

THE GLOBALIZATION OF ACCOUNTING STANDARDS

The world of accounting is changing fast. Here are some recent headlines:

- IASB Chair Meets with New SEC Chair, Washington, D.C., (WebCPA.com, Feb. 12, 2009)
- New SEC Chair May Delay IFRS Roadmap, Washington, D.C., (WebCPA.com, January 16, 2009)
- FASB, IASB Speed up Plans for Convergence, *Reuters*, 5/1/08
- SEC Exempts Foreign Firms From U.S. Rules On Accounting (*International Herald Tribune*, 11/17/07)
- IFRS, GAAP Accounting Convergence Could Take Years (*Daily News*, 11/28/07)
- Majority of CFOs Do Not Agree With SEC on IFRS - More Than Three-Fourths Have No Experience in Preparing IFRS Statements (*Business Wire*, 10/25/07)

This is exciting (at least to accountants)! There is no doubt that the United States is moving toward converging US GAAP with the International Financial Reporting Standards (IFRS) that are followed by most of the rest of the world.

But, that convergence certainly hasn't happened yet, and there currently is much misunderstanding about the status and timing of the convergence process. Why are these changes taking place? Who are the key players, in business, politics and regulation? What critical differences between US and international GAAP exist

currently? How can you keep up to date with this changing landscape of converging accounting standards?

This supplement is designed to answer these questions by first explaining the background and current status of the convergence process, and then illustrating key differences between US and international GAAP for each chapter of the Spiceland text. We think this will be a useful resource for understanding IFRS and current accounting developments. Also, given the fast pace of change in this area, the supplement will be

On November 15, 2007, the U.S. Securities and Exchange Commission voted unanimously to accept from "foreign private issuers" financial statements that are prepared using International Financial Reporting Standards (IFRSs) as issued by the International Accounting Standards Board (IASB) without reconciliation to U.S. Generally Accepted Accounting Principles.

"SEC to FPIs: No need to reconcile IFRSs to U.S. GAAP," Bruce Pounders, Nov.18, 2007

updated periodically to make sure you are up-to-date with the convergence process.

Toward Convergence

Most industrialized countries have organizations responsible for determining accounting and reporting standards. In some countries, the United Kingdom for instance, the responsible organization is a private sector body similar to the FASB in the United States. In other countries, such as in France, the organization is a governmental body.

Accounting standards prescribed by these various groups are not the same. Standards differ from country to country for many reasons, including different legal systems, levels of inflation, culture, sophistication and use of capital markets, and political and economic ties with other countries. These differences can cause problems for multinational corporations. A company doing business in more than one country may find it difficult to comply with more than one set of accounting standards if there are important differences among the sets. These differences also cause problems for investors who must struggle to compare companies whose financial statements are prepared under different standards. It has been argued that different national accounting standards impair the ability of companies to raise capital in international markets.

In response to this problem, the **International Accounting Standards Committee (IASC)** was formed in 1973 to develop global accounting standards. The IASC reorganized itself in 2001 and created a new standard-setting body called the **International Accounting Standards Board (IASB)**. The IASC now acts as an umbrella organization similar to the Financial Accounting Foundation (FAF) in the United States. This new global standard-setting structure is consistent with an FASB vision report aimed at identifying an optimal standard-setting environment.¹ The IASB's objectives are (1) to develop a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements, and (2) to cooperate with national accounting standard-setters to achieve convergence in accounting standards around the world.

The IASC issued 41 International Accounting Standards (IASs). The IASB endorsed these standards when it was formed in 2001. Since then, the IASB has revised many of them and has issued eight standards of its

¹ *International Accounting Standard Setting: A Vision for the Future* (Norwalk, Conn.: FASB, 1998).

The *International Accounting Standards Board (IASB)* is dedicated to developing a single set of global accounting standards.

own, called **International Financial Reporting Standards (IFRSs)**. Compliance with these standards is voluntary, since the IASB has no enforcement authority. However, more and more countries are basing their national accounting standards on international accounting standards. The International Organization of Securities Commissions (IOSCO) approved a resolution permitting its members to use these standards to prepare their financial statements for cross-border offerings and listings. By late 2007, over 100 jurisdictions, including Hong Kong, Australia, and the countries in the European Union (EU), either require or permit the use of IFRS or a local variant of IFRS.² Some 7,000 listed EU companies are affected. In 2007, China began requiring its 1,400 listed companies to report under IFRS-aligned standards.

In the United States, the move toward convergence of accounting standards began in earnest with the cooperation of the FASB and the IASB in 1994 that led to a common EPS standard for both IFRS and U.S. GAAP. Chapter 19 describes this standard.

In 2002, the FASB and IASB signed the so-called Norwalk Agreement, formalizing their commitment to convergence of U.S. GAAP and IFRS. Under this agreement, the boards pledged to remove existing differences between their standards and to coordinate their future standard-setting agendas so that major issues are worked on together. Recent standards issued by the FASB that you will encounter in our later discussions on share-based compensation, nonmonetary exchanges, inventory costs, and the fair value option are examples of this commitment to convergence. In the spring of 2008, the FASB and IASB outlined their plan to accelerate the convergence of U.S. GAAP and IFRS to enable U.S. companies to move to international standards by 2013. “It is a new world and we’re going to have to figure out how to play in that,” said Robert Herz, chairman of the FASB.²⁰ In the “new world” to which Herz refers the financial statements in all major capital markets are based on a single set of standards.

