

International Financial Reporting Standards (IFRS)

Bankers Should Brace Themselves *for* Large-Scale Accounting Changes

*One of the latest effects of globalization is the adoption of international accounting standards. The new standards are expected to have a **large impact** on North American bankers and many of their clients. Adoption is expected soon.*

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BY KARINE BENZACAR

IT IS RARE to find accountants leading change. But as North American accounting regulators adopt the international accounting standards, the changes that will result will have a major impact on the business world. Banks and their clients need to be prepared.

Accounting transactions are governed by a set of rules known as *generally accepted accounting principles* (GAAP). Until recently, each country had its own GAAP and operated with its own set of accounting guidelines. However, accounting is like other facets of the business world in that standardization throughout different countries reduces complexity and costs, and therefore consistent accounting guidelines are now being encouraged throughout the world.

The International Financial Reporting Standards (IFRS) are replacing individual-country GAAPs. More than 100 countries have adopted IFRS, and the United States and Canada are about to jump on board. Since bankers spend a lot of their time looking at financial statements, they will need to familiarize themselves with the impact the new standards will have on the statements, especially since accountants anticipate changes to net income simply as a result of the new accounting practices.

Why IFRS?

The goal of IFRS is to create the same set of accounting standards for all countries, which should ultimately make it easier to conduct business internationally and raise funds in global capital markets. When each country has its own GAAP, organizations and investors that do business in several countries need to understand each nation's accounting principles. In addition, if an American company is listed on

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a foreign stock exchange, it needs to comply with foreign regulations to reconcile its financial statements.

What Is IFRS All About?

IFRS has been around in various forms since 1973 and was previously known as IAS (or International Accounting Standards). It gained substantial momentum when members of the European Union and Australia adopted it in 2005. New Zealand followed suit in 2007. Today, IFRS is widely used throughout the major economies of the world and is becoming more popular among nations as time passes. Japan, India, South Korea, and Canada will implement the IFRS in 2011.

Initially, the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC)—the U.S. regulators of the accounting industry and the stock exchanges, respectively—were not receptive to adopting IFRS in the United States. “Our objective was to get to a set of high-quality standards,” said Bob Hertz, head of the FASB, at an April international accounting conference sponsored by the International Accounting Standards Board (IASB), the regulatory body that governs IFRS, and the Canadian Institute for Chartered Accountants (CICA) in Toronto. Regulators were not convinced that IFRS was more robust than U.S. GAAP, and thus they believed that the effort and cost of converting to a different accounting system were not justified. However, opinions have begun to change recently, and although the U.S. has not yet made any official announcements regarding conversion dates, it is clear that IFRS is coming to the U.S. and it is coming fast.

One of the large differences between U.S. GAAP and IFRS is the mindset on which they are based. U.S. GAAP is rules-based, which means a set of rules governs accounting transactions. IFRS is principles-based. “Principles-based accounting is a major shift in mindset for Americans,” says Sir David Tweedie, chairman of the IASB.

A rules-based system is black and white; either someone breaks a rule or they don't. However, with a principles-based system, accountants must exercise their own professional judgment using accounting guidelines to determine how to account for a particular transaction. “The intention of a principles-based system is to focus

on presenting the business reality of business transactions,” says Bill Murphy, National IFRS Advisory Services Leader of KPMG in Toronto. “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.”

For that reason, some experts fear it will be easier to camouflage unsavory business transactions in the financial statements. During the April CICA/IASB conference, John Carchrae, chief accountant of the Ontario Security Commission, said, “It is a good thing to have more room for professional judgment, but judgment needs to be exercised carefully and rigorously.”

One thing is certain: As a result of the increase in professional judgment, a lot more disclosures will be required in the financial statement notes than under the current GAAP. This news is not likely to be greeted enthusiastically by bankers, most of whom will have to upgrade their skills in reading financial statement notes.

Because Canadian GAAP is already principles-based, IFRS is more similar to Canadian GAAP than to U.S. GAAP. But there are still differences between Canadian accounting and IFRS. As a result of an official ruling by the Canadian Accounting Standards Board (AcSB), the regulators of Canadian accounting, all publicly accountable organizations must use IFRS by January 1, 2011, and many Canadian companies have already begun migration efforts.

IFRS conversions involve analyzing a company's current financial reporting policies and comparing them in detail to the IFRS standards. Each company will undergo a different level of conversion effort, depending on its industry and its operations. Some industries, such as utilities affected by rate regulation, manufacturing, insurance, banking, and oil and gas, are quite largely affected. Experts all agree that IFRS implementation can be just as large and expensive an undertaking as Sarbanes-Oxley (SOX) implementations were.

