast to U.S. practice, IFRS specifically prohibit "deferred tax assets/liabilities" in current assets and liabilities.

IFRS STATEMENT OF CASH FLOWS (EXHIBITS 2–3A AND 2–3B)

Similarly to U.S. GAAP, IFRS require presentation of the statement of cash flows with cash flows organized by operating, investing, and financing activities. IFRS allow either the direct method or indirect method for reporting cash flows from operations. Entities reporting under IFRS are encouraged to use the direct method. GSK uses the indirect method but does not show the detail in the face of the statement of cash flows. This reconciliation is found in footnote 36 (see Exhibit 2–3B) and is similar that the reconciliation that is in the face of U.S. GAAP statements of cash flows under the indirect method. Cash flows related to taxation must be separately disclosed and are usually identified in the cash flow from operating entities section unless an entity can specifically identify a tax cash flow with an underlying financing or investing activity. Cash flows from interest and dividends received and paid are to be each disclosed separately. Entities must consistently classify these items period to period either as operating, investing, or financing activities. Interest paid and interest and dividends received, if helping to determine profit or loss, may be classified as operating activities. Alternatively, entities may choose to classify these items as investing or financing flows because they are costs related to obtaining financing or represent returns on investment.

In a significant difference from U.S. GAAP, IFRS exclude noncash investing and financing activities from the statement of cash flows. Entities disclose the relevant information related to these transactions in the notes to financial statements.

IFRS STATEMENT OF RECOGNIZED INCOME AND EXPENSE (EXHIBIT 2–4)

IFRS require a statement of changes in equity. Some entities choose to present a statement of changes in equity similar to the U.S. GAAP statement of stockholders' equity, which has columns for each equity account with presentation of the items affecting the balance of each account from beginning to end of period. Alternatively, IFRS allow a choice to present a statement of recognized income and expense. This alternative will show profit and loss, items recognized directly in equity, and transactions with owners. This latter treatment will not show reconciliation of all equity account beginning and ending balances which a company could choose to disclose in the notes. Under any of these choices, the following must be disclosed:

- Profit or loss from the period.
- Items of income or expense recognized directly in equity.
- The sum of choices (1) and (2) must be allocated to amounts attributable to parent and minority interests.
- For each component of equity, the cumulative effects of retrospective application or retrospective restatement in accordance with IAS 8.

Exhibit 2–2: IFRS Balance Sheet or Statement of Financial Position

CONSOLIDATED BALANCE SHEET
at 31st December 2008

1B: After 1/1/09 an IFRS balance sheet may be titled "Statement of Financial Position".

2B: IFRS requires a current and prior year comparative presentation.

	Notes	**2008 £m**	2007 £m
Non-current assets			
Property, plant and equipment	17	**9,678**	7,821
Goodwill	18	**2,101**	1,370
Other intangible assets	19	**5,869**	4,456
Investments in associates and joint ventures	20	**552**	329
Other investments	21	**478**	517
Deferred tax assets	14	**2,760**	2,196
Derivative financial instruments	41	**107**	1
Other non-current assets	22	**579**	687
Total non-current assets		**22,124**	17,377
Current assets			
Inventories	23	**4,056**	3,062
Current tax recoverable	14	**76**	58
Trade and other receivables	24	**6,265**	5,495
Derivative financial instruments	41	**856**	475
Liquid investments	32	**391**	1,153
Cash and cash equivalents	25	**5,623**	3,379
Assets held for sale	26	**2**	4
Total current assets		**17,269**	13,626
Total assets		**39,393**	31,003
Current liabilities			
Short-term borrowings	32	**(956)**	(3,504)
Trade and other payables	27	**(6,075)**	(4,861)
Derivative financial instruments	41	**(752)**	(262)
Current tax payable	14	**(780)**	(826)
Short-term provisions	29	**(1,454)**	(892)
Total current liabilities		**(10,017)**	(10,345)
Non-current liabilities			
Long-term borrowings	32	**(15,231)**	(7,067)
Deferred tax liabilities	14	**(714)**	(887)
Pensions and other post-employment: benefits	28	**(3,039)**	(1,383)
Other provisions	29	**(1,645)**	(1,035)
Derivative financial instruments	41	**(2)**	(8)
Other non-current liabilities	30	**(427)**	(368)
Total non-current liabilities		**(21,058)**	(10,748)
Total liabilities		**(31,075)**	(21,093)
Net assets		**8,318**	9,910
Equity			
Share capital	33	**1,415**	1,503
Share premium account	33	**1,326**	1,266
Retained earnings	34	**4,622**	6,475
Other reserves	34	**568**	359
Shareholders' equity		**7,931**	9,603
Minority interests	34	**387**	307
Total equity		**8,318**	9,910

3B: Note the ordering of the assets. Here, non-current assets are listed first, ahead of current assets. IFRS does not specify the ordering.

4B: Current assets should be shown separately from non-current assets unless an order of liquidity presentation is more relevant.

5B: In the liabilities section the current liabilities are listed before the non-current ones.

6B: When using current and non-current categories, deferred tax assets and liabilities should not be classified as current.

7B: Instead of A = L + E we see A – L = E

9B: "Additional Paid-In Capital in Excess of Par value" is renamed as Share premium account.

8B: Balancing total for the balance sheet is:

Net Assets (A – L)
=
Total Equity

Exhibit 2–3A: Statement of Cash Flows

104 Gsk Annual Report 2008
FINANCIAL STATEMENTS

1C: The statement of cash flows is a required statement.

2C: Note that the statement resembles GAAP's structure with cash flows organized by operating, investing, and financing activities.

CONSOLIDATED CASH FLOW STATEMENT
for the year ended 31st December 2008

	Notes	**2008 £m**	2007 £m	2006 £m
Cash flow from operating activities				
Profit after taxation for the year		**4,712**	5,310	5,498
Adjustments reconciling profit after tax to operating cash flows	36	**4,343**	2,770	2,705
Cash generated from operations		**9,055**	8,080	8,203
Taxation paid		**(1,850)**	(1,919)	(3,846)
Net cash inflow from operating activites		**7,205**	6,161	4,357
Cash flow from investing activities				
Purchase of property, plant and equipment		**(1,437)**	(1,516)	(1,366)
Proceeds from sale of property, plant and equipment		**20**	35	43
Purchase of intangible assets		**(632)**	(627)	(224)
Proceeds from sale of intangible assets		**171**	9	175
Purchase of equity investments		**(87)**	(186)	(57)
Proceeds from sale of equity investments		**42**	45	32
Share transactions with minority shareholders	38	**–**	–	(157)
Purchase of businesses, net of cash acquired	38	**(454)**	(1,027)	(273)
Disposal of businesses and interest in associates	38	**–**	–	5
Investments in associates and joint ventures	38	**(9)**	(1)	(13)
Decrease/(increase) in liquid investments		**905**	(39)	(55)
Interest received		**320**	247	299
Dividends from associates and joint ventures		**12**	12	15
Net cash outflow from investing activities		**(1,149)**	(3,048)	(1,576)
Cash flow from financing activities				
Proceeds from own shares for employee share options		**9**	116	151
Shares acquired by ESOP Trusts		**(19)**	(26)	–
Issue for share capital	33	**62**	417	316
Purchase of own shares for cancellation		**(3,706)**	(213)	–
Purchase of Treasury shares		**–**	(3,538)	(1,348)
Increase in long-term loans		**5,523**	3,483	–
Repayment of long-term loans		**–**	(207)	–
Net (repayment of)/increase in short-term loans		**(3,059)**	1,632	(739)
Net repayment of obligations under finance leases		**(48)**	(39)	(34)
Interest paid		**(730)**	(378)	(414)
Dividends paid to shareholders		**(2,929)**	(2,793)	(2,598)
Dividends paid to minority interests		**(79)**	(77)	(87)
Other financing cash flows		**68**	(79)	16
Net cash outflow from financing activities		**(4,908)**	(1,702)	(4,737)
Increase/(decrease) in cash and bank overdrafts	37	**1,148**	1,411	(1,956)
Exchange adjustments		**1,103**	48	(254)
Cash and bank overdrafts at beginning of year		**3,221**	1,762	3,972
Cash and bank overdrafts at end of year		**5,472**	3,221	1,762
Cash and bank overdrafts at end of year comprise:				
Cash and cash equivalents		**5,623**	3,379	2,005
Overdrafts		**(151)**	(158)	(243)
		5,472	3,221	1,762

4C: Cash flows from taxes are usually shown as operating activities unless they can be identified with financing and investing activities.

3C(A): IFRS statements often move the detail of cash flows from operating activities to the notes. See the following detail extracted from GSK's note #36. Cash generated of 9.055 ties to detailed schedule in the note.

6C: Interest paid, interest received, and dividends received under GAAP are shown as operating activities. This is usually the case for IFRS also but these activities can be shown as interest paid is here, as financing activities.

8C: The components of cash & cash equivalents with a reconciliation to the statement of financial position are given.

7C: Non-cash investing and financing activities are not disclosed at the bottom of the statement as required under GAAP.

Exhibit 2–3B Statement of Cash Flows

36 Adjustments reconciling profit after tax to operating cash flows

	2008 £m	2007 £m	2006 £m
Profit after tax	**4,712**	5,310	5,498
Tax on profits	**1,947**	2,142	2,301
Share of after tax profits of associates and joint	**(48)**	(50)	(56)
ventures	**530**	191	65
Finance income/costs	**920**	796	732
Depreciation	**311**	226	226
Amortisation of intangible assets	**436**	206	208
Impairment and assets written off	**(170)**	(5)	(158)
Profit on sale of intangible assets	**(33)**	(32)	(18)
Profit on sale of equity investments			
Changes in working capital:			
Increase in inventories	**(411)**	(457)	(298)
Decrease/(increase) in trade receivables	**519**	(77)	(255)
Decrease/(increase) in other receivables	**22**	(2)	(274)
(Decrease)/increase in trade payables	**(39)**	9	82
(Decrease)/increase in other payables	**(162)**	(196)	272
Increase/(decrease) in pension and other provisions	**548**	(123)	(270)
Share-based incentive plans	**241**	237	226
Other	**(268)**	(95)	(78)
Cash generated from operations	**9,055**	8,080	8,203

3C(B): Note #36 provides the detail of GSK's cash flows from operations. The cash generated from operating activities ties back to the total found in operating section of the statement of cash flows.

5C: IFRS allows cash flows from operations to be reported using either the direct or indirect method. GSK uses the indirect method.

Further required presentations, either as part of the statement of equity or in notes, include:

- Distributions to/from owners of the company.
- For each component of equity (retained earnings, capital, additional paid in capital, reserve, etc.) a reconciliation of balances between the beginning and end of the period.

GSK chooses to present a statement of recognized income and expense (Exhibit 2–4).

PROPOSED PRESENTATION OF FINANCIAL STATEMENTS[4]

The financial statements for GSK represent an example of current practice, but a goal of the MOU between the IASB and the FASB is to create a common standard for the form, content, classification, aggregation, and display of items in financial statements. The boards developed three objectives for financial statement presentation:

- To portray a cohesive picture of an entity's activities. "Cohesion" means that to the extent possible, the categories and sections in the financial statements should be in the same order so that the relationships between items across financial statements are clear.