Although many argue that a single set of global standards will improve comparability of financial reporting and facilitate access to capital, others

**ROBERT HERZ—
FASB CHAIRMAN**

We believe now is the appropriate time to develop a plan for moving all U.S. public companies to an improved version of IFRS and to consider any actions needed to strengthen the IASB as the global accounting standard setter. (from his testimony before Congress, October, 2007).

The commitment to narrowing differences between U.S. GAAP and international standards has influenced many FASB Standards.

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International Financial Reporting Standards are gaining support around the globe.

² See <http://www.iasplus.com/useias.htm>.

²⁰ “FASB, IASB speed up plans for convergence,” *Reuters*, May 1, 2008.

argue that U.S. standards should remain customized to fit the stringent legal and regulatory requirements of the U.S. business environment. There also is concern that differences in implementation and enforcement from country to country will make accounting appear more uniform than actually is the case. Another argument is that competition between alternative standard-setting regimes is healthy and can lead to improved standards.

U.S. standards and IFRS have not fully converged, but in 2007 the SEC eliminated the requirements for foreign companies that issue stock in the United States to include in their financial statements a reconciliation of IFRS to U.S. GAAP.

The SEC published a proposed “roadmap” for the potential transition to IFRS by U.S. companies on November 14, 2008, two months after it was originally approved by unanimous vote of the Commission. If certain milestones are achieved, the mandated transition to IFRS would occur in stages, beginning with large accelerated filers for fiscal years ending on or after December 15, 2014.

Some firms would be allowed to begin transitioning in 2010 for their financial statements beginning after December 15, 2009. These are the 20 largest U.S.-based companies in a given industry according to market capitalization – about 120 in total. Due to the quick time frame it is expected that many eligible firms will choose not to early adopt. Smaller accelerated filers would report under IFRS for years ending on or after December 15, 2015, and non-accelerated filers would begin using IFRS for years ending on or after December 15, 2016.

Note that for three-year comparative purposes, firms using IFRS for years ending after December 15, 2014, actually would be required to apply IFRS beginning with the year ending after December 15, 2012.

Some feel that the recent financial crisis and economic slowdown will impact any move to IFRS. Companies already burdened with trying to deal with cost cuts, layoffs, and other effects of the slowdown would find burdensome the additional costly transition to IFRS. Two of President Barack Obama's top economic advisers have decidedly different views on IFRS. Paul Volcker, a former Federal Reserve chairman and now chairman of Obama's Economic Recovery Advisory Board, has enthusiastically endorsed IFRS, while Mary Schapiro, chairwoman of the Securities and Exchange Commission, is much cooler to IFRS and has advocated a go-slow approach.

We now provide chapter-by-chapter brief descriptions of the important differences that still remain between U.S. GAAP and IFRS.

DIFFERENCES BETWEEN U.S. GAAP AND IFRS

Chapter 1 Financial Accounting

Where We Are and What's Ahead

In the United States, the FASB's **conceptual framework** serves primarily to guide standard setters, while internationally the IASB's conceptual framework also serves to indicate GAAP when more specific standards are not available. The FASB and the IASB presently are working together to develop a common conceptual framework that would underlie a uniform set of standards internationally. This framework will build on the existing IASB and FASB frameworks and will consider developments since the original frameworks were issued.

Chapter 2 Review of the Accounting Process

This chapter provides an overview of the accounting process. There are no relevant IFRS or convergence topics not dealt with in other chapters.

Chapter 3 The Balance Sheet and Financial Disclosures

Where We Are and What's Ahead

The FASB and IASB are working on a project to establish a common standard for presentation of information in the financial statements, including the classification and display of line items and the aggregation of line items into subtotals and totals. This standard will have a dramatic impact on the presentation of financial statements. An important part of the current proposal involves the organization of all of the basic financial statements using the same format – operating, investing, and financing activities. These classifications would be used in the balance sheet (statement of financial position), statement of changes in equity, statement of comprehensive income (including the income statement), and statement of cash flows.

Segment Reporting. U.S. GAAP, *SFAS No. 131*, requires companies to report information about reported segment profit or loss, including certain revenues and expenses included in reported segment profit or loss, segment assets, and the basis of measurement. The international standard on segment reporting, *IFRS No.8*, requires that companies also disclose total *liabilities* of its reportable segments.

Chapter 4 The Income Statement and Statement of Cash Flows

Where We Are and What's Ahead

As discussed above, the joint FASB and IASB project on financial statement presentation could have a significant impact on income statement presentation. The outcome of this project could resolve some of the current differences between U.S. GAAP and IFRS discussed below.

Earnings per Share. *IAS No. 33* and *SFAS No. 128* are similar in most respects. But a few differences between IFRS and US GAAP remain as a result of differences in the application of the treasury stock method, the treatment of contracts that may be settled in shares or cash; and contingently issuable shares. In August 2008, the FASB issued an Exposure Draft proposing amendments to FASB 128, “Earnings per Share.” Simultaneously, the IASB issued a parallel proposal to amend IAS 33, “Earnings per Share.” The comment period for both documents ended on December 5, 2008, and final Standards are due any day now.

The proposed amendments reflect the boards’ efforts to converge the guidance on EPS in U.S. GAAP and IFRS as well as to clarify and simplify this guidance. Since other accounting differences between U.S. GAAP and IFRS preclude the possibility of achieving a common numerator (i.e., earnings) in EPS calculations, the Boards instead focused on achieving a common denominator (i.e., number of shares). Proposed changes in the application of the treasury stock method include (a) assuming the repurchase of shares at the year-end price rather than the average market price for the period and (b) omitting from the diluted EPS calculation any instruments measured at fair value with changes in fair value reported in earnings.

