IFRS — THE NEXT ACCOUNTING REVOLUTION

Whoever said the accounting world wasn't dynamic? Over the past few years, demand for accounting professionals has been strong as companies strengthened their internal controls to comply with Sarbanes Oxley (SOX) legislation and the Canadian equivalent. Now, International Financial Reporting Standards (IFRSs) are coming to Canada and are about to change Canadian accounting.

BY KARINE BENZACAR, CMA

Most accountants, regardless of their specialty, are familiar with Canadian generally accepted accounting principles (GAAP). However, each country has its own set of accounting standards. With increasing globalization, companies or investors who do business in several countries need to understand each nation's accounting principles. In addition, if a Canadian company is listed on a foreign stock exchange, it needs to comply with foreign regulations to reconcile its financial statements to foreign accounting standards. The goal behind IFRS is to harmonize accounting between countries which should ultimately make it easier to conduct business internationally and raise funds in global capital markets.

What is IFRS?

IFRS is the official reporting standard which was recently adopted by over 100 countries around the world. It has been around, in various forms, since 1973, and was previously known as IAS (or International Accounting Standards). However, it has only recently begun to be used more prevalently throughout the world. The European Union and Australia decided that public companies would be required to use IFRS in 2005. New Zealand converted in 2007. On Feb. 13, 2008, the Canadian Accounting Standards Board decided to make IFRS mandatory for all publicly-accountable enterprises starting in January 2011. Other countries such as China, Japan, India, and South Korea are also targeting a 2011 implementation date.

If every country uses different accounting standards, investors have difficulty comparing companies and investors ultimately bear the costs of translation. At an IFRS conference sponsored jointly by the Canadian Institute of Chartered Accountants (CICA) and the International Accounting Standards Board (IASB) in April, Paul Cherry, chairman of the Canadian Accounting Standards Board, commented on the importance of Canada converging with a global standard: "We have tried hard to give the country the maximum amount of time possible to move to IFRS but on the other hand, we have to look at the realities of the business world ... the whole purpose of the exercise is to provide access to capital markets in a cost-effective manner."

BOTH IFRS AND CANADIAN GAAP ARE PRINCIPLES-BASED WHILE U.S. GAAP IS MORE RULES-BASED.

"The goal of IFRS is to have all countries follow the same accounting standards, thereby simplifying the process for all concerned," says Geoff Leverton, leader, Capital Markets Group, Pricewaterhouse Coopers, Toronto.

Both IFRS and Canadian GAAP are principles-based while U.S. GAAP is more rules-based. "The intention of a principles-based system is to focus on presenting the business reality of business transactions," Bill Murphy, leader, National

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IFRS Advisory Services, KPMG, Toronto, says. "However, since a principles-based system relies on the professional judgment of those applying the standards, it may be possible for two well-qualified accountants to apply the standards differently." As a result of this factor, IFRS requires more disclosures than Canadian GAAP.

In the mid 1990s, Canada began aligning its accounting standards with U.S. GAAP, especially since more and more companies began to tap into U.S. capital markets for financing. However, after the Enron collapse, the Canadian Accounting Standards Board started to rethink its strategy of aligning with the U.S. and began leaning toward the international standards.

Although IFRS is similar to Canadian GAAP, similar does not mean identical and experts across the industry all agree that IFRS implementation can be just as large an undertaking as Sarbanes Oxley (SOX) implementations were. The common theme among organizations who have begun implementing IFRS is that there is a lot of work involved in order to understand the impact that IFRS will have on the organization.

SOME INDUSTRIES WHERE IFRS WILL MEAN SIGNIFICANT ACCOUNTING CHANGES ARE FINANCIAL SERVICES, UTILITIES SUBJECT TO RATE REGULATION, INSURANCE, MANUFACTURING, AND OIL AND GAS.