[4] This section is based on Financial Accounting Standards Board (FASB), "Preliminary Views on Financial Statement Presentation," *Financial Accounting Series Discussion Paper* (October 16, 2008). Comments on the proposed presentations were due by April 14, 2009.

Exhibit 2–4: Statement of Recognized Income and Expense

GSK Annual Report 2008 **105**
FINANCIAL STATEMENTS

CONSOLIDATED STATEMENT OF RECOGNIZED INCOME AND EXPENSE
for the year ended 31st December 2008

	2008 £m	2007 £m	2006 £m
Exchange movements on overseas net assets	**1,101**	411	(359)
Tax on exchange movements	**15**	21	(78)
Fair value movements on available-for-sale investments	**(81)**	(99)	84
Deferred tax on fair value movements on available-for-sale investments	**8**	19	(15)
Actuarial (lossess)/gains on defined benefit plans	**(1,370)**	671	429
Deferred tax on actuarial movements in defined benefit plans	**441**	(195)	(161)
Fair value movements on cash flow hedges	**6**	(6)	(5)
Deferred tax on fair value movements on cash flow hedges	**(3)**	2	2
Net profits/(losses) recognized directly in equity	**117**	824	(103)
Profit for the year	**4,712**	5,310	5,498
Total recognized income and expense for the year	**4,829**	6,134	5,395
Total recognized income and expense for the year attributable to:			
Shareholders	**4,670**	6,012	5,307
Minority interests	**159**	122	88
	4,829	6,134	5,395

1D: A statement of recognized income and expenses can be chosen to replace a GAAP style "Statement of Stockholders' Equity".

3D: This section shows all items recognized directly in equity (that is not on the I/S).

2D: Show profit for the period.

4D: This statement must show total income and expense of the period as attributed to parent and minority interests.

- To disaggregate information so that it is useful in predicting an entity's future cash flows.
- To help users assess an entity's liquidity and financial flexibility. Users should be able to assess an entity's ability to meet its financial commitments, invest in business opportunities, and respond to unexpected needs.[5]

It addresses only the organization and presentation of information and the need for totals and subtotals in the financial statements. It does not address any issues of recognition or measurement of the individual items included in the statements. This work is being completed in three phases:

- **Phase A:** Issuance by the IASB of a revision of its IAS No. 1, *Presentation of Financial Statements*. Phase A was completed in 2007. This revision calls for four financial statements, each with at least two years of comparative data, as follows:
  - Statement of comprehensive income
  - Statement of financial position
  - Statement of cash flows
  - Statement of changes in equity
- **Phase B:** Completed in 2008, Phase B presents tentative and preliminary views on how financial information should be presented in the financial statements.
- **Phase C:** The goal of Phase C is to arrive at converged standards on financial statements presentation by 2011. The boards will also work on the presentation of interim financial information.

[5] Memorandum of Understanding between the FASB and the IASB, February 2007.

Exhibit 2–5: Parallel Classification Scheme of the Financial Statements

Statement of Comprehensive Income	Statement of Financial Position	Statement of Cash Flows
Business • Operating income and expense • Investing income and expense	**Business** • Operating assets and liabilities • Investing assets and liabilities	**Business** • Operating cash flows • Investing cash flows
Financing • Financing asset income • Financing liability expense	**Financing** • Financing assets • Financing liabilities	**Financing** • Financing asset cash flows • Financing liability cash flows
Income Taxes (relating to business and financing)	**Income Taxes (deferred and payable)**	**Income Taxes (cash taxes paid)**
Discontinued Operations, Net of Tax	**Discontinued Operations**	**Discontinued Operations**
Other Comprehensive Income, Net of Tax	**Equity (Share capital, retained earnings, other comprehensive income)**	**Equity**

Phase B addresses the goal of showing a cohesive financial picture of an entity through financial statement presentation. All similar line items across the statements should be labeled in the same way and in the same order. The joint task force proposed a structure, as shown in Exhibit 2–5, for achieving this objective of cohesion across the statements. Note that all proposed statements follow roughly the current organization of the statement of cash flows. All statements will be divided into five categories as follows:

- Business, includes line items related to operating and investing activities
- Financing, includes line items related to financing activities
- Income taxes
- Discontinued operations
- Equity

The resulting statements, especially the statement of comprehensive income and the statement of financial position will differ substantially from current U.S. GAAP and IFRS financial statements. Illustrations for these two proposed statements appear in the following sections.

PROPOSED STATEMENT OF COMPREHENSIVE INCOME

Management chooses what goes into each category (as shown in Exhibit 2–4) and explains its choices in the accounting policy note to the financial statements. Note that joint task force provided the illustrations for discussion and that the final statement formats may differ.

Exhibit 2–6 illustrates the five-part classification scheme in the proposed statement of comprehensive income. Note first that the statement's title now includes the words *comprehensive*

Exhibit 2–6: Proposed Statement of Comprehensive Income

	For the year ended 31 December	
	2010	**2009**
BUSINESS		
Operating		
Sales—wholesale	2,790,080	2,591,400
Sales—retail	697,520	647,850
Total revenue	*3,487,600*	*3,239,250*
Cost of goods sold		
Materials	(1,043,100)	(925,000)
Labour	(405,000)	(450,000)
Overhead—depreciation	(219,300)	(215,000)
Overhead—transport	(128,640)	(108,000)
Overhead—other	(32,160)	(27,000)
Change in inventory	(60,250)	(46,853)
Pension	(51,975)	(47,250)
Loss on obsolete and damaged inventory	(29,000)	(9,500)
Total cost of goods sold	(1,969,425)	(1,828,603)
Gross profit	*1,518,175*	*1,410,647*
Selling expenses		
Advertising	(60,000)	(50,000)
Wages, salaries, and benefits	(56,700)	(52,500)
Bad debt	(23,068)	(15,034)
Other	(13,500)	(12,500)
Total selling expenses	*(153,268)*	*(130,034)*
General and administrative expenses		
Wages, salaries, and benefits	(321,300)	(297,500)
Depreciation	(59,820)	(58,500)
Pension	(51,975)	(47,250)
Share-based remuneration	(22,023)	(17,000)
Interest on lease liability	(14,825)	(16,500)
Research and development	(8,478)	(7,850)
Other	(15,768)	(14,600)
Total general and administrative expenses	*(494,189)*	*(459,200)*
Income before other operating items	*870,718*	*821,413*
Other operating income (expense)		
Share of profit of associate A	23,760	22,000
Gain on disposal of property, plant and equipment	22,650	–
Realized gain on cash flow hedge	3,996	3,700
Loss on sale of receivables	(4,987)	(2,025)
Impairment loss on goodwill	–	(35,033)
Total other operating income (expense)	*45,419*	*(11,358)*
Total operating income	**916,137**	**810,055**

	For the year ended 31 December	
	2010	**2009**
Investing		
Dividend income	54,000	50,000
Realized gain on available-for-sale securities	18,250	7,500
Share of profit of associate B	7,500	3,250
Total investing income	**79,750**	**60,750**
TOTAL BUSINESS INCOME	**995,887**	**870,805**
FINANCING		
Interest income on cash	8,619	5,500
Total financing asset income	**8,619**	**5,500**
Interest expense	(111,352)	(110,250)
Total financing liability expense	**(111,352)**	**(110,250)**
TOTAL NET FINANCING EXPENSE	**(102,733)**	**(104,750)**
Profit from continuing operations before taxes and other comprehensive income	*893,154*	*766,055*
INCOME TAXES		
Income tax expense	(333,625)	(295,266)
Net profit from continuing operations	*559,529*	*470,789*
DISCONTINUED OPERATIONS		
Loss on discontinued operations	(32,400)	(35,000)
Tax benefit	11,340	12,250
NET LOSS FROM DISCONTINUED OPERATIONS	**(21,060)**	**(22,750)**
NET PROFIT	**538,469**	**448,039**
OTHER COMPREHENSIVE INCOME (after tax)		
Unrealized gain on available-for-sale securities (investing)	17,193	15,275
Revaluation surplus (operating)	3,653	(1,492)
Foreign currency translation adjust—consolidated subsidiary	2,094	1,690
Unrealized gain on cash flow hedge (operating)	1,825	
Foreign currency translation adjust—associate A (operating)	(1,404)	(1,300)
TOTAL OTHER COMPREHENSIVE INCOME	**23,361**	**14,173**
TOTAL COMPREHENSIVE INCOME	**561,830**	**462,212**
Basic earnings per share	7.07	6.14
Diluted earnings per share	6.85	5.96

Source: IASB, Preliminary Views on Financial Statement Presentation (October 2008).

income, indicating that it will include items that previously were disclosed separately as other comprehensive income. (IFRS allows for the option of presenting comprehensive income in a separate statement.) It is important to note that, as noted above, IFRS specifies minimal information on this statement. However, except for the last section of the statement disclosing other comprehensive income, the other sections are not dramatically different for the traditional income statement. Use of the term *net profit* is used where the term *net income* is traditionally used.

The following characterize the considerable detail of *business section*:

- Cost of goods sold is deducted from sales to reach gross profit.
- Selling expenses are separated from general and administrative expenses.
- Other operating income (expense) includes various gains and losses as well as the share of any associate (controlling investments) profit.
- Total operating income is a subtotal.
- Income and gains from investing activities including the share of any associate (less than controlling investments) profit are shown after total operating income.
- The bottom line of the business section is *total business income*.

IFRS do not define operating income, allowing companies some flexibility in format. For instance, IFRS allow the order and detail of the line items in this section to be organized by function (cost of goods sold, gross profit, operating expenses, as illustrated) or by the nature of the expense (not illustrated), such as materials, labor, overhead, bad debt expense, and so forth.

The *financing section* consists of interest income on cash and interest expense.

The *income taxes section* consists of incomes tax expense.

The *discontinued operations section* consists of income, gains, or losses on discontinued operations including showing the tax effect.

Finally, the *other comprehensive section* consists of such items as:

- Unrealized gains on available-for-sale securities
- Revaluation surplus
- Foreign currency translation adjustments
- Unrealized gains on cash-flow hedges

PROPOSED STATEMENT OF FINANCIAL POSITION

Exhibit 2–7, which shows a proposed statement of financial position (balance sheet), demonstrates the radical change that the previously described approach makes to the traditional form of the balance sheet. No longer will assets and liabilities be on opposite sides of the balance sheet. On the contrary, the following will characterize the *business section*:

- Both short-term and long-term assets and liabilities will be presented.
- The short-term section will first list receivables, inventories, and prepaid assets (cash is not included) followed by a deduction for accounts payable and other current liabilities.
- The long-term section lists property, plant, and equipment, goodwill, intangibles, and other assets and liabilities (net).
- The long-term section includes available-for-sale securities and other long-term investments including investments in affiliates.
- The bottom line for the business section is *net business assets*.