Bankers must be cognizant of the large costs involved in the upcoming conversion efforts for their clients. The common agreement among organizations that 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. At the April CICA/IASB conference, Linda Mezon, RBC Financial Group chief accountant, said, “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.”

It's an advantage for North American businesses that they can rely on the experiences of their European counterparts that have already gone through a conversion process. The European implementation has already refined many of the IFRS standards so North American companies are working with a stronger starting point than their European peers were. In many cases, European companies had much larger changes to their reporting than the North American organizations because their local-county GAAPs differed more

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from IFRS than did North American GAAPs.

“What people don’t realize is that the European change-over went very well, and there were a lot more differences between many European standards and IFRS,” Tweedie says.

A Few Key Differences between Current GAAP and IFRS

At first glance there are many similarities between existing GAAP and IFRS, but the differences are in the details. Some major differences between U.S. or Canadian GAAP and IFRS include the following.

- **Fixed-asset valuations:** Under current GAAP, fixed assets are valued at historical cost less depreciation. Under IFRS, companies have the option of revaluing fixed assets to their fair market value. Companies will also be required to value each individual component of an asset. For example, instead of listing an airplane as an asset, a company would be required to list separately each component of the plane, such as the body, the engine, the computers, the fuel gauge, and so on.
- **Business combinations:** A number of changes to rules are related to business combinations, which occur when companies acquire control or significant influence over other companies, such as through a merger or acquisition. Assets and liabilities acquired will be reported at 100% of their fair value, even if less than 100% 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 need to expense transaction and restructuring costs rather than capitalize them to goodwill as is currently done. If the fair value of the assets acquired exceeds 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, with each company recording its proportionate share of assets, liabilities, and income in its own books, account by account. IFRS rules could account for them under the proportional method or the equity method of consolidation. This means that the company could report only its share of income in the joint venture.
- **Impairment of nonfinancial assets.** The impairment tests for nonfinancial 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,” says Murphy.

All of these changes have a large impact on bankers. IFRS could change net income and EPS for a company simply as a result of different accounting conventions. Bankers will need to review their debt covenants and lending practices that rely on financial ratios, and they may need to draft new agreements to compensate for the new accounting guidelines.

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The Status of IFRS Adoption

IFRS is coming to North America, but it is being adopted quite differently in Canada and the United States. Canadian regulators have chosen to adopt IFRS in its entirety. A recent Canadian exposure draft, “Adopting IFRS in Canada,” explains that Canadian regulators intend to adopt IFRS “in full and without modification. To do otherwise would result in multiple and possibly conflicting versions of IFRS globally, if enough other national standard setters did the same. This would defeat the purpose of global convergence, which is to move toward a single set of high-quality accounting standards for use throughout the world.” However, in cases where Canada has identified a challenge in adopting a certain standard for one of its industries, such as oil and gas, and the same industry in other countries could also be challenged by the IFRS standard, Canada has entered into discussions with IASB to change the standard.

Canada’s decision to move to IFRS surprised many professionals throughout the world because Canada has always looked to the U.S. for guidance on accounting policies. Tweedie says, “If anyone would have expected Canada to change standards, they would have expected Canada to adopt U.S. GAAP. Canada’s decision to adopt IFRS took the world by surprise.”

In the United States, FASB is working jointly with the IASB to analyze and modify the accounting standards before adopting them. In February 2006, the FASB and IASB issued a memorandum of understanding that dealt with creating various projects to analyze the accounting standards with a detailed work plan for 2006 through 2009.

What Kinds of Organizations Will Be Impacted?

The answer to this question depends on whether the organization is located in Canada or the United States.

Within the United States, FASB is “converging” U.S. GAAP with IFRS. No official announcement has yet mandated companies to convert to IFRS, but as with any GAAP changes, all organizations are expected to comply. If the U.S. adopts IFRS directly, it is likely that public companies and state-controlled corporations will be immediately affected and private companies will be given the option. Eventually, it is likely that all organizations will adopt IFRS.

Canadian accounting regulators made a formal announcement in February requiring “publicly accountable” entities to convert their financial reporting to IFRS. Publicly accountable entities are defined as all companies except:

- (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.

—Excerpted from the CICA exposure draft on Adopting IFRSs in Canada (April 2008).