Extraordinary items. U.S. GAAP provides for the separate reporting, as an extraordinary item, of a material gain or loss that is unusual in nature and infrequent in occurrence. In 2003, the IASB revised *IAS No. 1*, “Presentation of Financial Statements.” The revision states that neither the income statement nor any notes may contain any items called “extraordinary.”

Discontinued Operations. U.S. GAAP, *SFAS No. 144*, considers a discontinued operation to be a component of an entity whose operations

and cash flows can be clearly distinguished from the rest of the entity that has either been disposed of or classified as held for sale. *IFRS No. 5* also defines a discontinued operation as a component of an entity that has been disposed of or is classified as held for sale. What constitutes a component of an entity, however, differs considerably between the international standard and *SFAS No. 144*. *IFRS No. 5* considers a component to be primarily either a major line of business or geographical area of operations. The U.S. definition is much broader than its international counterpart.

In 2008, the FASB and IASB began working on a joint project to develop a common definition of what constitutes a discontinued operation. The FASB issued its proposed *Staff Position 144-d* to amend *SFAS No. 144* and simultaneously the IASB issued an Exposure Draft to amend *IFRS No. 5*.

Both proposed amendments advocate an “operating segment” as defined in *SFAS No. 131* and *IFRS No. 8*, as a candidate for a component of an entity that has been disposed of or is classified as held for sale would be reported in the discontinued operation section of the income statement. The Boards decided that a “business” as defined in *SFAS No. 141 (R)* and *IFRS No. 3* also is a candidate. As a

As a result of these amendments, for financial statements issued for fiscal years beginning after December 15, 2009, a discontinued operation is a component of an entity that is:

1. An operating segment (as that term is defined in *SFAS No. 131*) and either has been disposed of or is classified as held for sale; or
2. A business (as that term is defined in *SFAS No. 141 (R)*) that meets the criteria to be classified as held for sale on acquisition.

The amendments also include a common set of disclosure requirements for discontinued operations.

Comprehensive Income. As part of a joint project with the FASB, the International Accounting Standards Board (IASB) in 2007 issued a revised version of *IAS No. 1*, “Presentation of Financial Statements” that revised the standard to bring international reporting of comprehensive income largely in line with U.S. standards. It provides the option of presenting revenue and expense items and components of other comprehensive income either in (a) a single statement of comprehensive income or (b) in a separate income statement followed by a statement of comprehensive income. U.S. GAAP also allows

reporting other comprehensive income in the statement of shareholders' equity.

Statement of Cash Flows. Like U.S. GAAP, international standards also require a statement of cash flows. Consistent with U.S. GAAP, cash flows are classified as operating, investing, or financing. However, the U.S. standard designates cash outflows for interest payments and cash inflows from interest and dividends received as operating cash flows. *IAS No. 7* allows companies to report cash outflows from interest payments as either an operating *or* financing cash flows and cash inflows from interest and dividends as either an operating *or* investing cash flows. U.S. GAAP classifies dividends paid to shareholders as financing cash flows. The international standard allows companies to report dividends paid as either financing *or* operating cash flows.

Chapter 5 Income Measurement and Profitability Analysis

Where We Are and What's Ahead

U.S. GAAP and IFRS provide similar general guidance concerning the timing and measurement of revenue recognition. However, U.S. GAAP includes many additional rules and other guidance promulgated by the FASB, the SEC, and others. Some of those rules are designed to specify appropriate accounting for particular industries; others are designed to discourage aggressive revenue recognition. It is unclear currently how the additional rules that are included in U.S. GAAP will be handled in the convergence process. Also, the FASB and IASB have undertaken a major project that is reconsidering the definition of revenue and when it should be recognized. Depending on the outcome of that project, revenue recognition practices could change dramatically. The major current differences between U.S. GAAP and IFRS include:

Long-Term Contracts. *IAS No. 11* governs revenue recognition for long-term construction contracts. Like U.S. GAAP, that standard requires the use of percentage-of-completion accounting when estimates can be made precisely. However, unlike U.S. GAAP, the international standard requires the use of the cost recovery method

rather than the completed contract method when estimates cannot be made precisely enough to allow percentage-of-completion accounting. Under the cost recovery method, contract costs are expensed as incurred, and an exactly offsetting amount of contract revenue is recognized, such that no gross profit is recognized until all costs have been recovered. Under both methods, no gross profit is recognized until the contract is essentially completed, but revenue and construction costs will be recognized earlier under the cost recovery method than under the completed contract method.

Multi-Part Contracts and Industry-Specific Revenue Recognition. *IAS No. 18* governs most revenue recognition under IFRS. The general revenue recognition principles in this standard are consistent with U.S. GAAP, but there is less specific guidance for multiple-deliverable arrangements and industry-specific concerns like software revenue recognition.

Chapter 6 Time Value of Money Concepts

This chapter provides a discussion of time value of money. There are no relevant IFRS or convergence topics not dealt with in other chapters.

Chapter 7 Cash and Receivables

Where We Are and What's Ahead

Accounting for cash and receivables under both U.S. GAAP and international standards is essentially the same. No major convergence efforts are anticipated.

Chapters 8 and 9 Inventories

Where We Are and What's Ahead

As discussed below, international standards do not allow the use of the LIFO inventory method. This particular difference represents a major convergence challenge. The LIFO conformity rule, which requires U.S. companies that use LIFO for tax purposes also use LIFO for financial reporting, means that the elimination of LIFO for financial reporting also would require the elimination of its use for tax purposes. Resolving this

issue would require not only agreement by the FASB and IASB, but also of the U.S. Congress. Perhaps unrelated to the convergence issue, in 2006 U.S. Senate leaders proposed repealing the LIFO inventory method. This proposal was quickly opposed by special interest groups and many companies whose tax liability would increase if LIFO were no longer allowed.