Exhibit 2–7: Proposed Statement of Financial Position

	As at 31 December	
	2010	**2009**
BUSINESS		
Operating		
Accounts receivable, trade	945,678	541,375
Less allowance for doubtful accounts	(23,642)	(13,534)
Accounts receivable, net	922,036	527,841
Inventory	679,474	767,102
Prepaid advertising	80,000	75,000
Foreign exchange contracts—cash flow hedge	6,552	3,150
Total short-term assets	*1,688,062*	*1,373,092*
Property, plant and equipment	5,112,700	5,088,500
Less accumulated depreciation	(2,267,620)	(2,023,500)
Property, plant and equipment, net	2,845,080	3,065,000
Investment in associate A	261,600	240,000
Goodwill	154,967	154,967
Other intangible assets	35,000	35,000
Total long-term assets	*3,296,647*	*3,494,967*
Accounts payable, trade	(612,556)	(505,000)
Advances from customers	(182,000)	(425,000)
Wages payable	(173,000)	(200,000)
Share-based remuneration liability	(39,586)	(21,165)
Current portion of lease liability	(35,175)	(33,500)
Interest payable on lease liability	(14,825)	(16,500)
Total short-term liabilities	*(1,057,142)*	*(1,201,165)*
Accrued pension liability	(293,250)	(529,500)
Lease liability (excluding current portion)	(261,325)	(296,500)
Other long-term liabilities	(33,488)	(16,100)
Total long-term liabilities	*(588,063)*	*(842,100)*
Net operating assets	**3,339,504**	**2,824,795**
Investing		
Available-for-sale financial assets (short-term)	473,600	485,000
Investment in associate B (long-term)	46,750	39,250
Total investing assets	**520,350**	**524,250**
NET BUSINESS ASSETS	**3,859,854**	**3,349,045**
FINANCING		
Financing assets		
Cash	1,174,102	861,941
Total financing assets	**1,174,102**	**861,941**

(*Continued*)

Exhibit 2–7: Proposed Statement of Financial Position (*Continued*)

	As at 31 December	
	2010	**2009**
Financing liabilities		
Short-term borrowings	(562,000)	(400,000)
Interest payable	(140,401)	(112,563)
Dividends payable	(20,000)	(20,000)
Total short-term financing liabilities	*(722,401)*	*(532,563)*
Long-term borrowings	(2,050,000)	(2,050,000)
Total financing liabilities	**(2,772,401)**	**(2,582,563)**
NET FINANCING LIABILITIES	**(1,598,299)**	**(1,720,621)**
DISCONTINUED OPERATIONS		
Assets held for sale	856,832	876,650
Liabilities related to assets held for sale	(400,000)	(400,000)
NET ASSETS HELD FOR SALE	**456,832**	**476,650**
INCOME TAXES		
Short-term		
Deferred tax asset	4,426	8,907
Income taxes payable	(72,514)	(63,679)
Long-term		
Deferred tax asset	39,833	80,160
NET INCOME TAX ASSET (LIABILITY)	**(28,255)**	**25,388**
NET ASSETS	*2,690,132*	*2,130,462*
EQUITY		
Share capital	(1,427,240)	(1,343,000)
Retained earnings	(1,100,358)	(648,289)
Accumulated other comprehensive income, net	(162,534)	(139,173)
TOTAL EQUITY	**(2,690,132)**	**(2,130,462)**
Total short-term assets	**4,197,021**	**3,605,591**
Total long-term assets	**3,383,231**	**3,614,377**
Total assets	**7,580,252**	**7,219,968**
Total short-term liabilities	**(2,252,057)**	**(2,197,406)**
Total long-term liabilities	**(2,638,063)**	**(2,892,100)**
Total liabilities	**(4,890,120)**	**(5,089,506)**

Source: IASB, *Preliminary Views on Financial Statement Presentation,* October 2008.

The *financing section* will be characterized by the following:

- Cash will no longer include cash equivalents and will be considered a financing asset.
- Financing liabilities will include both short-term and long-term liabilities not included elsewhere.

- The bottom line for the financing section is *net financing assets* (or *liabilities* if the balance is negative).

The *income taxes section* will consist of:

- Short-term income taxes payable
- Long-term deferred income taxes (net)
- The bottom line for the income taxes section is *net income tax* assets (or *liabilities* if the balance is negative)

The discontinued operations section will consist of:

- Assets classified as held for sale
- Liabilities classified as held for sale
- The bottom line for the discontinued operations section is *net assets held for sale*

Finally, the *equity section* will consist of:

- Common stock and additional paid-in capital
- Treasury stock, retained earnings
- Accumulated other comprehensive income
- The bottom line for the equity section is *total equity*

ASSIGNMENTS

1. What are IFRS and how do they relate to IAS?
2. What is the objective of financial statements and what two assumptions underlie them?
3. Why are qualitative characteristics important?
4. What is the difference between understandability and relevance?
5. Is reliability the same as accuracy?
6. What are the characteristics of reliability?
7. What is comparability and to what does it apply?
8. What are assets, liabilities, and equity? Define each.
9. What are venues and expenses? Define each.
10. What are measurement, recognition, and derecognition? Define each and tell how they relate to each other?
11. List the five sections that all proposed financial statements should contain.
12. How does the balance sheet under proposed IFRS differ from U.S. GAAP?
13. What is the proposed new name for the income statement and why does it have this name?
14. How does the proposed IFRS statement of cash flows differ from the way most of these statements are prepared in the United States?
15. What does the proposed schedule in Exhibit 5 reconcile and why is it useful?
16. *Class or group discussion*: Is historical cost or fair value more in line with the qualitative characteristics of the conceptual framework and why?
17. *Class or group discussion*: Define the concepts of *conservatism* under U.S. GAAP and *prudence* under IFRS. How are they similar and how are they different? Do they represent a significant difference between U.S. GAAP and IFRS? Give an example of how they might differ in their application.

18. *Exercise*: Match the selected sections of IASB-proposed financial statements (letters) with their respective components (numbers):

a. Statement of comprehensive income-business
b. Statement of comprehensive income-financing
c. Statement of financial position-business
d. Statement of financial position-financing
e. Statement of cash flows-business
f. Statement of cash flows-financing
g. None of the above

1. Operating cash flows
2. Financing assets
3. Discontinued operations
4. Financing liability expense
5. Operating income and expense
6. Investing cash flows
7. Financing liability cash flows
8. Investing assets and liabilities
9. Financing liabilities
10. Financing asset income
11. Financing asset cash flows
12. Operating assets and liabilities
13. Income taxes
14. Investing income expense

19. *Exercise:* Match the selected sections of IASB-proposed statement of comprehensive income statement (letters) with their respective components (numbers).

a. Revenue
b. Cost of goods sold
c. Selling expenses
d. General and administrative expenses
e. Other operating income (expenses)
f. Investing income
g. Financing asset income
h. Financing liability expense
i. Other comprehensive income

1. Labor
2. Realized gain on available-for-sale securities
3. Unrealized gain on available-for-sale securities
4. Materials
5. Change in inventory
6. Advertising
7. Research and development
8. Dividend income
9. Depreciation
10. Interest income on cash
11. Share-based remuneration
12. Revaluation surplus (operating)
13. Interest expense
14. Depreciation
15. Overhead
16. Foreign currency translation adjust
17. Sales

20. *Exercise:* Match the selected sections of IASB-proposed statement of financial position (letters) with their respective components (numbers).

a. Short-term assets
b. Long-term assets
c. Short-term liabilities
d. Long-term liabilities
e. Investing assets
f. Financing assets

1. Accrued pension liability
2. Cash
3. Accounts receivable, trade
4. Wages payable
5. Available-for-sale financial assets
6. Foreign exchange contracts- cash flow hedge

g.	Short-term financing liabilities	7.	Accounts payable, trade
h.	Discontinued Operations	8.	Inventory
		9.	Short-term borrowing
		10.	Assets held for sale
		11.	Prepaid advertising
		12.	Goodwill
		13.	Interest payable
		14.	Advances from customers
		15.	Property, plant and equipment
		16.	Dividends payable
		17.	Interest payable on lease liability

21. ***Case:*** Assume you work for a company that has used the U.S. GAAP practice of valuing buildings at historical cost less accumulated depreciation. Your company is considering revaluing the building annually based on fair value. Based on the concepts underlying the IFRS framework, how does fair value differ from historical cost? Use the example of fair value presented in the text as a starting point.

III. KEY DIFFERENCES BETWEEN IFRS AND U.S. GAAP

Differences between U.S. GAAP and IFRS are numerous. Several years ago the FASB published *The IASC-US Comparison Project*. Literally hundreds of differences were identified in it.[1] Many differences were minor technicalities but some were major. The volume provides evidence of the problem's scope and eventually led to the convergence efforts of the IASB and the FASB. Underlying reasons for these differences exist. This section summarizes several major differences between IFRS and U.S. GAAP.

PRINCIPLES-BASED VS. RULES-BASED STANDARDS

Considerable debate exists regarding the issue of principles-based versus rules-based standards. **Rules-based standards** are perceived to be the dominant approach of the FASB. This approach attempts to anticipate all or most of the application issues and prescribes solutions. As a result, U.S. GAAP as codified by the FASB consists of about 17,000 pages. **Principles-based standards** are stated as the dominant approach of the IASB. In this case, the standards are less prescriptive and rely on broad statements of objectives and principles to be followed. Consequently, IFRS are contained in about 2,500 pages or about 15 percent as much as U.S. GAAP. Greater reliance is placed on the preparer's judgment to align the financial reporting with the conceptual framework.

Perceived differences in the two approaches are shown in Exhibit 3–1. Proponents of the FASB approach argue that the standards are rooted in the conceptual framework and that preparers demand guidance in specific situations. U.S. GAAP are older than IFRS and over time have developed a detailed prescription. In time, the IASB will face pressure from preparers and auditors to provide more guidance. Critics of rules-based standards argue that companies structure agreements and transactions to achieve particular objectives and may not reflect the underlying substance. For example, companies structure long-term lease agreements as operating leases when in substance they are capital leases. The result is significant "off-the-balance-sheet" financing. Proponents of principle-based standards argue that they also contain rules and it is only a matter of degree. More importantly in the case of long-term leases, the lease would be judged as a capital lease regardless of the specific terms resulting in greater comparability because like items would be treated in a similar way. There is no doubt that principles-based standards place more reliance on professional judgment. However, judgments are often dependent on the person's culture and prior experience. For instance, research shows that a preparer's judgment often falls back on the historical practices of his/her country, which may differ from past practices in another country. Thus, judgments often differ from person to person, company to company, and industry to industry.

INCOME MEASUREMENT

Both U.S. GAAP and IFRS recognize accrual accounting as the key concept underlying income measurement. However, the FASB and IASB implement this concept very differently, as shown in Figure 3–1. *U.S. GAAP emphasize the matching rule and measurement of items*

[1] Carrier Bloomer, ed., *The IASC-US Comparison Project: A Report on the Similarities and Differences between IASC Standards and U.S. GAAP* (Norwalk, CT: FASB, 1996).

Exhibit 3–1: Comparison of Rules-Based Standards and Principles-Based Standards

Attribute	Rules-Based Standards	Principles-Based Standards
Conceptual framework	Less reliance	More reliance
Professional judgment	Less reliance	More reliance
Level of detailed guidance	More	Less
Amount of industry specific guidance	Extensive	Little

on the income statement. Thus, revenues are recognized in the periods earned and expenses are recorded in the periods in which they occurred. The balance sheet impacts—increases, decreases, or both in assets and liabilities—are the result from these recognitions of revenue and expense. However, *IFRS emphasize measurement of assets and liabilities on the balance sheet at fair value*. The resulting increases, decreases, or both, are then reflected as revenues and expenses in the income statement. In other words, revenues and expenses under IFRS are matched through a balance sheet valuation process.