Linda Mezon, chief accountant at RBC Financial Group, summarized the conversion process when addressing accountants at the April CICA/IASB conference: "Canadian GAAP is similar to IFRS but there are changes and you will have to be aware of those changes. The trick is for you to understand those changes and how they apply to your business."

One big advantage that Canadian businesses have is that they can rely on the experience of their European counterparts and that Canadian standards are much more similar to IFRS than many of the former European standards were. Sir David Tweedie, chairman of of the IASB says, "What people don't realize is that the European changeover went very well. The advantage Canada has compared to Europe is that the [Canadian] standards are very similar."

How are organizations affected?

Only publicly accountable enterprises such as public and crown corporations as well as other entities, such as government business enterprises and government business-type organizations, are immediately affected by IFRS. They are mandated to change their reporting to comply with IFRS. If a Canadian public company doesn't convert to IFRS by 2011, its stock could de-listed from Canadian stock exchanges. Private enterprises that are subsidiaries of multinational corporations may be directed by their parent to change.

The requirements for private companies, pension plans, public sector entities, and not-for-profit organizations have not yet been finalized but each of these sectors may end up with its own specific set of accounting standards. "It is likely that there will be a number of different sets of accounting standards in Canada, as many as five or six sets of standards, each with varying degrees of IFRS content depending on the type of entity involved," Murphy, says.

Most companies will be impacted by IFRS but different industries will face different challenges. "Converting to IFRS can take at least two years, depending on the complexity of the organization," Leverton says. "Small firms in simple industries will likely have a shorter implementation period than large multinationals operating with different business

What is the U.S. doing about IFRS?

Historically, Canada has followed the U.S. for accounting guidance, up until recently. The U.S. has been slow to adopt IFRS. A few years ago, the Financial Accounting Standards Board (FASB), the governing accounting body in the U.S., was not very receptive to IFRS. However, the board's opinion is beginning to change. As the majority of developed nations move toward IFRS, the US is beginning to reconsider its decision to maintain US GAAP. More and more money is being raised in capital markets outside of the US than ever before. "In order to continue to be considered a major economic player and maintain their position as one of the leaders of a global economy, it's likely that Americans will eventually conform to the international standard," says Leverton of Pricewaterhouse-Coopers. In fact, effective Mar. 4, 2008, the U.S. Securities Exchange Commission (SEC) is allowing listed foreign private issuers (i.e. non-U.S. companies listed on American stock exchanges) to report their financial statements using IFRS rather than U.S. GAAP. This alleviates foreign companies from reconciling their statements to U.S. standards. The general consensus among experts is that the U.S. will convert to IFRS, probably in 5 to 7 years. For a change the U.S. will be copying Canada and not the other way around.

platforms with numerous legacy systems."

Some industries where IFRS will mean significant accounting changes are financial services, utilities subject to rate regulation, insurance, manufacturing, and oil and gas.

"On a conceptual basis, IFRS and Canadian GAAP are very similar. However, across many aspects, there are significant differences when one starts looking at the two reporting standards in detail," Matt Bootle, partner, Professional Practice Group, Ernst and Young, Calgary. "The specific differences will depend on the particular industry and the actual company."

Some major examples of differences between Canadian GAAP and IFRS include the following:

- **Business combinations:** There are a number of changes to rules related to business combinations, which occur when companies acquire control or significant influence over other companies. Assets and liabilities acquired will be reported at 100 per cent of their fair value, even if less than 100 per cent of the business is acquired. Under current GAAP, only the portion that the buyer is acquiring is reported at fair value; the rest is reported at book value. The acquirer will also need to expense acquisition related costs rather than including them in goodwill as is currently done under Canadian GAAP. If the fair value of the assets acquired exceed the fair value of the consideration paid, under IFRS the difference is considered a bargain purchase and included in income.
- **Consolidation methods of joint ventures:** Currently, joint ventures are accounted for using the proportional method of accounting; this means that each company records its proportionate share of assets, liabilities, and income in its own books account by account. IFRS rules will account for them under the equity method of consolidation. This means that the company will report only its share of income in the joint venture.
- **Impairment of non-financial assets:** The impairment tests for non-financial assets, such as fixed assets and goodwill are based on discounted cash flows for the relevant cash generating units (CGUs). Since CGUs may need to be identified at a more granular level than reporting segments, a company may end up recognizing impairment charges sooner or more frequently under IFRS than under Canadian GAAP. A further difference between Canadian GAAP and IFRS is that IFRS requires companies to reverse previous impairment write-downs, other than for goodwill, if the conditions that caused the impairment no longer exist. "These changes effectively could make net income more volatile than what we see now," Murphy says.