Inventory Cost Flow Assumptions. *IAS No. 2* does not permit the use of LIFO. Because of this restriction, many U.S. multinational companies employ the use of LIFO only for all or most of their domestic inventories and FIFO or average cost for their foreign subsidiaries. **General Mills** provides an example with a disclosure note included in a recent annual report.

Inventories (in part)

All inventories in the United States other than grain are valued at the lower of cost, using the last-in, first-out (LIFO) method, or market... Inventories outside of the United States are valued at the lower of cost, using the first-in, first-out (FIFO) method, or market.

Lower of cost or market. International standards also require inventory to be valued at the lower of cost or market. You just learned that in the U.S., market is designated as replacement cost with a ceiling of net realizable value (NRV) and a floor of NRV less a normal profit margin. However, the designated market value according to *IAS No. 2* always is net realizable value.

IAS No. 2 also specifies that if circumstances reveal that an inventory write-down is no longer appropriate, it should be reversed. Reversals are not permitted under U.S. GAAP.

Cadbury Schweppes, Plc., a U.K. company, prepares its financial statements according to IFRS. The following disclosure note illustrates the designation of market as net realizable value.

Inventories (in part)

Inventories are recorded at the lower of average cost and estimated net realizable value.

Chapters 10 and 11 Operational Assets

Where We Are and What's Ahead

As discussed below, international standards allow the revaluation of operational assets. U.S. GAAP does not permit revaluation. Also, development expenditures that meet specified criteria are capitalized as an intangible asset under international standards. U.S. GAAP requires these expenditures to be expensed. Reconciling these differences will be a major convergence hurdle.

Valuation of Property, Plant and Equipment. *IAS No. 16* allows a company to value property, plant and equipment (PP&E) subsequent to initial valuation at (1) cost less accumulated depreciation or (2) fair value (revaluation). If revaluation is chosen, all assets within a class of PP&E must be revalued on a regular basis. U.S. GAAP prohibits revaluation.

British Airways, Plc., a U.K. company, prepares its financial statements according to IFRS. The following disclosure note illustrates the company's choice to value PP&E at cost:

Property, plant and equipment (in part)

Property, plant and equipment is held at cost. The Group has a policy of not revaluing tangible fixed assets.

Valuation of Intangible Assets. *IAS No. 38* allows a company to value an intangible asset subsequent to initial valuation at (1) cost less accumulated amortization or (2) fair value if fair value can be determined by reference to an active market. Because very few intangible assets are traded on an active exchange, very few intangible assets are accounted for under the revaluation option. If revaluation is used, all assets within that class of intangibles must be revalued on a regular basis. U.S. GAAP prohibits revaluation.

Interest Capitalization. *SFAS No. 34* requires a company to capitalize interest during the construction period of a qualified asset. *IAS No. 23*, as originally issued, allowed a company to choose between (1) capitalization and (2) immediate expensing of interest incurred during the construction period. In 2007, *IAS No. 23* was revised and now requires the capitalization of interest in most

situations, effectively eliminating the major difference between U.S. GAAP and international standards in this area. This illustrates one of three ways the IASB and FASB are moving toward convergence: (1) revising international standards to converge with U.S. standards (this instance), (2) revising U.S. standards to converge with international standards, and (3) working jointly to develop common standards.

Research and Development Expenditures. Other than software development costs incurred after technological feasibility has been established, U.S. GAAP requires all research and development expenditures to be expensed in the period incurred. *IAS No. 38* draws a distinction between research activities and development activities. Research expenditures are expensed in the period incurred. However, development expenditures that meet specified criteria are capitalized as an intangible asset.

Heineken, a company based in Amsterdam, prepares its financial statements according to IFRS. The following disclosure note describes the company's adherence to *IAS No. 38*. The note also describes the criteria for capitalizing development expenditures.

Software, research and development and other intangible assets (in part)

Expenditures on research activities, undertaken with the prospect of gaining new technical knowledge and understanding, are recognized in the income statement when incurred. Development activities involve a plan or design for the production of new or substantially improved products and processes. Development expenditures are capitalized only if development costs can be measured reliably, the product or process is technically and commercially feasible, future economic benefits are probable, and Heineken intends to and has sufficient resources to complete development and to use or sell the asset.

Impairment of Value. Highlighted below are some important differences in accounting for impairment of value for tangible operational assets and finite life intangibles between *SFAS No. 144* and *IAS No. 36* “Impairment of Assets.”

	U.S. GAAP	IFRS
Recognition	An impairment loss is required when an asset’s book value exceeds the undiscounted sum of the asset’s estimated future cash flows.	An impairment loss is required when an asset’s book value exceeds the higher of the asset’s value-in- use (present value of estimated future cash flows) and fair value less costs to sell.
Measurement	The impairment loss is the difference between book value and fair value.	The impairment loss is the difference between book value and the recoverable amount (the higher of the asset’s value-in-use and fair value less costs to sell).
Subsequent reversal of loss	Prohibited.	Required if the circumstances that caused the impairment are resolved.

Cadbury Schweppes, Plc., a U.K. company, prepares its financial statements according to IFRS. The following disclosure note describes the company’s impairment policy:

Impairment review (in part)

The Group carries out an impairment review of its tangible assets when a change in circumstances or situation indicates that those assets may have suffered an impairment loss.... Impairment is measured by comparing the carrying amount of an asset ... with the “recoverable amount,” that is the higher of its fair value less costs to sell and its “value in use.” Value in use is calculated by discounting the expected future cash flows,...