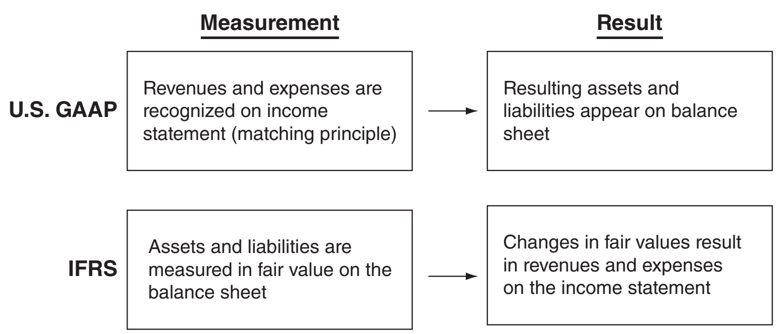

Figure 3–1: Contrasting Approaches To Accrual Accounting and Income Determination

FAIR VALUE MEASUREMENTS

Various notions of value (summarized in Exhibit 3–2) are important under U.S. GAAP. For example, assets are recorded initially at cost but thereafter may be adjusted to other values. In addition, U.S. GAAP have many definitions of fair value or market value. For instance, inventory is measured at lower of cost or market, where market is measured by replacement (or entry) cost. When receivables are estimated or valued at net of allowance for uncollectible accounts, the value is net realizable (exit) value. All long-term assets, except land, are subject to estimates of depreciation, depletion, or amortization and are subject to annual impairment tests, which can be based on various concepts of market depending on the situation. Securities (except held-to maturity) are valued at market price usually from an established market.

Exhibit 3–2: Approaches to Asset Valuation under U.S. GAAP

Asset Category	Basis of Valuation	Origin*
Cash	Fair value	Exit
Cash Equivalents	Fair value or amortized cost	Exit or entry Amortized
Receivables	Net realizable value	Exit
Inventories	Lower of Average, LIFO, or FIFO cost; or replacement cost	Various Entry
Short-term Investments	Fair value, or amortized cost	Exit or entry Amortized
Long-term Investments	Fair value or cost adjusted for changes in equity	Entry or exit
Property	Purchase cost (or at fair value if impaired)	Entry or exit
Plant and Equipment	Depreciated cost (or at fair value if impaired)	Entry depreciated or exit
Intangible Assets with definite life	Amortized cost (or at fair value if impaired)	Entry amortized or exit
Intangible Assets with indefinite life	Cost (or at fair value if impaired	Entry or exit

*The origin of entry value is the cost principle. The source of exit value is fair value.

In contrast to U.S. GAAP, IASB defines fair value as a single concept based on exit value or selling value in a ready market.[2] Specifically, fair value is the amount an asset may be exchanged for, or a liability settled, between knowledgeable parties in an arm's length transaction. The best evidence of fair value is quoted prices in an active market. If the market for a financial instrument is not active, a valuation technique must be used. The objective of a valuation technique is to establish what the transaction price is on the measurement date in an arm's length exchange motivated by normal business considerations. Valuation techniques include using arm's length market transactions between knowledgeable, willing parties, if available; reference to the current fair value of another instrument that is substantially the same; discounted cash flow analysis; and options pricing models.[3]

REVENUE RECOGNITION

As discussed earlier, revenue recognition under U.S. GAAP and IFRS take different approaches. Under U.S. GAAP, revenue is defined without respect to the balance sheet effect. It must meet all the following conditions before revenue is to be recognized:[4]

[2] The FASB and IASB recently reached a tentative agreement to define fair value as an exit value. The Boards will discuss at a future meeting where that definition should be used. "Summary of Board Decisions," FASB, January 10, 2010.

[3] IASB Expert Advisory Panel, Measuring and Disclosing the Fair Value of Financial Instruments in Markets that are No Longer Active (October 2008).

[4] Securities and Exchange Commission (SEC), *Staff Accounting Bulletin No. 10* (1999).

- Persuasive evidence of an arrangement exists.
- Product or service has been delivered.
- Seller's price to the buyer is fixed or determinable.
- Collectability is reasonably assured.

By contrast, IFRS define revenue from a balance sheet point of view. Revenue is viewed as the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when the inflows result in an increase in equity (other than investments from investors). Revenue is measured as the fair value for which the asset could be exchanged, or the liability settled, between knowledgeable, willing parties to an arm's length transaction.

IFRS go on to say that revenue is recognized when:

- There are probable future economic benefits.
- Revenue can be measured reliably.
- Costs can be measured reliably.
- Significant risk and rewards of ownership are transferred.
- Managerial involvement is not retained as to ownership or control.

While similar to U.S. GAAP criteria, the main difference is that future commitments would not be recognized under U.S. GAAP but may be recognized under IFRS if these criteria are met. For example, if a company has a firm commitment or agreement to provide services in the future at a fixed price, the above criteria may be met. It is possible to determine the future cash flows, and therefore the fair value, of the agreement. Thus, an asset exists and recognition occurs.

In applying these revenue recognition concepts, U.S. GAAP often rely on industry practice whereas IFRS rely more on judgment. U.S. GAAP address revenue recognition extensively in sixteen standards, twenty-four interpretations, and numerous other related documents. IFRS include two standards and three interpretations on the subject. For instance, IFRS typically record service revenue using the *percentage-of-completion method* (recognizing revenue as the percentage of the total project completed at each stage) whereas U.S. GAAP rely more on specific industry guidance. For the software industry, U.S. GAAP provide specific guidance for typical software arrangements, upfront fees, and multiple deliverable arrangements whereas IFRS provide only general guidance. However, IFRS provide specific guidance for revenue recognition on construction contracts, requiring the use of percentage-of-completion method. Alternatively, U.S. GAAP allow either percentage of completion or the *completed-contract method* (recognizing all revenue at the time the contract is completed). For example, Boeing currently recognizes all revenue when an aircraft is delivered even though it takes more than a year to build it. But under IFRS, the company would recognize revenue at each stage of building the aircraft.

The IASB and the FASB are working to eliminate these complex differences in revenue recognition through the convergence project. The goal is to create a unified standard for U.S. companies that follow U.S. GAAP and non-U.S. companies that follow IFRS. The boards jointly issued a discussion paper in December 2008 entitled, "Preliminary Views on Revenue Recognition in Contracts with Customers," and are currently drafting an exposure draft of a new standard due for release in 2010. The exposure draft boils revenue recognition down to a single, contract-based model.[5] In other words, whether or not revenue is recognized depends solely on the terms of a contract between the customer and the seller. It sounds simple, but the difficulties of reaching a common standard can be inferred from the length of time taken to arrive at a draft standard.

---

[5] Steven M. Mintz, "Proposed Changes in Revenue Recognition Under U.S. GAAP and IFRS, *CPA Journal,* December 2009.

PROVISIONS

Two important categories of provisions are commitments and contingencies. U.S. GAAP do not record commitments, such as purchase agreements, as liabilities even though they are a legal obligation since they do not meet the technical definition of a liability. Disclosure in a note to the financial statements is required. Under IFRS, these agreements are recognized when an entity has a demonstrable commitment.

Under U.S. GAAP, contingent assets and liabilities are recognized if they are probable and can be estimated, otherwise they are disclosed in the notes to the financial statements. When the criteria for recognition are met, both contingent assets and liabilities are recorded at fair value. Under IFRS, the criteria for recognition are similar—that is, there must be a present obligation that arises from past events and fair value must be determinable—but in a major difference, only contingent liabilities (and not contingent assets) are recognized under IFRS.

COMPREHENSIVE INCOME AND RECYCLING

Remember, entities are required to present either a combined statement of comprehensive income or two separate statements—one for profit and loss and one for other comprehensive income. However, U.S. GAAP permit a firm to select from three reporting alternatives for comprehensive income—(1) a separate statement, (2) inclusion in the income statement, or (3) inclusion in the statement of stockholders' equity. Currently, 80 percent of U.S. companies follow the latter approach,[6] but under IFRS only the first two approaches are allowed. Also, U.S. GAAP and IFRS are similar in that items included in comprehensive income may be reported net of tax.

Recycling occurs if an item, such as an unrealized gain and loss, is previously classified as other comprehensive income and later is realized in net income. Under IFRS and U.S. GAAP recycling occurs for the following items:

- Cumulative foreign currency translation adjustments
- Unrealized gains and losses on AFS securities
- Unrealized gains and losses on effective cash flow hedges

Actuarial gains and losses are recycled under U.S. GAAP, but IFRS recognize the OCI amount immediately in retained earnings. Finally, IFRS forbid recycling of revaluation surplus associated with long-lived assets (see discussion below).

INVENTORIES

Inventory accounting is essentially the same with two major exceptions. First, IFRS specifically forbid the use of LIFO (last in, first out), a method of accounting for the cost of inventory. LIFO is used by more than one-third of U.S. companies[7] because in periods of rising prices, it produces a lower taxable income. The United States income tax law requires the use of LIFO for financial reporting purposes *if* a company uses LIFO for tax purposes. Prohibiting LIFO for financial reporting purposes could be a barrier to U.S. adoption of IFRS. The LIFO companies

[6] American Institute of CPAs, *Accounting Trends and Techniques,* 62 ed. (New York: 2008), 430.
[7] Ibid., 159.

would recognize potentially large taxable gains on inventory valuation if they were forced to change from LIFO to another method. However, a change in the tax law permitting LIFO for tax purposes without mandating its use for financial reporting would eliminate this barrier.

Second, U.S. GAAP value inventory using the lower-of-cost-or-market method. This differs from IFRS in three ways:

- Market is defined as net replacement value, not fair value as defined by IFRS.
- U.S. GAAP do not recognize increases in market above cost but IFRS do.
- U.S. GAAP prohibit the reversal of write downs if replacement costs subsequently increases but IFRS do not.

PROPERTY, PLANT, AND EQUIPMENT

Three major differences between U.S. GAAP and IFRS in the accounting for property, plant, and equipment (PPE) are:

- Revaluation
- Component depreciation
- Interest cost during construction

Revaluation recognizes a change in the fair value of an asset after its initial acquisition. U.S. GAAP do not allow upward revaluation except for financial instruments and business combinations. IFRS, on the other hand, *permit* downward and upward revaluation for tangible and identifiable intangible long-term assets and *require* it for investment properties and for agricultural products. In the latter two cases, the change in fair value is reported on the income statement. Under U.S. GAAP, PPE must be carried at historical cost less accumulated depreciation. By contrast, IFRS allow PPE to be valued at historical cost or at fair value if readily measurable less accumulated depreciation.

IFRS require depreciation of assets on a component basis, U.S. GAAP do not. The component basis acknowledges that each component of a building, production process, or other PPE asset has its own useful life and fair value. Finally, U.S. GAAP require interest cost on assets during contraction to be capitalized as a part of PPE and depreciated, whereas IFRS allow expensing or capitalization. Interest cost on constructed assets is now included as part of the convergence project.

When electing to revalue, the revaluation must be applied to the entire class or component of PPE, such as land, buildings, or equipment. When revaluation results in an increase a debit is made to the asset account and a credit is made to an equity account called **revaluation surplus.** When a revaluation results in a decrease to an asset, a debit is made to a loss account (or a previously established revaluation surplus) and a credit is made to an asset account.