What is the best way to convert to IFRS?

Public companies should already be looking at the impact of IFRS on their reporting and should be planning for their conversion. Although a conversion date of January 2011 seems far away, the timelines are actually much shorter than they seem. In order to report a comparative balance sheet on January 2011, the best approach for companies is to begin keeping a parallel IFRS set of books starting in 2010. If systems changes are required, they will need to be done and tested in 2009. Since we are already halfway through 2008, there really isn't much time left to undertake the implementation.

PUBLIC COMPANIES SHOULD ALREADY BE LOOKING AT THE IMPACT OF IFRS ON THEIR REPORTING AND SHOULD BE PLANNING FOR THEIR CONVERSION.

IFRS conversion is a large project and like any large project, effective project management is critical. There should be a cross-functional team assembled to manage the migration. Many organizations might be tempted to ask their financial staff to assume IFRS responsibilities in addition to their daily roles, but this is a mistake. "For any enterprise, this is much more than a technical exercise. The implementation will need to involve many groups, both internal and external to the organization and ensure that the message is properly communicated to external stakeholders," Bootle says. The team should be led by a professional project manager and should comprise IT staff and change management professionals in addition to financial reporting individuals. Communication across all levels and functions of the organization is important.

Entities affected by IFRS

The Accounting Standards Board requires that all Canadian reporting entities be required to apply IFRS after Jan. 2, 2011 with the exception of the following:

(a) Private enterprises, that is, profit-oriented entities that:

(i) have not issued (and are not in the process of issuing) debt or equity instruments in a public market; and

(ii) do not hold assets in a fiduciary capacity for a broad group of outsiders.

Entities with fiduciary responsibility, such as banks, credit unions, insurance companies, securities brokers/dealers, mutual funds, and investment banks, stand ready to hold and manage financial resources entrusted to them by clients, customers or members not involved in the management of the entity.

(b) Not-for-profit organizations, as defined in the CICA Accounting Handbook.

(c) Public sector entities to which the standards contained in the CICA Public Sector Accounting Handbook apply.

- *excerpt from the CICA exposure draft on Adopting IFRSs in Canada (April 2008)*

Who does IFRS impact?

IFRS will impact almost everyone. The implications of IFRS are much broader than financial reporting. Like SOX implementations, it's likely that IFRS implementations will require large system changes; this means that IT specialists will be busy over the next few years. Many companies currently have executive compensation packages which are based on net income. Since net income will change under IFRS reporting, it may be necessary to alter some of the compensation formulas. It is also necessary to communicate the impact of IFRS changes to anyone affected by the change in financial reporting — such as bankers, who typically use financial ratios in lending decisions and debt covenants, stock analysts, and portfolio managers. This means that, not only should professionals in these fields update their knowledge, but investor relations' departments should start strategizing on how to best communicate the impact of accounting changes on results.

Anyone who either prepares or relies on financial results needs to understand the impact of IFRS on an organization. While financial employees and those involved in an IFRS migration will need to understand the details behind IFRS, non-financial managers may only need a high-level awareness of the issues so that they can supply the proper information to those responsible for the implementation. In any event, one thing is certain — although many people haven't heard about IFRS today, in a couple of years, it will become standard accounting terminology. ■

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