Impairment of Value - Goodwill. Highlighted below are some important differences in accounting for the impairment of goodwill between U.S. GAAP and *IAS No. 36*.

	U.S. GAAP	IFRS
Level of testing	<i>Reporting unit</i> – a segment or a component of an operating segment for which discrete financial information is available.	<i>Cash generating unit (CGU)</i> – the lowest level at which goodwill is monitored by management. A CGU can't be lower than a segment.
Measurement	A two step process: 1. Compare the fair value of the reporting unit with its book value. A loss is indicated if fair value is less than book value. 2. The impairment loss is the excess of book value over implied fair value.	One step: Compare the recoverable amount of the CGU (the higher of fair value less costs to sell and value in use) to book value. If the recoverable amount is less, reduce goodwill first, then other assets.

U.S. GAAP and *IAS No. 36* both require goodwill to be tested for impairment at least annually, and both prohibit the reversal of goodwill impairment losses.

Chapter 12 Investments

Where We Are and What's Ahead

Both U.S. standards and IFRS permit companies to elect the fair value option for investments. The FASB and IASB have agreed to long-term objectives for accounting for financial instruments that include a requirement that they be measured at fair value. Many believe that the fair value option is just the first step in a fair value agenda that could lead to future standards requiring fair value measurement not only for financial assets and liabilities, but for certain non-financial assets as well. Existing differences between U.S. GAAP and IFRS for investments include:

Fair Value Option. International accounting standards are more restrictive than U.S. standards for determining when firms are allowed to elect the fair value option. Under *IFRS No. 39*, companies can elect the fair value option only in specific circumstances. For example, a firm can elect the fair value option for an asset or liability

in order to avoid the accounting mismatch that occurs when some parts of a fair value risk-hedging arrangement are accounted for at fair value and others are not. Or, a firm can elect the fair value option for a group of financial assets or liabilities that are managed on a fair value basis, as documented by a particular risk-management or investment strategy. Although *SFAS No. 159* indicates that the intent of the fair value option is to address these sorts of circumstances, it does not require that those circumstances exist.

Terminology. Trading securities and other instruments for which the fair value option is elected are referred to under IFRS as securities at “fair value through profit and loss (FVTPL).”

Equity Method. Like U.S. GAAP, international accounting standards require the equity method for use with significant influence investees (which they call “associates”), but there are a few important differences. *IFRS No. 28* governs application of the equity method and requires that the accounting policies of investees be adjusted to correspond to those of the investor when applying the equity method.³ U.S. GAAP has no such requirement.

IFRS No. 31 governs accounting for joint ventures, in which two or more investors have joint control. That standard allows investors to account for a joint venture using either the equity method or a method called “proportionate consolidation,” whereby the investor combines its proportionate share of the investee’s accounts with its own accounts on an item-by-item basis.⁴ U.S. GAAP generally requires that the equity method be used to account for joint ventures.

Comprehensive Income. As part of a joint project with the FASB, the International Accounting Standards Board (IASB) in 2007 issued a revised version of *IAS No. 1*, “Presentation of Financial Statements” that revised the standard to bring international reporting of comprehensive income largely in line with U.S. standards. It provides the option of presenting revenue and expense items and components of other comprehensive income either in (a) a single statement of comprehensive income or (b) in a separate income statement followed by a statement of comprehensive income. U.S. GAAP also

³ “Investments in Associates,” *International Accounting Standard 28* (London, UK: IASCF, 2003).

⁴ “Interests in Joint Ventures,” *International Accounting Standard 31* (London, UK: IASCF, 2003).

allows reporting other comprehensive income in the statement of shareholders' equity.

Chapter 13 Current Liabilities and Contingencies

Where We Are and What's Ahead

As we discussed earlier, the FASB and the IASB presently are working together to develop a common conceptual framework that might eventually underlie a uniform set of standards internationally. One aspect of the project is examining the definition of liabilities, a change in which could affect the way some current liabilities are reported. Another outcome of the joint project likely will be a narrowing of the differences between IFRS and U.S. GAAP in accounting for contingencies described below.

Classification of Liabilities to be Refinanced. Under U.S. GAAP, liabilities payable within the coming year are classified as long-term liabilities if refinancing is completed before date of issuance of the financial statements. Under IFRS, refinancing must be completed before the balance sheet date. The FASB is considering an exposure draft proposing the IFRS method.

Contingencies. Accounting for contingencies is part of a broader international standard, *IAS No.37*, "Provisions, Contingent Liabilities and Contingent Assets." US GAAP has no equivalent general standards on "provisions," but provides specific guidance on contingencies in *SFAS No. 5*, "Accounting for Contingencies." A difference in accounting relates to determining the existence of a loss contingency. We accrue a loss contingency under U.S. GAAP if it's both probable and can be reasonably estimated. IFRS are similar, but the threshold is "more likely than not." This is a lower threshold than "probable."

Another difference in accounting relates to whether to report a long-term contingency at its face amount or its present value. Under IFRS, present value of the estimated cash flows is reported when the effect of *time value of money is material*. According to US GAAP, though, discounting of cash flows is allowed when the *timing of cash flows is certain*. Here's a portion of a footnote from the financial statements of Electrolux, which reports under IFRS:

Note 29: US GAAP information (in part)

Discounted provisions

Under IFRS and US GAAP, provisions are recognized when the Group has a present obligation as a result of a past event, and it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation. Under IFRS, where the effect of time value of money is material, the amount recognized is the present value of the estimated expenditures. IAS 37 states that long-term provisions shall be discounted if the time value is material. According to US GAAP discounting of provisions is allowed when the timing of cash flow is certain.

