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The Changing Face of Regulation

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SHOULD THE U.S. BE CONCERNED ABOUT IFRS?

There are two real issues for US companies – firstly should they choose to move to IFRS and secondly would it make any difference? Generally a single set of global accounting standards must be an appropriate response to some of the problems that are being faced and therefore a move to Internationally Recognised IFRS standards must make sense. Rohan Badenhorst, CIMA, offers his views.

A brief synopsis

For many companies there will be limited change to the existing appearance of their accounts and consequently limited investor concerns. However there are some types of institution which will have significant changes. The largest issue is that under IFRS investment, properties no longer need to be depreciated if they are maintained to adequate standard and accounted for under fair value. Companies may be more inclined to own their property on this basis since there would only be a financing stream and not an expense stream. Secondly, any contract that runs over the year end will have a proportion of its income included in the profit and loss account.

Consequently any contracting firm that is undertaking shorter contracts will initially receive a profit burst and also show unrealised profits. Thirdly, there will be no requirement for goodwill to be amortised if it is maintained. Since goodwill is at the heart of the real asset value of many enterprises this will significantly change the results for acquisitive companies. Finally for financial institutions there are the rather surprising "held to maturity" rules which could result in the banking book being marked to market for three years.

These changes in composite will make a major change for many firms and are just a small sample of the type of issues to consider. Will they make the results of the firm more "true and fair"?

Actually while we are producing accounts which fail to address the key intangibles issues effectively – that of intellectual property, branding and the value of management, staff, customers and relationships – then the accounts will still not achieve their real objectives.

So for non financial companies that have no material contracts, property or goodwill, there is likely to be no real change. For the rest, your accounts will start to look rather different and the ratios used by analysts will change.

Drivers of change

Over the past few years the FASB (Financial Accounting Standards Board – the US Financial Accounting Regulator) and the IASB (International Accounting Standards Board) have been working on a joint project to harmonise accounting standards and regulations to a similar project timeframe.

Over the last few months, between January –

SHOULD THE U.S. BE CONCERNED ABOUT IFRS CONTINUED

March 2010, it has become apparent that the time table for harmonisation is slipping and that the two organisations won't meet the time table commitments, however the underlying harmonisation objective is still very much in play.

The biggest areas of change currently hinge around Financial Instruments, both as far as financial assets, liabilities, hedge accounting and impairment of assets and liabilities are concerned. This has mainly been driven by the financial crisis and the higher profile the G20 has attached by adding global financial regulation to its agenda.

Work on IFRS 9 – Financial Instruments (the replacement to IAS39 Financial Instruments – Recognition & Measurement) commenced in November 2008 and was added to the FASB's agenda in December 2008. The project is split into three distinct areas namely part 1, dealing with classification and measurement, part 2 with amortised cost and impairment and part 3 with hedge accounting. Delivery of the final version of the standard is likely to be towards the end of 2010, provided there are no delays to the published IASB time table.

IFRS 7 Financial Instruments – Disclosures is also impacted and being amended in line with the IFRS 9 requirements. IFRS 7 deals with and requires in the main enhanced disclosures related to both quantitative and qualitative measures in addition to market, credit and liquidity risks.

What is impacted?

The following areas are specifically affected by the potential transition from US GAAP to IFRS, as per the Securities and Exchange Commission's (SEC) work plan published recently:

Characteristics of IFRS

1. Sufficient development and application of IFRS for the U.S. domestic reporting system
2. The independence of standard setting for the benefit of investors

Transitional issues around IFRS

1. Investor understanding and education regarding IFRS
2. Examination of the U.S. regulatory environment that would be affected by a change in accounting standards
3. The impact on issuers, both large and small, including changes to accounting systems, changes to contractual arrangements, corporate governance considerations, and litigation contingencies
4. Human capital readiness

The opportunities and concerns

The opportunities IFRS conversion presents:

- To take a new look at old processes
- Cost reduction possibilities (after implementation) – efficiencies built into processes
- Global scale
- Overhaul accounting and governance systems

Some of the concerns raised by conversion to IFRS:

- SEC raised issues around:
  - o Common control transactions
  - o Recapitalisation transactions
  - o Reorganisations and
  - o acquisitions of minority interests
- Cost of conversion
- Tax implications for organisations with inventory (LIFO not allowed under IFRS)
- Accounting, recognition and measurement of Financial Instruments
- Accounting for hedge transactions
- Contractual arrangements

The table opposite presents some of the issues to consider and areas within the business that will be affected by the conversion to IFRS.

What next?

Proverbially speaking the IFRS train has left the station, the only major uncertainties with regard to the US adoption of IFRS is around:

- The timetable
- Any special provisions and amendments to bring the two codes in alignment

Therefore the SEC holds the interests of U.S. investors and markets, users and issuers of financial reports.

The most likely dates to keep an eye on in terms of conversion are around the beginning to middle of 2014. However, in our experience it takes around 18 months before the switch-over date in order to start the planning, education, implementation and embedding phases of a conversion project.

A further driver of change from US GAAP to IFRS is the fact that ongoing foreign investment in the United States continues to grow and mostly these are organisations and entities that have already adopted IFRS and will add further impetus to the move and switch towards IFRS in the US.

Getting Started

Finally, Human Capital Readiness, as identified by the SEC requires to ensure that US organisations are prepared to meet the transitional

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Martix of IFRS impact to consider

Source: http://ifrsusa.wordpress.com/prepare-now-to-smoothly-transition-to-ifrs/

Accounting & Finance	Valuations of assets/liabilites	Accounting calculations	Supporting documentation	Policies and procedures	Financial Statements	Footnotes	Regulatory requirements
Internal Audit & Controls	Scoping methodologies	Internal controls for new procedures	Control documentation	Testing approaches professional standards utilized (use US stadards or international standards)			
Information Technology	Accounts and chart of account structure	IT controls for IFRS data conversions	Controls around new applications	Data privacy controls			
Tax	Review of current processes for gathering tax data	Uncertain tax position processes (since these will change)	Change in the starting point for all tax positions (IFRS financials vs US GAAP financials)	Changes related to FAS 109, FIN 48, FAS 123R			
Treasury	Debt covenants	Hedging agreements	Legal agreements that require audited financial statements				
Planning & Budgeting	Strategic plans and initiatives	New approach to budgeting and planning	Inclusion in accounting an financial planning	Research and analysis of competitors			
Management Reporting	Impact on key performance indicators and similar metrics	Management report impact	Impact on competitiveness				
Investor Relations	Planning and timing of external communications	Communicating the financial impact with shareholders, analysts and the public					
Human Resources	Incentive compensation plans	Training	Development of talent	Management of contractors & consultants needs to assist with the transaction			

challenges that the switch to IFRS will entail.

The two main areas of Human Capital Readiness focus on

- Education and training and
- Auditor capacity

Arguably the biggest challenge is insuring that both existing and future practitioner are brought up to speed on the framework and detail of IFRS, as it is less rules-based and therefore less prescriptive than US GAAP and demands a greater appreciation and utilisation of judgment as far as the understanding of the economic substance of transactions are concerned.

Auditors will also have to ensure that within their own systems of quality control, which encompasses their hiring practices, assignment of personnel to engagements, professional development and advancement activities, they address the implications that IFRS will necessitate.

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