To illustrate, assume that in 2010 Turnbow Company measures property, plant, and equipment at revalued amounts and that it owns a building with a cost of $100,000 and a current fair value of $120,000. The increase from the cost of the building to its fair value follows:

2010		
Building	$20,000	
Revaluation Surplus, Building		$20,000

After revaluation, the value on the balance sheet must represent its current fair value. At each year end, management should consider whether the asset's fair value materially differs from its carrying value.

Subsequent decreases in an asset's value are first charged against any previous revaluation surplus for that asset; then, the excess should be expensed. If previous revaluations resulted in an expense, subsequent increases in value should be charged to income to the extent of the previous expense. Any excess is credited to equity (revaluation surplus).

Next, assume that in 2011 Turnbow Company determines that the fair value of the building has decreased to $90,000. The appropriate entry is as follows:

2011		
Revaluation Surplus, Buildings	$20,000	
Revaluation Loss, Buildings	10,000	
Buildings		$30,000

After a revaluation, accumulated depreciation must be also remeasured. Two methods are permitted as follows:

- ***Proportional Method***: Accumulated depreciation is restated proportionately so that the asset's carrying amount after revaluation equals its revalued amount.
- ***Reset Method***: Accumulated depreciation is eliminated against the asset's gross carrying amount and the net amount is restated to the revalued amount of the asset.

To illustrate the *promotional method*, assume that Turnbow Company owns a different building that costs $200,000 with accumulated depreciation of $80,000 and a carrying value of $120,000. Assume the building's current fair value is $150,000. Turnbow restates both the building account and the accumulated depreciation account using the ratio of net carrying amount to gross carrying amount of 80 percent ($120,000/$150,000). The building's carrying value is increased to the fair value in the following entry, which increases the Building to $250,000, Accumulated Depreciation to $100,000, Carrying Value to $150,000, and creates a Revaluation Surplus of $30,000, which is classified as equity:

Building	$50,000	
Accumulated Depreciation, building		$20,000
Revaluation Surplus, Building		30,000
$200,000/.8 = $250,000; $250,000 − $200,000 = $50,000		
$80,000/.8 = $100,000; $100,000 − $80,000 = $20,000		

Under the *reset method*, Turnbow first resets or reduces accumulated depreciation by $80,000 to $0. Next, the resulting balance of the buildings account of $120,000 ($200,000 − $80,000) increased by $30,000 and now the carrying value equals the $150,000 fair value. The entries are as follows:

Accumulated Depreciation, Buildings	$80,000	
Buildings		$80,000
Buildings	$30,000	
Revaluation Surplus, Buildings		$30,000

In both cases, the resulting carrying value of the buildings is increased to $150,000 and a revaluation surplus of $30,000 is recorded. Next year, the annual depreciation expense will be based on the $150,000 carrying value. In addition the buildings will be assessed for revaluation in subsequent years. At derecognition (disposal or sale) date, any remaining revaluation surplus is closed directly to retained earnings.

The revaluation surplus included in equity may be transferred directly to retained earnings when the surplus is realized, such as in the case of sale of the asset. It may also be realized over time as the asset is used by the entity. Also, subsequent depreciation is applied to the remaining carrying value of the building. Thus, assuming the building has a remaining useful life of 20 years and has no salvage value, depreciation will be computed on the carrying value of the building at $150,000, resulting in annual depreciation of $7,500 ($150,000/20 years). The realized revaluation surplus will be realized annually in the amount of $2,500 ($50,000/20 years). The entry is as follows:

Depreciation Expense	$7,500	
Revaluation Surplus, Building	2,500	
Accumulated Depreciation, Buildings		$7,500
Retained Earnings		2,500

The revaluation surplus, assuming no further revaluations (or impairments), will reduce to 0 over the 20-year period.

IMPAIRMENT

While both U.S. GAAP and IFRS provide for impairment testing of long-lived assets (tangible and intangible), the differences are significant. U.S. GAAP require impairment tests at the "reporting unit" (RU) level whereas IFRS test for impairment at the "cash generating unit" (CGU) level. The RU is an operating unit, or one-step below an operating unit, for which management regularly reviews financial information. A CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows of other assets or groups of assets. In some companies, these approaches may result in different units to which impairment tests are applied, and therefore produce different results. How to test also differs.

U.S. GAAP impairment tests for long-lived assets are a two-step process:

1. If the total undiscounted future cash flows of RU long-lived assets is greater than their carrying value, then no impairment exists and no further step is required.
2. If the carrying value of their assets is less than the total undiscounted future cash flows (present value), then compute the present value of the future cash flows. The impairment loss equals the carrying value minus the discounted cash flows.

IFRS impairment tests do not consider undiscounted cash flows, but compare the carrying value with the recoverable amount which is the greater of

- Net selling price—the market value of the asset less disposal costs.
- Value in use—the discounted value of the future net cash flows (present value).

Furthermore, U.S. GAAP prohibit impairment reversals in the future, but IFRS allow such reversals if values recover except for goodwill that cannot be reversed. To illustrate IFRS treatment, consider the examples below.

Example 1: A building has a fair value of $180,000 and a carrying value of $224,000. The asset impairment of $44,000 ($224,000 – $180,000) is recorded as follows:

Impairment Loss (expense)	$44,000	
Accumulated Impairment Loss		$44,000

Accumulated Impairment Loss is a contra-asset account and is deducted from the building account on the balance sheet. Further impairment in future years would increase the accumulated impairment loss similarly. A future revaluation increase in value would first be used to reduce the accumulated impairment loss to zero before creating a revaluation surplus. Similarly, when an asset has a revaluation surplus and incurs a reduction in fair value, the revaluation surplus absorbs the reduction before a loss is recorded, as illustrated in Example 2.

Example 2: Assume a building with a revaluation surplus of $25,000 is now deemed impaired by $39,000. The entry to record the asset at fair value is:

Impairment Loss	$14,000	
Revaluation Surplus. Building	25,000	
Accumulated Impairment Loss		$14,000
Building		25,000

RESEARCH AND DEVELOPMENT COSTS

Several important differences between U.S. GAAP and IFRS exist with regard to accounting for research and development costs:

- U.S. GAAP require both research and development costs to be expensed as incurred. By contrast, IFRS require research costs to be expensed but development costs to be capitalized and amortized when technical and economic feasibility of a project can be demonstrated.
- Under IFRS, in-process research and development costs, acquired as part of a business combination, are capitalized, amortized, and are subject to impairment tests. For now, U.S. GAAP require expensing of in-process research and development although this may change as part of the convergence project.
- Under U.S. GAAP, internal software development costs can be capitalized in certain circumstances. Under IFRS, internal software development is not specifically addressed, and thus, the rules of research and development costs stated above apply.

Exhibit 3–3: Equity Terminology under U.S. GAAP and IFRS

U.S. GAAP	IFRS
Common stock	Share capital
Paid-in capital or	
Additional paid-in capital	Share premium
Retained earnings or	Retained earnings, retained profits, or
Reinvested earnings	Accumulated profit and loss
Treasury stock	Treasury stock
Accumulated other comprehensive income	General reserves or other reserve accounts

EQUITY

A major classification difference between U.S. GAAP and IFRS relates to (1) the definition of equity and (2) the distinction between debt and equity. Equity accounting is part of the convergence project, which will possibly reduce the difference. Exhibit 3–3 shows the differences in terminology between U.S. GAAP and IFRS.

Under IFRS, equity includes only the common or basic shareholder interests, whereas under U.S. GAAP stockholders' equity includes all shareholder interest including preferred stock.

"Reserves" is a term rarely used in U.S. GAAP, but is often used in IFRS to refer to all equity accounts other than share capital and premium. General reserves include components of other comprehensive income. Revaluation surplus is classified in equity as other reserve accounts.

Treasury stock is shown as a deduction in both cases but under IFRS it may be deducted against any of the equity accounts on the basis of judgment as to the most appropriate account. No gains or losses are recorded on sale on treasury. Any difference between purchase and sale price is an increase or decrease in equity.

Under U.S. GAAP, there is a "mezzanine" category, which exists between debt and equity. Examples of this mezzanine level are deferred income taxes and minority interest. IFRS, on the other hand, do not recognize this "neither debt nor equity" category. Under IFRS, everything is either debt or equity, and equity is limited to the common stockholder interest. This raises questions in at least three areas:

1. How are compound financial instruments such as convertible bonds and stocks, which have characteristics of both debt and equity, to be classified?
   - U.S. GAAP: convertible bonds are classified as debt and convertible stock is classified as equity.
   - IFRS: "split" accounting is required for these compound instruments. Under split accounting, the proceeds of the financial instrument are allocated between its debt component at fair value and it equity component at the residual value.
2. How is minority interest classified?
   - U.S. GAAP: Minority interest is classified as "mezzanine" and thus is not part of equity.
   - IFRS: Minority interest is classified as equity.
3. How should deferred income tax assets and liabilities be classified?
   - U.S. GAAP: Deferred income tax assets and liabilities are classified based on the classification of the related asset or liability. Thus, the classification may be either current or non-current.
   - IFRS: Deferred income tax assets **or** liabilities are classified only as non-current.

SHARE-BASED PAYMENTS

U.S. GAAP and IFRS handle share-based payments (SBP) in a similar manner in that both:

- Recognize goods or services paid in shares or SBP.
- Measure SBP at fair value on the grant date.
- True up for failure to meet service, non-market vesting conditions.
- Do not true up for failure to meet market conditions.
- Remeasure cash-settled SBP through settlement.

A major difference is that U.S. GAAP rules apply only to employee SBP, whereas IFRS apply to all SBP, including non-employee SBP. Numerous other technical differences are beyond the current discussion.

CONSOLIDATION

U.S. GAAP, with few exceptions, require a greater than 50 percent ownership before financial statements of related companies are consolidated into a single set of financial statements. IFRS place more weight on judgment rather than voting control. IFRS consolidation is based on assessing risks and rewards, as well as governance and decision-making activities. Thus, under IFRS, consolidation may be required more often than under U.S. GAAP when a company has less than 50 percent ownership but effectively controls the other entity. (This option is allowed under U.S. GAAP but is rarely employed in practice.) Consequently, under IFRS, joint ventures, special purpose entities (SPE), and franchises will more likely be consolidated.

Since 2009, both U.S. GAAP and IFRS report income of less than 100 percent owned subsidiaries in the same way. The parent company will include 100 percent of the subsidiary's income in its income. The income attributable to shareholders of the subsidiary will be deducted on the face of the statements to present net income attributable to the parent.

ASSIGNMENTS

1. What are rules-based and principles-based standards and how do they differ in application across four characteristics?
2. How do U.S. GAAP and IFRS differ in their implementation of accrual accounting?
3. Why is the characterization of U.S. GAAP, based on historical cost, not valid? Give examples.
4. Why is fair value critical to U.S. GAAP and IFRS and how do they differ in the application of fair value?
5. Why is revenue recognition a good example of the contrasting approaches of IFRS and U.S. GAAP to level of detail? Why might this situation change?
6. How does the IFRS balance sheet approach to revenue recognition differ for the U.S. GAAP approach?
7. Do U.S. GAAP or IFRS give more industry guidance? Give an example.
8. How do U.S. GAAP and IFRS differ with regard to recognition of purchase commitments?
9. How do U.S. GAAP and IFRS differ with regard to recognition of contingencies?
10. What is recycling and how does it apply to comprehensive income?
11. What are the two main differences in inventory accounting between U.S. GAAP and IFRS?
12. What are the three major differences between U.S. GAAP and IFRS in the use market value in inventory accounting?
13. What is revaluation; to what does it apply; and how would it result in a revaluation surplus? Where does the revaluation surplus appear in the financial statements?
14. What are the two methods that may be used to accomplish a revaluation?
15. What eventually happens to the revaluation surplus?
16. To what business units does impairment test apply under U.S. GAAP and IFRS?
17. How do impairment tests differ under U.S. GAAP and IFRS?
18. What is the difference in accounting for research and development cost between U.S. GAAP and IFRS?