Chapter 14 Bonds and Long-Term Notes

Where We Are and What's Ahead

The joint project of the FASB and the IASB to develop a common conceptual framework includes examining the definition of liabilities, potentially affecting the way we account for long-term liabilities. More specifically, the two Boards are collaborating on projects related to “hybrid” securities that likely will eliminate differences in how we account for convertible debt. Longer term, the two Boards are cooperating on a project that addresses the distinction between liabilities and equity, which likely will eliminate many existing differences.

Distinction between Debt and Equity for Preferred Stock. The primary standard for distinguishing between debt and equity in the U.S. is *SFAS No.150*, “Accounting for Certain Financial Instruments: Characteristics of both Liabilities and Equity;” under IFRS, it’s *IAS No. 32*, “Financial Instruments: Disclosure and Presentation.” Differences in the definitions and requirements under these standards can result in the same instrument being classified differently between debt and equity under IFRS and US GAAP. Most preferred stock (preference shares) is reported under IFRS as debt with the dividends reported in the income statement as interest expense. Under U.S. GAAP, that’s the case only

for “mandatorily redeemable” preferred stock. Unilever describes such a difference in a disclosure note:

Additional information for US investors [in part]

Preference shares

Under IAS 32, Unilever recognises preference shares that provide a fixed preference dividend as borrowings with preference dividends recognised in the income statement. Under US GAAP such preference shares are classified in shareholders’ equity with dividends treated as a deduction to shareholder’s equity.

Convertible Bonds. Under IFRS, convertible debt is divided into its liability and equity elements. Under US GAAP, the entire issue price is recorded as debt.

Fair Value Option. International accounting standards are more restrictive than U.S. standards for determining when firms are allowed to elect the fair value option. Under *IFRS No. 39*, companies can elect the fair value option only in specific circumstances. For example, a firm can elect the fair value option for an asset or liability in order to avoid the accounting mismatch that occurs when some parts of a fair value risk-hedging arrangement are accounted for at fair value and others are not. Or, a firm can elect the fair value option for a group of financial assets or liabilities that are managed on a fair value basis, as documented by a particular risk-management or investment strategy. Although *SFAS No. 159* indicates that the intent of the fair value option is to address these sorts of circumstances, it does not require that those circumstances exist.

Transaction Costs. Under IFRS, transaction costs reduce the amount recorded for bonds and other liabilities not classified at “fair value through profit and loss (FVTPL). Under U.S. GAAP, transaction costs are recorded separately and are amortized over the term of the related bonds. These costs generally are debited to a “bond issue costs” account and amortized on a straight-line basis.

Chapter 15 Leases

Where We Are and What's Ahead

Similar to U.S. GAAP, *IAS No. 17*, "Leases," also distinguishes between operating and nonoperating (finance) leases. Although conceptually similar, *IAS No. 17* provides less specific guidance than U.S. GAAP in classifying leases.

The IASB and FASB are collaborating on a joint project for a revision of leasing standards. The Boards have agreed that a "right of use" model (where the lessee recognizes an asset representing the right to use the leased asset for the lease term and recognizes a corresponding liability for the lease rentals, whatever the term of the lease) is the only approach which recognizes assets and liabilities that corresponded to the conceptual framework definitions. Many people expect the new standard to result in most, if not all, leases being recorded as an intangible asset for the right of use and a liability for the present value of the lease payments.

The impact of any changes will be significant; U.S. companies alone have over \$1.25 trillion in operating lease obligations. At present a few important differences remain.

Lease classification. We discussed four classification criteria used under U.S. GAAP to determine whether a lease is a capital lease. Under IFRS, a lease is a capital lease (called a finance lease under IFRS) if substantially all risks and rewards of ownership are transferred. Judgment is made based on a number of "indicators" including some similar to the specific criteria of U.S. GAAP. More judgment, less specificity is applied.

Leases of land and buildings. Under *IAS No. 17*, land and buildings elements are considered separately unless the land element is not material. Under U.S. GAAP, materiality is defined precisely and with a higher threshold. Land and building elements generally are accounted for separately unless land represents more than 25% of the total fair value of the leased property. If the land's value is less than 25% of the combined fair value, it is in effect ignored and both the lessee and the lessor treat the land and building as a single unit. The single leased asset is depreciated as if land were not involved.

Present value of minimum lease payments. Under *IAS No. 17*, both parties to a lease generally use the rate implicit in the lease to discount minimum lease payments. Under U.S. GAAP, lessors use the implicit rate, and lessees use the incremental borrowing rate unless the implicit rate is known and is the lower rate.

Recognizing a gain on a sale and leaseback transaction. When the leaseback is an operating lease, under *IAS No. 17*, the gain is recognized immediately, but is amortized over the lease term (as a reduction of rent expense) under U.S. GAAP. When the leaseback is a finance (capital) lease, under *IAS No. 17*, the gain is recognized over the lease term, but is recognized over the useful life of the asset under U.S. GAAP.

Chapter 16 Accounting for Income Taxes

Where We Are and What's Ahead

One of the IASB and FASB short-term convergence projects focuses on accounting for income taxes. The objective is to reduce differences in income tax standards. The IASB will revise *IAS No.12*, while the FASB will revise *SFAS No. 109*. Although both are based on the same fundamental approach, the two standards differ mainly due to allowing different exceptions to their common approach. The convergence strategy is to eliminate the exceptions. Tentative decisions include the IASB adopting the same classification approach for deferred tax assets and liabilities as used under U.S. GAAP.