Only publicly accountable companies, such as public corporations and crown corporations, are immediately affected by IFRS. No regulatory changes have been mandated for private Canadian companies, but they will have the option of converting to IFRS. The requirements for private companies, pension plans, public sector organizations, 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 in Canada there will be many versions of GAAP in the near future. ❖

The two accounting boards are mainly investigating:

- The conceptual accounting framework.
- Accounting for financial instruments.
- Fair value measurement.
- Consolidations.
- Revenue recognition.
- Financial statement presentation.

“We concluded that both of our standards [the U.S. standards and the international standards] were in some desperate need of some overhaul,” said Hertz in a joint presentation with Tweedie at the April IFRS conference in Toronto. “The objective of our agreement was to get to high-quality standards around the world. If the U.S. is going to adopt IFRS in the future, we have to make sure it makes sense for everyone rather than just adopt it.”

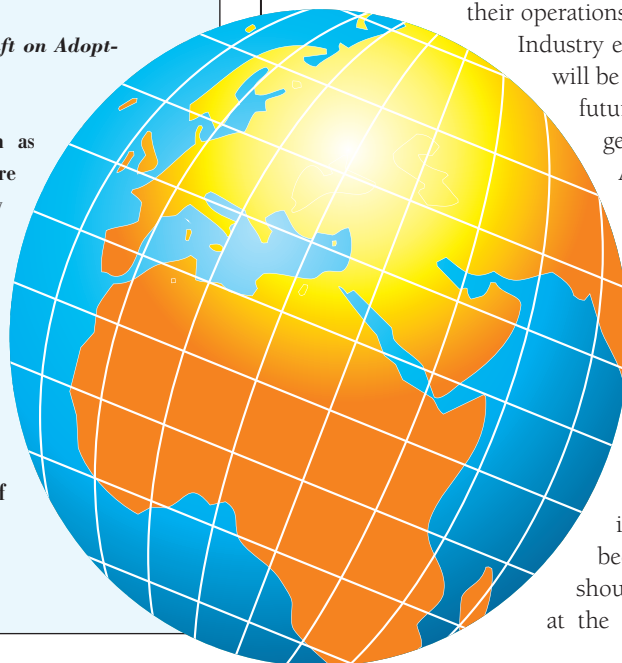
Tweedie acknowledged the large role of the U.S. in improving the international standards, saying, “The IASB is making some adoptions of U.S. standards; the U.S. is making some adoptions of IFRS.” It is quite likely that the U.S. will have a large impact on changing what financial statements look like around the world.

While analyzing standards and developing high-quality international standards, the U.S. is using the term “convergence,” meaning that U.S. accounting standards are quickly changing to mirror international standards where FASB sees fit. But if the U.S. accounting standards are being brought in line with IFRS, many professionals in the industry are questioning why the U.S. doesn’t adopt IFRS directly. Companies that stand to gain the most are multinationals headquartered in the U.S. but with subsidiaries located in countries already practicing IFRS. Ironically, it is more cumbersome for these companies to report their financial results following U.S. GAAP when many of their operations are already using IFRS.

Industry experts agree that the U.S. will be adopting IFRS in the near future; the question is no longer “if” but “when.” At the April conference, Hertz said, “IFRS is obviously spreading to many parts of the world and will continue to do so. We need to set a date in the U.S. to get there.”

What Should Bankers Be Concerned About?

In Canada, where a firm implementation date has been set, public companies should already be looking at the impact of IFRS on their



reporting and should be planning for their conversion. Bankers should be asking their clients for their implementation plans because they will likely involve a substantial amount of resources, both human and financial.

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 system 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. If Canadian clients have not begun their IFRS migration efforts by now, there is a risk that they may not be able to complete the exercise in a cost-effective manner, depending on the nature of their industry.

In the U.S., clients need to stay abreast of the changes affecting the accounting system as we know it. Detailed conversion plans would be premature at this point, but companies should be closely following the convergence efforts between the IASB and FASB while anticipating the dedication of substantial resources, both human and

financial, to conversion efforts in the future. If clients are not aware of the fact that new accounting guidelines are coming, this may signal a risk in that they are not keeping current on changing industry regulations, which could potentially have a large impact on their organizations.

Moreover, the implications of IFRS are much broader than financial reporting. Cross-functional teams should be involved in the changeover within organizations. For example, many companies currently have executive compensation packages that are based on net income. Since net income will change under IFRS reporting, it may be necessary to alter some of the compensation formulas.

Last, but certainly not least, bankers will also have to understand the impact of IFRS on their clients and how IFRS conversions will affect the financial ratios used in lending decisions and existing debt covenants. ❖



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