19. What is a mezzanine category and why is it an important classification issue?
20. How does the classification of minority interests, deferred tax and liabilities, and convertible bonds and stocks differ under U.S. GAAP and IFRS?
21. What role does judgment play in deciding whether a controlling interest exists for consolidation under U.S. GAAP and IFRS?
22. *Discussion or group question*: Among the differences between U.S. GAAP and IFRS listed in this section, which two do you feel the most difficult to reconcile and why?
23. *Exercise—Revaluation* Reval Inc. prepares financial statements in accordance with IFRS and has elected to use the revaluation model to account for its buildings. Reval Inc. acquired a building on January 1, 20X3 for $300,000. At that time it estimated the useful life of the building to be 60 years, with no residual value. It is now January 1, 20X3. The carrying amount of the building is $275,000 ($300,000 – (5 × $5,000)). Reval Inc. has obtained an appraisal valuing the building at $385,000.

Part I:

1. Show the accounting entries to recognize the revaluation and corresponding depreciation in 20X3.
2. Show the balances on the building and revaluation surplus accounts at December 31, 20X3.

Part II:

On January 1, 20X4, a major fire damages a significant part of the building. Reval Inc. has no insurance and the value of the damaged building is impaired, such that the remainder of the building has a value of only $250,000. Show the entries to reflect the impairment on January 1, 20X4.

24. *Exercise: Impairment* Impair Inc. has an operating segment that is composed of three cash generating units (CGUs) as follows:

CGU A – retail operations located in the Midwestern U.S.
CGU B – retail operations located in the Eastern U.S.
CGU C – retail operations located in the Pacific Northwest U.S.

Impair has discrete financial information available for each CGU, however segment management does not regularly review the operating results of each CGU. Financial information for each CGU is as follows:

	CGU A	**CGU B**	**CGU C**
Identifiable long-lived assets	$100,000	$250,000	$250,000
Other identifiable net assets	25,000	20,000	50,000
Goodwill	75,000	50,000	80,000
Book value	$200,000	$320,000	$380,000
Undiscounted cash flows of CGU	$225,000	$225,000	$700,000
Value in use of CGU	190,000	190,000	570,000
Fair value of CGU	185,000	185,000	560,000

The fair value of the operating segment (CGUs A, B, and C collectively) is $940,000.

Under IFRS:

1. Determine the amount of impairment loss to be recognized and the amount of any impairment loss that is assigned to goodwill.
2. Determine what amount, if any, of the impairment loss potentially is available to recover if the situation changes at a later point in time.

Under U.S. GAAP:

1. Determine the amount of impairment loss to be recognized and the amount of any impairment loss that is assigned to goodwill.
2. Determine what amount, if any, of the impairment loss is potentially available to recover if the situation changes at a later point in time.

IV. IFRS FOR SMALL- AND MEDIUM-SIZED ENTITIES

The IASB issued its landmark ***IFRS for Small and Medium-sized Entities (IFRS for SMEs)*** in July 2009. These standards open the door for U.S. private entities with no public accountability to begin using IFRS for SMEs immediately. This action is possible because, as noted in an earlier chapter, the AICPA has designated the IASB as a high-quality standard setter; thus, opening the door for its standards to be used in the United States by private companies. U.S. public companies fall under the jurisdiction of the SEC, which has not yet approved the use of IFRS by these companies. This chapter covers the definition of an SME; identifies the benefits and costs of adoption of IFRS for SMEs; summarizes their development and field tests; and compares and contrasts full IFRS with IFRS for SMEs.

IFRS FOR SMEs DEFINED AND DESCRIBED

The IFRS for SMEs project has been ongoing for several years, first by the IASC and then the IASB. An important contributor to the current SME standards was a 40-member working group of SME experts. By February 2007, the IASB issued an Exposure Draft (ED) first in English then ultimately in five additional languages (Spanish, French, German, Polish, and Romanian). Field testing of the ED included 116 small-and medium-size companies in 20 countries. After receiving 162 comment letters on the ED, further simplifications were made in the final document.

A primary objective of IFRS for SMEs is to provide a set of standards for firms that publish general-purpose financial statements but are entities that have no public accountability. Specifically, an SME must meet these two criteria:

- Have no publicly-traded debt or equity
- Not hold assets as fiduciary for a broad group of outsiders (i.e., fiduciaries include banks, insurance companies, securities broker/dealers and mutual funds)

Most notably, the IASB did not include a size test in its definition of an SME.

As a complete and separate set of financial accounting and reporting standards, IFRS for SMEs are a simplified version of full IFRS. It numbers about 230 pages, whereas full IFRS numbers about 2,500 pages. By contrast, U.S. GAAP numbers about 25,000 pages. Even the FASB codified version of U.S. GAAP are slimmed down to only about 17,000 pages.[1]

The impact of IFRS for SMEs on private entities globally and in the United States is potentially enormous. In the EU, there are about 21 million public and private entities, of which approximately 5 million are businesses that require a statutory audit and must use of IFRS. The remaining 16 million other types of private entities typically report under their local GAAP. In the United States, there are about 20 million entities, of which approximately 25,000 require a statutory audit as SEC registrants, banks, and other regulated business entities. The other more than 19 million U.S. entities currently using U.S. GAAP may now consider use of IFRS for SMEs if they qualify.

IFRS for SMEs provide potential benefits for most U.S. private companies. The simplified IFRS for SMEs are much easier and less costly to implement than full IFRS because, in addition

[1] "Is Small Biz Ready to Adopt IFRS for SMEs?' *WebCPA*, July 13, 2009.

to being shorter and simpler, they have fewer differences from U.S. GAAP than exist under full IFRS (see Exhibit 4–1). Further, some entities gain distinct advantages from adopting IFRS for SMEs. Among these are;

- Entities owned by a foreign parent currently using IFRS
- Entities with foreign investors familiar with IFRS
- Entities that are suppliers to foreign companies using IFRS
- Entities that have a foreign venture capital partner familiar with IFRS
- Growing entities preparing to enter public markets where a full IFRS would otherwise be required

Not every U.S. SME will want to immediately change to the new IFRS for SMEs. According to Ron Box, the CFO at Joe Money Machinery in Alabama said, "I will consider adopting the new standard when the primary users of financial statements are fully educated in it and can intelligently evaluate it."[2] This concern is very real. U.S. banks lending money to an SME are unlikely to be familiar with the IFRS for SMEs. This may create a new hurdle especially if a business owner is seeking an extension on a line of credit. Also, existing debt covenants may need revision after assessing impact of IFRS for SMEs on the financial statements. Practically speaking, it may be expensive to hire staff trained in IFRS for SMEs. Finally, IFRS for SMEs relies more heavily on professional judgment than U.S. GAAP.

Some surveys about IFRS for SMEs address the concerns raised in the previous paragraph. For example, Deloitte reported the results of a survey of U.S. private companies.[3] Among the 220 companies responding, 45 percent were closely held and 29 percent were family owned. Deloitte assumed a threshold for SME classification was a SME with less than $1 billion in revenue. The results indicated that:

- 43 percent of SMEs were unaware of the IFRS for SMEs.
- 3 percent of SMEs currently used the full IFRS.
- 7 percent would consider using IFRS for SMEs in the near future.
- 63 percent of SMEs would adopt when required.

Further, evidence from Australia may be indicative of the reception in the United States Since 2005 Australian law requires businesses over a certain size to publish financial statements using full IFRS if any two criteria below are met:

- Revenue is greater than $25 million.
- Assets are greater than $12.5 million.
- Number of staffs are 50.

A recent survey in Australia by Grant Thornton found overwhelming support for IFRS for SMEs.[4] Eighty-three percent of Australia respondents support IFRS for SMEs. The primary reasons are the immediate benefits of reduced complexity and cost of implementing full IFRS. These respondents were Australian company directors, auditors, accounting firms, and professional bodies.

Thus, IFRS for SMEs are expected to reduce the cost of compliance compared with full IFRS and reduce the complexities in areas such as scope, measurement and disclosure. And because the jurisdiction of full IFRS does not necessarily extend to private entities, IFRS for

[2] "Private Companies Get IFRS Made Easy," *CFO.com*, July 10, 2009.

[3] "IFRS survey 2009 for private companies," *Deloitte* (2009).

[4] "Accounting Standards 'Need Simplifying,'" *Brisbanetimes.com*, June 16, 2009.

SMEs may provide a potential alternative to local country GAAP if adopted. The cost burden is further reduced because the IASB plans to limit changes to IFRS for SMEs to once every three years.

"FULL IFRS" AND "IFRS FOR SMEs" COMPARED AND CONTRASTED

Full IFRS has been modified in several ways resulting in IFRS for SMEs. First, certain topics are omitted from SME standards. Second, usually the simplest of alternative methods was chosen. Third, many recognition and measurement principles were simplified. Fourth, substantially fewer disclosures are required. Fifth, IFRS for SMEs has a simplified redrafting of the financial statements.

For example, topics included in full IFRS but eliminated for SMEs' IFRS include:

- Earnings per share
- Interim financial reporting
- Segment reporting
- Special accounting for assets held for sale

There are also some options from the full IFRS that have been eliminated for SMEs:

- For investment property, measurement is driven by circumstances rather than allowing an accounting policy choice between the cost and fair value models.
- Various options for government grants eliminated in favor of a single simplified model.
- Biological assets measured at fair value with changes taken to profit and loss only when fair value is readily determinable without undue cost or effort. Otherwise, use cost-depreciation-impairment model.
- Share-based payments require use observable market value but if unavailable, directors' best estimate of fair value is used.

Recognition and measurement principles for financial instruments are simplified for the SMEs in the following ways:

- If certain criteria are met, measure securities at cost or amortized cost. All others are measured at fair value with changes in fair value reflected in profit and loss. Eliminates complexities of classifying securities into four categories.
- Derecognition of financial instruments eliminates "pass though" and "continuing involvement" tests that are required in full IFRS.
- Hedge accounting requirements are simplified (including calculations) and tailored for SMEs.

Additional simplifications include:

- The valuation of "Investments in Joint Venture and Associates" may be measured at cost *unless* there is a published price quotation (when fair value must be used). Other fair value levels do not apply.
- Measuring defined benefit obligation has been simplified. All past service costs must be recognized immediately in profit and loss. It permits the recognition of actuarial gains and losses in other comprehensive income or immediate recognition in P&L. It required use of projected unit credit method to measure obligation and related expense *only if* possible without undue cost or effort.