Some current differences:

Classification of Deferred Taxes. Under U.S. GAAP, deferred tax liabilities and deferred tax assets are classified in the balance sheet as current and noncurrent based on the classification of the underlying asset or liability. Under IFRS, though, they always are classified as noncurrent. The IASB is considering amending *IAS 12* to be consistent with U.S. GAAP in this regard.

Tax Rate for Measuring Deferred Tax Assets and Liabilities. Deferred taxes are based on currently enacted tax rates under U.S.

GAAP. Under IFRS, deferred taxes are based on “substantially enacted” rates, meaning “virtually certain.” The IASB is considering amending *IAS 12* to define “substantive enactment” as occurring when any future steps in the enactment process will not change the outcome.

Recognition of Deferred Tax Assets. Under *IAS No. 12*, “Income Taxes,” deferred tax assets are recorded only if realization of the tax benefit is “probable.” As we discussed in the chapter, we recognize all deferred tax assets under U.S. GAAP, but record a valuation allowance unless realization is “more likely than not.” The IASB is considering amending *IAS 12* to be consistent with U.S. GAAP in this regard.

Non-Tax Differences Affect Taxes. Despite the similar approaches for accounting for taxation under *IAS No. 12*, “Income Taxes,” and *SFAS No. 109*, “Accounting for Income Taxes,” differences in reported amounts for deferred taxes are among the most frequent between IFRS and US GAAP. Although differences in the specific IFRS and US GAAP guidance in several areas account for many of the disparities, the principal reason is that a great many of the non-tax differences between IFRS and US GAAP affect net income and shareholders’ equity and therefore have consequential effects on deferred taxes.

Chapter 17 Pensions

Where We Are and What’s Ahead

The FASB and IASB both are formally reconsidering all aspects of accounting for postretirement benefit plans. *SFAS No. 158* is Phase 1 of that project.¹⁴ In Phase 2 the Board is considering overhauling the entire system for accounting for and reporting on postretirement benefits. This result might include immediately including gains and losses in pension expense, thereby eliminating income smoothing. The IASB is undertaking a similar project. A recent IASB *Discussion Paper* proposes changes that will “leapfrog” *SFAS 158* but fall short of what likely will result from the ongoing joint project of the IASB and FASB that is scheduled for

¹⁴ “Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R),” *Statement of Financial Accounting Standards No. 158* (Stamford, Con.: FASB, 2006), par. B16.

completion by June 2011. The cornerstone of the Discussion Paper is that *all* changes in the Defined Benefit Obligation (PBO under U.S. GAAP) and Plan Assets will be reported in earnings as they occur. Several current differences exist.

Discount Rate. Under IFRS, we use a discount rate consistent with rates of return on high-quality corporate bonds with maturities consistent with the duration of the defined benefit obligation. Under U.S. GAAP, we use a rate that could be used currently to settle the obligation. Discount rates recently reported have ranged from 4.5% to 9%, with 5.5% being the most commonly assumed rate (*AICPA, Accounting Trends and Techniques, 2007*).

Actuarial Gains and Losses. We've seen that *SFAS No. 158* requires that actuarial gains and losses be included among OCI items in the statement of comprehensive income, thus subsequently become part of accumulated other comprehensive income. This is permitted under *IAS No. 19*, but not required.

Then, if gains and losses are included in comprehensive income, under *IAS No. 19* they cannot subsequently be amortized to expense and recycled or reclassified from other comprehensive income as is required under *SFAS No. 158* if the net gain or net loss exceeds the 10% threshold.

An IASB Discussion Paper proposes amending *IAS 19* so that all gains and losses from re-measuring the obligation are recognized immediately in net income.

Prior Service Cost. Under *IAS No. 19*, prior service cost (called past service cost under IFRS) is expensed immediately to the extent it relates to benefits that have vested. The amount not yet expensed is reported as an offset or increase to the defined benefit obligation. Under U.S. GAAP, prior service cost is not expensed immediately, but is included among other comprehensive income items in the statement of comprehensive income and thus subsequently becomes part of accumulated other comprehensive income where it is amortized over the average remaining service period.

An IASB Discussion Paper proposes amending *IAS 19* so that any prior service cost (past service cost under IFRS) is recognized immediately in net income.

Comprehensive Income. As part of a joint project with the FASB, the IASB in 2007 issued a revised version of *IAS No. 1*, "Presentation of

Financial Statements” that revised the standard to bring international reporting of comprehensive income largely in line with U.S. standards. It provides the option of presenting revenue and expense items and components of other comprehensive income either in (a) a single statement of comprehensive income or (b) in a separate income statement followed by a statement of comprehensive income. U.S. GAAP also allows reporting other comprehensive income in the statement of shareholders’ equity.

Limitation on Recognition of Pension Assets. Under *IAS No. 19*, pension assets cannot be recognized in excess of the net total of unrecognized past (prior) service cost and actuarial losses plus the present value of benefits available from refunds or reduction of future contributions to the plan. There is no such limitation under U.S.GAAP.

Chapter 18 Shareholders’ Equity

Where We Are and What’s Ahead

The joint “financial statement presentation” project will dramatically change the format and display of all financial statements including the balance sheet (referred to as the statement of financial position in the project). The proposed organization of all of the basic financial statements using the same format – operating, investing, and financing activities – will significantly affect the presentation of shareholders’ equity items. Current differences between U.S. GAAP and IFRS include:

Use of the term “reserves.” Shareholders’ equity is classified under IFRS into two categories: common stock and “reserves.” The term reserves is considered misleading and thus is discouraged under U.S. GAAP.