Exhibit 4–1: Full IFRS Compared to IFRS for SMEs

Full IFRS	IFRS for SMEs
• Property, Plant and Equipment (PPE) may be carried at historical cost or at revalued amount (if fair value can be measured reliably) less accumulated depreciation. • Residual value, useful life and depreciation method are reviewed *annually* as part of impairment tests. • Borrowing costs on qualifying assets *must be* capitalized. Other borrowing costs are expensed. • Research costs are expensed. Development costs *must be* capitalized and amortized if criteria are met. • An intangible with an indefinite life shall *not* be amortized. • Revaluation of intangibles is permitted. • Held-to-maturity investments are measured at amortized cost using effective interest method. • Proportionate consolidation *may be used* to account for a jointly controlled entity. • Assets or groups of assets held-for-sale are classified separately.	• Property, Plant and Equipment (PPE) must be carried at historical cost less accumulated depreciation. • Residual value, useful life and depreciation method are reviewed *only if* there is an indication of related asset impairment. • *All* borrowing costs are expensed when incurred. • Research and development costs *are expensed* when incurred. • *Always amortize* goodwill and indefinite-life intangibles. (Use 10 years if life cannot be estimated reliably.) • Revaluation of intangibles is prohibited. • There is *no* designation of held-to-maturity securities. Debt instruments that meet certain criteria are measured at amortized cost using effective interest method. • Proportionate consolidation *is not an option* to account for a jointly controlled entity. • No separate held-for-sale classification.

Exhibit 4–1 summarizes some of the major recognition, valuation and classification differences between the full IFRS and the IFRS for SMEs. The result of the simplification draws the full IFRS standards closer to U.S. GAAP. To give two examples:

- Property, plant and equipment must be carried at historical cost less accumulated depreciation and never reflect an increase in value.
- Research and development costs are expensed when incurred rather than capitalizing development costs.

SUMMARY, RESOURCES, AND TRANSITION

In summary, IFRS for SMEs is a stand-alone set of financial accounting standards. IASB preliminary plan is to update IFRS for SMEs on a three- year cycle. Until the IFRS for SMEs are amended, any changes to the full IFRS do not apply to the IFRS for SMEs. Furthermore, when revision of SME standards is made the IASB will consider any new and amended IFRS as well as issues raised by IFRS for SMEs adopters. Further developments for IFRS for SMEs are covered in the next chapter.

The complete IFRS for SMEs standard, along with the basis for conclusions, illustrative financial statements, and a presentation and disclosure checklist, can be downloaded for free from **http://go.iasb.org/IFRSforSMEs.**

Transition to the IFRS for SMEs for first time adopters is discussed on pages 204–208 of the standard. It is a major simplification of IFRS 1 "First time adoption of IFRS."

ASSIGNMENTS

1. What are IFRS for SMEs and what need are they meant to serve?
2. What are the two criteria for determining an SME?
3. Why would U.S. private companies be interested in IFRS for SMEs?
4. What U.S. companies are most likely to be earlier adopters of IFRS for SMEs?
5. What are some examples of topics not required under IFRS for SMEs?
6. What are some options that have been eliminated under IFRS for SMEs?
7. What are some simplifications from full IFRS by IFRS for SMEs?
8. Referring to Exhibit 4–1, what do you think are five of the most important differences between full IFRS and IFRS for SMEs?
9. *Discussion or group question*: Do you think U.S. private companies will embrace IFRS for SMEs? Why or why not?
10. *Case*: Private, Inc. is a growing U.S. manufacturing company of solar water processing equipment that exports 50 percent of its product. The CEO has commissioned a feasibility study for adoption of IFRS for SMEs. She has heard at a conference that IFRS for SMEs could be beneficial for the company's financial reporting. She has asked you, as CFO, to investigate the differences in IFRS for SMEs from full IFRS and indicate the differences that you think would have the most impact of your company. Refer to Exhibit 4–1 in developing your answer and be sure to take into account the type of business in which Private, Inc. is engaged.

V. THE CURRENT STATUS AND FUTURE OF IFRS

The momentum toward IFRS for public companies in the United States and elsewhere seems strong. The FASB, IASB, SEC, AICPA, big accounting firms, and others support this movement. A survey of CFOs and other financial professionals by Deloitte reports that although many of the companies are delaying plans for IFRS as they wait for the SEC to clarify its position, 70 percent favor adopting IFRS as proposed in the SEC roadmap. They want the SEC to set a firm date for adoption of IFRS.[1] As noted earlier, the FASB and the IASB reaffirmed their commitment to intensifying the effort the complete the major convergence projects described in their memorandum. After a slow start with the new administration in Washington, the SEC under Mary Schapiro, President Obama's choice as chair of the SEC, seems ready to support at least convergence of U.S. GAAP and IFRS. The SEC's draft Five-Year Strategic Plan, released in October 2009, includes support for a single set of high-quality accounting standards and promotes the convergence effort of the FASB and the IASB.[2] The SEC reaffirmed in February 2010 its intention to make a decision in 2011 as whether to require IFRS beginning in 2015.[3]

As noted previously, some important accounting organizations including the National Association of State Boards of Accountancy (NASBA)[4] and the New York Society of CPAs (NYSSCPA) have opposed the SEC roadmap,[5] However, they would appear to be in the minority. A survey of accounting professionals by the AICPA taken after the SEC's roadmap was released shows the sentiment in business moving toward IFRS. Fifty-five percent majority of CPAs at firms and companies nationwide are preparing in some way for adoption of IFRS (up from 41 percent previously). Forty-five percent are not preparing yet for IFRS (down from 59 percent previously.

The Chair of the IASB, Sir David Tweedie, met with Schapiro in an attempt to keep the roadmap on track.[6] Tweedie says, "IFRS are well advanced toward becoming the global language for financial reporting, which is one of the reasons why G-20 leaders at their meeting in London this year called for substantial progress toward global accounting standards."[7] He also sites plans for IFRS in Japan, India, and Korea as evidence of momentum in Asia.

Critics make valid points, but it seems unlikely that they will prevail. Whatever the final timing of the SEC roadmap, the FASB–IASB convergence efforts and joint standards are closing the gap between U.S. GAAP and IFRS and companies are planning for the transition.

---

[1] "SEC Should Approve Adoption of IFRS," *AccountingWEB,* October 6, 2009

[2] Ibid.

[3] "New IFRS Timeline Emerges from SEC Vote on Work Plan," *JournalofAccountancy.com*, February 24, 2010.

[4] "NASBA Response to SEC Roadmap," *NASBA.org*, February 19, 2009.

[5] "New York CPAs Slam IFRS Roadmap," *CFO.com,* March 6, 2009.

[6] "IASB'S Tweedie Meets New SEC Chairman," *Accountancy Age* February 13, 2009.

[7] Ramona Dzinkowski, "What's Ahead for Global Standards," *Strategic Finance,* November 2009.

REMAINING DIFFERENCES BETWEEN U.S. GAAP AND IFRS

In sum, many similarities between U.S. GAAP and IFRS exist, but significant differences remain, including:

- ***Concepts and approaches***: for example, IFRS allow revaluation of non-financial assets.
- ***Acceptable methods***: for example, IFRS prohibit LIFO inventory accounting.
- ***Levels of details***: for example, the contrasting approaches to revenue recognition.
- ***Industry specific guidance***: for example, U.S. GAAP provide substantially more industry guidance.
- ***Scope of application***: for example, employee share-based payments under U.S. GAAP versus all share-based payments under IFRS.
- ***Implementation details***: for example, differences in effective dates and transition.

Over time as the joint IASB–FASB efforts continue, many differences will be reduced or eliminated. The IASB and FASB are collaborating on the many convergence topics, including the ambitious and the convergence agenda for 2010 shown in Exhibit 5–1. Other topics being considered are convergence are the following:

- Income taxes
- Insurance contracts
- Post-employment benefits (including pensions)
- Discontinued operations
- Earnings per share
- Various aspects of the conceptual framework[8]

Exhibit 5–1: Joint FASB–IASB Convergence Projects

PROJECT	GOALS FOR 2010
Financial instruments, recognition, and measurement	Issue FASB exposure draft, late 2009/ early 2010
Financial instruments with characteristics of equity	Issue FASB/IASB draft, first quarter
Consolidation and special-purpose entities	Issue FASB draft, first half
Fair-value measurement guidance	Issue IFRS, second quarter
Emissions-trading schemes	Issue FASB/IASB draft, second quarter
Revenue recognition	Issue FASB/IASB draft, second quarter
Financial-statement presentation	Issue FASB/IASB draft, second quarter
Leases	Issue FASB/IASB draft, second half
Derecognition	Issue IFRS, second half

By reducing differences between U.S. GAAP and IFRS, the convergence effort will facilitate the adoption of IFRS should the SEC decide in 2011 to mandate IFRS.

[8] IASB, "IASB Work Plan—Projected Timetable as of 31 October 2008" (2008).

Almost 8,000 European companies in 25 countries underwent the transition from their local GAAP to IFRS since 2005, and thus provide some evidence as to how difficult the transition may be in the United States. Although few U.S. companies are currently planning the transition, they will surely learn from the European experience. The IASB provides in IFRS No. 1 directions for first-time adopters to make this transition to IFRS.[9] For instance, when a company issues comparative financial statements, IFRS must be applied to the current year and retroactively to the prior year. While the IASB makes some allowances under IFRS No. 1 to facilitate the transition process, such as allowing for financial statement presentations that do not go as far as the proposed presentations discussed in Chapter 2 of this document, the transition to IFRS is quite technical, requires careful planning, and is likely to be more costly than experienced in Europe.[10] So far, few companies have taken the SEC up on the call for voluntary adoption of IFRS.[11] The risks and costs in a period of financial crisis are too high. The estimated cost to adopt IFRS varies but most companies estimate the cost between .125 percent and .250 percent of revenues.[12] Thus, the cost for a $10 billion company would be between $12,500,000 and $25 million depending on such factors as the type of industry, the firm size, complexity of the business, staffing abilities, and accounting policies.

Specific guidance is provided in IFRS No. 1 with regard to allowed exemptions by first-time adopters. For example, exemptions may be elected in some of the more complex reporting areas, such as other assets and liabilities, employee benefits, accumulated translation differences, compound financial instruments, insurance contracts, leases, and others. Also, companies may elect not to apply in the first year with certain fair value requirements in such areas as business combinations, revaluations, investment properties, and intangible assets. Estimates under IFRS should be consistent with those under U.S. GAAP unless there is objective evidence that those estimates were in error.

Finally, the company should provide a reconciliation with its IFRS financial statements to explain how the transition from U.S. GAAP to IFRS affected its reported financial position, financial performance, and cash flows.

Conversion to IFRS will require a whole company effort beyond just the accounting function. Key activities that will lead to a company's successful conversion include:

- Establishment of a project management team that has direction, comprehensive planning, execution tactics, and monitoring.
- Development of a conversion timeline.
- Identification of the areas other than financial reporting that will be affected.
- Development of an IT strategy that modifies all systems related to the conversion.
- Implementation of effective training across the entire organization.
- Learning from experiences in Europe and other countries.
- Establishment of a communications plan.[13]

It is projected that technical accounting work will account for only about 20 percent of the conversion cost. The rest of the cost will involve technology issues and processes. Most

[9] IASB, *IFRS No. 1: First-Time Adoption of International Financial Reporting Standards* (2007).

[10] Sarah Johnson, "Guessing the Cost of Conversion," *CFO.com,* March 30, 2009.

[11] "Copncerns About Cox IFRS Proposal," *Strategic Finance,* May 2009.

[12] "AICPA, "AICPA IFRS Preparedness Survey," **www.aicpa.org**, September 2009.

[13] Danita Osling, "Converting to IFRS," *Journal of Accountancy,* January 8, 2009.

companies feel that adopting IFRS will transform the finance function in their companies. Value will be created by mitigating financial reporting risk, decreasing financial transparency risk, and creating operational efficiencies.[14]

THE PROSPECTS FOR IFRS FOR SMES

IFRS for SMEs are potentially very attractive for the 20 million U.S. private companies, five million of which are corporations that are not public entities. As noted in Chapter 4, these private companies may use IFRS for SMEs now, and receive audit reports on their financial statements from their independent accountants under recent bylaw changes by the AICPA. IFRS for SMEs represent a complete set of accounting standards and are only 10 percent as long as the 2,500 pages of full IFRS and 1.5 percent as long as the 17,000 pages of codified U.S. GAAP. Sir Tweetie, Chair of the IASB maintains, "The British are proposing to adopt it [IFRS for SMEs], and it's going very well in other parts of Europe. That standard is proving hugely popular. . . . There are only 250 pages and it deals with all the major issues."[15] In December 2009, the AICPA and the Financial Accounting Foundation (governing board of the FASB) established a "blue-ribbon panel" to address how U.S. accounting standards can best meet the needs of users of private company financial statements. The panel plans to make recommendations on the future of standard setting for private companies and on whether separate, standalone accounting standards are needed for private companies. IFRS for SMEs is expected to be an important component of the panel's agenda. "The time has come for a new look at the policy issues of how U.S. GAAP are established for private companies," said AICPA CEO and President Barry Melanson.[16]

IMPLICATIONS FOR ACCOUNTING EDUCATION

Adapting to IFRS requires attention and study for U.S. accounting, audit, and tax practitioners, as well as accounting educators and students. Keeping up with all the changes is a daunting but important task. More importantly, the emphasis in IFRS accounting will not be on memorization of rules. The dual analytical effect of transactions resulting from business decisions and changes in the environment must be understood, but bookkeeping techniques are not essential knowledge. IFRS require accounting students (and educators) to realize that virtually every number in financial statements:

- Results from judgment and estimates
- Has a basis in valuation and fair value
- Is rooted in the conceptual framework
- Is based on an application of a standard

And, therefore, they must learn:

- To make judgments in a world of uncertainty
- To apply a variety of valuation models

[14] "Survey of >200 CFOs", *Accenture.com,* March 31,2009.

[15] Ramona Dzinkowski, "What's Ahead for Global standards," *Starategic Finance,* November 2009.

[16] The American Institute of Certified Public Accountants and the Ribbon Panel" to Address Standards for Private Companies," Press Release, AICPA, December 17, 2009.

- To focus on underlying concepts and their application
- To research standards and interpretations

Although the financial crisis impeded the SEC's effort to persuade 110 of the largest companies to voluntarily adopt IFRS,[17] most authorities feel the adoption of IFRS in the United States is simply a matter of time. As mentioned in the introduction, the AICPA has already made it possible through its code of professional conduct for U.S. private (non-public) companies to adopt IFRS. A recent survey shows that AICPA members expect a shift to IFRS in the next three to five years.[18] Another survey reports that investment executives and analysts believe that IFRS will make U.S. stocks more attractive to foreign investors and that most feel the SEC timeline is "about right." However, the same survey says that less than 20 percent of investors and analysts understand the implications of IFRS.[19] Three to five years is a relatively short period. Business and accounting students entering universities and colleges now will likely face IFRS when they graduate. For them to be well educated in IFRS, accounting educators face the imperative task of adapting the accounting curriculum for IFRS.

ASSIGNMENTS

1. What are the major types of differences between U.S. GAAP and IFRS? Give an example of each.
2. What is the convergence project and what are its goals for 2010?
3. What are the main generalizations that can be made about IFRS?
4. What are the characteristics of numbers in the financial statements under IFRS?
5. Do companies that adopt IFRS have to follow all the standards in the first year? What are some possible exceptions?
6. Why may IFRS for SMEs have an important impact of financial reporting in the United States?
7. What changes will likely take place in accounting education as a result of IFRS?
8. *Research question*: Choose one topic listed in Exhibit 5–1 that is being jointly studied for convergence by the IASB and the FASB. Go to the websites listed in Appendix D. Find references to the topic on at least five sites and summarize the current status of the joint effort in two pages, using a statement of the issues that needs to be resolved with regard to the topic.
9. *Class or group discussion*: What do you think will be the most challenging obstacle for a company moving to adopt IFRS?
10. *Case*: JRC, Inc. is a multinational U.S. public company that operates in more than 10 countries. Based on the belief that the SEC is likely to require a move to IFRS, the CEO has decided to form an IFRS Planning Task Force to address the JRC's possible transition to IFRS. The CEO has asked you, as CFO, to prepare a short memorandum to him that delineates broadly the financial reporting transition to IFRS (under IFRS No. 1) and also recommend what other divisions of the company should be represented in the task force.

[17] "Survey of Financial Execs Reveals Challenges with IFRS," *Business Finance,* November 25, 2008; "SEC Hit with Barrage of IFRS Transition Complaints, *Financial Week/Reuters,* November 19, 2008.

[18] "AICPA Members Expect Shift to IFRS to Take 3 to 5 Years," *CIO Today,* November, 2008.

[19] "KPMG Survey Favors IFRS Adoption," *WebCPA*, February 23, 2009.

APPENDIX A: COMMON ACRONYMS

AICPA	American Institute of Certified Public Accountants
ASBJ	Accounting Standards Board of Japan
EC	European Commission
FASB	Financial Accounting Standards Board
G4+ 1	Standard setters in the United Kingdom, Canada, the United States, and Australia, plus the IASC
IFAC	International Federation of Accountants
IAAER	International Association for Accounting Education and Research
IASCF	IASC Foundation
IAS	International Accounting Standards
IFRIC	International Financial Reporting Interpretation Committee
IFRS	International Financial Reporting Standards
IASC	International Accounting Standard Committee
IASB	International Accounting Standards Board
MOU	Memorandum of Understanding
NASBA	National Association of State Boards of Accountancy
NYSSCPA	New York State Society of CPAs
PCAOB	Public Companies Accounting Oversight Board
SAC	Standards Advisory Council
SIC	Standards Interpretation Committee
SEC	Securities and Exchange Commission
SME	Small and medium-sized entities

APPENDIX B: IFRS TIMELINE

YEAR	ACTION
2001	The IASB is established.
2002	The European Union (EU) announces member states must use IFRS beginning in 2005. The IASAB and FASB formally agree to undertake efforts to converge U.S. GAAP and IFRS (The "Norwalk Agreement").
2005	The SEC releases a roadmap for allowing IFRS filings without GAAP reconciliation for foreign firms by 2009, or earlier. The European Union begins transition to IFRS as does Australia.
2006	The IASB and FASB agree to work major projects jointly, reaffirming the "Norwalk Agreement."
2007	The SEC announces foreign filers in the United States can file IFRS statements without reconciliation to U.S. GAAP.
2008	The SEC releases updated Roadmap for moving U.S. Companies to IFRS. The AICPA's governing council amends its Code of Professional Conduct to recognize the IASB as issuing high quality standards on a par with the FASB.
2009	The SEC is unsuccessful in seeking large company volunteers to convert to IFRS on a trial basis. The cost is estimated at $32 million per company. Brazilian companies begin using IFRS.
2010	IASB–FASB convergence project continues with aggressive agenda. The SEC is expected to provide further guidance with regard to the Roadmap.
2011	Canadian, Indian, and Japanese companies are slated to begin using IFRS.
2012	The SEC decides whether to follow for mandating use of IFRS for U.S. public companies.
2013–2017	Phased-in requirement to use IFRS by U.S. public companies if the SEC decides to go forward.

APPENDIX C: CURRENT IFRS AND IAS

As of January 1, 2009

Introduction
Preface to International Financial Reporting Standards
Framework for the Preparation and Presentation of Financial Statements

IFRS 1	First-time Adoption of International Financial Reporting Standards
IFRS 2	Share-based Payment
IFRS 3	Business Combinations
IFRS 4	Insurance Contracts
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations
IFRS 6	Exploration for and Evaluation of Mineral Resources
IFRS 7	Financial Instruments: Disclosures
IFRS 8	Operating Segments
IFRS 9	Financial Instruments
IAS 1	Presentation of Financial Statements
IAS 2	Inventories
IAS 7	Cash Flow Statements
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors
IAS 10	Events after the Balance Sheet Date
IAS 11	Construction Contracts
IAS 12	Income Taxes
IAS 16	Property, Plant and Equipment
IAS 17	Leases
IAS 18	Revenue
IAS 19	Employee Benefits
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance
IAS 21	The Effects of Changes in Foreign Exchange Rates
IAS 23	Borrowing Costs
IAS 24	Related Party Disclosures
IAS 26	Accounting and Reporting by Retirement Benefit Plans
IAS 27	Consolidated and Separate Financial Statements
IAS 28	Investments in Associates
IAS 29	Financial Reporting in Hyperinflationary Economies
IAS 31	Interests in Joint Ventures
IAS 32	Financial Instruments: Presentation
IAS 33	Earnings per Share
IAS 34	Interim Financial Reporting
IAS 36	Impairment of Assets
IAS 37	Provisions, Contingent Liabilities and Contingent Assets
IAS 38	Intangible Assets
IAS 39	Financial Instruments: Recognition and Measurement
IAS 40	Investment Property
IAS 41	Agriculture

There are also 16 (2 superceded) International Financial Reporting Interpretations (IFRIC) and 11 active pronouncements of the Standards Interpretation Committee (SIC).

APPENDIX D: SELECTED WEBSITES WITH IFRS RESOURCES

ORGANIZATIONS

IASB, http://www.iasb.org/ The IASB website includes information on the organization, background on IFRS and summaries of the current standards. Full text of the standards and interpretations are available by subscription.
FASB, http://asc.fasb.org/ Click on international.
IAAER, http://www.iaaer.org/ Full members, $25 annually and student members, $20 annually have free access to the full text of the standards and interpretations.
AICPA, http://www.ifrs.com/ The AICPA site with online videos and a list of resources and CPE offerings.
SEC, http://www.sec.gov/ Click on Global Accounting standards in left column.

ACCOUNTING FIRMS

BDO Seidman, http://www.bdo.com/ Click on IFRS Resource Center.
Deloitte, http://www.deloitte.com/ Click on issues and International Financial Reporting Standards IFRS including webcast; **http://www.iasplus.com/** Another Deloitte site with extensive resources.
Ernst & Young, http://www.eyonline.ey.com/ Click on perspectives/overview/IFRS.
Grant Thornton, http://www.gtexperience.com/ Login: initial of first name and last name (e.g., jdoe), and then click on faculty curriculum resources.
KPMG, http://www.kpmgifrg.com/ and http://www.kpmgifrsinstitute.com/ KPMG's online IFRS library and resources.
PriceWaterhouseCoopers, http://www.pwc.com/ Search on IFRS, go to IFRS home page.