Distinction between debt and equity for preferred stock. The primary standard for distinguishing between debt and equity in the U.S. is *SFAS No. 150*, “Accounting for Certain Financial Instruments: Characteristics of both Liabilities and Equity;” under IFRS, it’s *IAS No. 32*, “Financial Instruments: Disclosure and Presentation.” Differences in the definitions and requirements under these standards can result in the same instrument being classified differently between debt and equity under IFRS and US GAAP.

Most preferred stock (preference shares) is reported under IFRS as debt with the dividends reported in the income statement as interest expense. Under U.S. GAAP. That's the case only for "mandatorily redeemable" preferred stock. Unilever describes such a difference in a disclosure note:

Additional information for US investors [in part]

Preference shares

Under IAS 32, Unilever recognises preference shares that provide a fixed preference dividend as borrowings with preference dividends recognised in the income statement. Under US GAAP such preference shares are classified in shareholders' equity with dividends treated as a deduction to shareholder's equity.

Comprehensive Income. As part of a joint project with the FASB, the International Accounting Standards Board (IASB) in 2007 issued a revised version of *IAS No.1*, "Presentation of Financial Statements" that revised the standard to bring international reporting of comprehensive income largely in line with U.S. standards. It provides the option of presenting revenue and expense items and components of other comprehensive income either in (a) a single statement of comprehensive income or (b) in a separate income statement followed by a statement of comprehensive income. U.S. GAAP also allows reporting other comprehensive income in the statement of shareholders' equity.

Chapter 19 Shared-Based Compensation and EPS

Where We Are and What's Ahead

The earnings per share requirements used in the U.S., *SFAS No. 128*, are a result of the FASB's cooperation with the IASB to narrow the differences between IFRS and U.S. GAAP. A few differences remain. The FASB and the IASB have issued Exposure Drafts for public comment designed to converge the computations of basic and diluted EPS with IFRS.

Earnings per Share. *IAS No. 33* and *SFAS No.128* are similar in most respects. But a few differences between IFRS and US GAAP

remain as a result of differences in the application of the treasury stock method, the treatment of contracts that may be settled in shares or cash; and contingently issuable shares. In August 2008, the FASB issued an Exposure Draft proposing amendments to FASB 128, “Earnings per Share.” Simultaneously, the IASB issued a parallel proposal to amend IAS 33, “Earnings per Share.” The comment period for both documents ended on December 5, 2008, and final Standards are due any day now.

The proposed amendments reflect the boards’ efforts to converge the guidance on EPS in U.S. GAAP and IFRS as well as to clarify and simplify this guidance. Since other accounting differences between U.S. GAAP and IFRS preclude the possibility of achieving a common numerator (i.e., earnings) in EPS calculations, the Boards instead focused on achieving a common denominator (i.e., number of shares). Proposed changes in the application of the treasury stock method include (a) assuming the repurchase of shares at the year-end price rather than the average market price for the period and (b) omitting from the diluted EPS calculation any instruments measured at fair value with changes in fair value reported in earnings.

Recognition of Deferred Tax Asset for Stock Options. Under U.S. GAAP, a deferred tax asset is created for the cumulative amount of the fair value of the options expensed. Under IFRS, the deferred tax asset isn’t created until the award is “in the money;” that is, has intrinsic value.

Chapter 20 Accounting Changes and Errors

Where We Are and What’s Ahead

The FASB and the International Accounting Standards Board have a continuing commitment to converge their accounting standards. As part of their short-term convergence effort, they identified how companies report accounting changes as an area in which the FASB could improve its guidance by converging it with the provisions of *IAS No. 8*, “Accounting Policies, Changes in Accounting Estimates and Errors.” The product of this effort is *SFAS No. 154*, “Accounting Changes and Error Corrections,” issued in 2005. Few differences remain, so it’s unlikely we will see much change in this area.

Error Corrections. When correcting errors in previously issued financial statements, IFRS permits the effect of the error to be reported in the current period if it's not considered practicable to report it retrospectively as is required by U.S. GAAP.

Chapter 21 Statement of Cash Flows Revisited

Where We Are and What's Ahead

The joint “financial statement presentation” project will dramatically change the format and display of all financial statements. The proposed organization of all of the basic financial statements will follow the classification currently used in the statement of cash flows – operating, investing, and financing activities. The notion of “cash equivalents” likely will not be retained. The FASB is leaning toward requiring the direct method of reporting operating activities; the IASB is leaning toward permitting either the direct or indirect method.

Classification of Cash Flows. Both U.S. GAAP and IFRS require a statement of cash flows classifying cash flows as operating, investing, or financing. A difference, though, is that *SFAS No. 95* designates (a) interest payments and interest received as operating cash flows and (b) dividend payments as financing cash flows and dividends received as operating cash flows. *IAS No. 7*, on the other hand, allows more flexibility. Companies can report interest and dividends received and paid as operating, investing, or financing cash flows, provided that they are classified consistently from period to period. Interest payments usually are reported as operating activities, but can be deemed financing activities. Dividend payments usually are reported as financing activities as under U.S. GAAP. However, interest received and dividends received normally are classified as investing activities.

Noncash Activities. U.S. GAAP requires significant noncash activities be reported either on the face of the statement of cash flows or in a disclosure note. IFRS requires reporting in a disclosure note, disallowing presentation on the face of the statement.