

Private Company Financial Reporting Update: IFRS or U.S. GAAP?

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2004 AICPA private company financial reporting task force survey

Support for different GAAP for private companies:

	<u>1983</u>	<u>2004</u>
CPA practitioners	60%	85%
Private company owners	40%	55%
External users	10%	50%

AICPA/FASB private company financial reporting initiatives

- 2004 – Private company financial reporting task force established
- May 2005 – AICPA Council Resolution
- June 2006 – AICPA/FASB joint proposal issued
 - Private company financial reporting committee established
 - “Represent” non-public entities
 - Makes recommendations to FASB of **modifications to GAAP standards** for private companies
- May 2007 – First recommendations letter
- Oct. 2008 – First FASB vote on PCFR issue

PCFRC recommended changes to FASB late 2007, 2008, early 2009

- Accounting changes
- Defining “private entity”
- Going concern
- Subsequent events
- Business combinations
- Financial asset disclosures
- Standards process
- Discontinued operations
- Adoption of IFRS
- Reporting entity definition
- Conceptual framework
- Loss contingencies
- Characteristics of equity
- FS presentation
- FIN 46R, VIE’s
- FIN 48, Oct 28, FASB voted NOT to exempt private entities, but will provide partial disclosure relief

Accounting standards for U.S. private companies

- Based on U.S. GAAP issued by FASB
- FASB considers “modifications” recommended by the PCFRC
- **PCFRC (www.pcfr.org) consists of:**
 - Chair, paid part-time employee of FASB
 - Four preparers/owners, four outside users, four CPA practitioners
 - Two-thirds majority needed to approve a recommendation

Accounting standards for U.S. private companies

- Primary purpose of FASB/U.S. GAAP is standards for public companies
- SEC proposed “roadmap” for public companies mandates IFRS adoption – “one global accounting standard” phased in 2011-2016 – **Last year for U.S. GAAP is 2015?**
- If public companies adopt IFRS, what happens to U.S. GAAP?
- Will private entities have to adopt IFRS?
- Is there an IFRS for private entities (PE’s)?

IFRS for private entities initiatives

- Initiated by smaller & developing nations to replace local country GAAP?
- Jan. 2005 – Draft of an ED for SMEs
- Feb. 2007 – ED of IFRS for SMEs issued
- June 2007 – Field-tested by 116 companies in 20 countries, seven languages
- Nov. 2007 – Comments: 162 letters
- June 2009 – Final document expected: “IFRS for Private Entities”

IASB's IFRS for private entities

- Feb. 2009, Deloitte polled 1700 finance professionals, mostly private companies, on private entity IFRS
- 40% indicated they would take action on IFRS for private entities
 - 14% consider near-term adoption vs. GAAP
 - 26% would assess costs and benefits

U.S. GAAP overview

- 25,000 pages of guidance
- Industry-specific accounting guidance
- “Rules-based” – specific guidance, focused on public companies
- “Modifications” for private companies
- FASB influenced by SEC, U.S. political climate, litigation culture
- History of options (LIFO, FIFO) but narrowing
- Simple majority of five changes rules

IFRS overview

- 2,000 pages of guidance
- No industry guidance
- “Principles-based” – less specific?
Focused on multinational companies
- IASB influenced by European cultures, various EU securities regulators and world politics
- Super-majority of 16 to effect change

IFRS for private entities

- Simplified 250 pages of guidance
- Exposure Draft issued in Feb. 2007
- Based on IFRS principles but stands alone
- Focus is private companies that publish financials for external users
- Final standard expected June 2009
- Updated every two years
- Initiative was for less developed nations?

PCFRC roadmap if IFRS becomes GAAP for U.S. public companies

PCFRC has published five models:

1. IFRS for private entities or IFRS “as published” by the IASB – no U.S. changes
2. U.S. version of IFRS for Private Entities
3. U.S. version of IFRS
4. U.S. GAAP revised for private entities
5. U.S. GAAP retained and updated

Private entity standards if IFRS becomes GAAP for U.S. public companies

- U.S. public company accounting standards could be:
 - IFRS “as published” by the IASB
 - A US “version” of IFRS “as adopted” by the SEC and the FASB
- PCFRC roadmap contemplates the possibility that SEC adopts IFRS, PE’s can keep GAAP
- Can there be a complete, separate set of standards for U.S. private entities?
- Two separate sets of standards in U.S.?

One global standard vs. multiple standards

Issues with multiple standards in the U.S.

1. Funding for multiple boards
 - FASB is funded by public companies
2. Funding education – since 2000:
 - 13% decrease in accounting professors
 - 15% increase in accounting students
 - Average age of PhD is 57 years
 - Penn University limited to 300 accounting students
3. If public companies adopt IFRS, it's unlikely there will be a U.S. GAAP for PEs?

Why IFRS as “global standard?”

- U.S. GAAP too detailed
- The rest of the world will not accept (or is not ready for) detailed guidance based on U.S. culture, U.S. litigation environment, U.S. SEC, U.S. politics
- IFRS already widely accepted by EU, Asian nations

Private company standards are linked to public company standards in the U.S.

What are the alternatives for public companies?

1. Adoption of IFRS, as published by IASB

- SEC Chair, Jan. 09 “I am not bound by the existing [proposed] roadmap...” [to mandate IFRS in 2011 - 2016]

2. Converge U.S. GAAP with IFRS

- FASB Chairman, April, 2009, “10 to 15 years under ideal conditions”

3. Adoption of U.S. version of IFRS

- IFRS modified by FASB or SEC or both

A U.S. version of IFRS?

- Alternative to convergence – adoption of a U.S. version of IFRS
 - Many countries that have adopted IFRS have adopted a version, especially in Asia
 - FASB currently “riding two horses”
 - Changes to GAAP to converge
 - Changes to GAAP to stay current
 - U.S. IFRS would be “modifications” to IFRS?
 - U.S. PE IFRS would be based on U.S. IFRS?

Why one global accounting standard?

- Is there “one true answer” to report earnings, equity?
- If there are multiple acceptable answers, why one global accounting standard?

One global accounting standard

- Improve **comparability, consistency**
- **Costly for multinational** companies to have different standards for each country
- A global economy needs one accounting standard to **access capital markets**
 - Different standards are perceived to result in a “**competitive advantage**” for one standard user
- Inefficient/costly for each country to maintain a “local country” GAAP
- Global academic community needs a single standard for international business educators

IFRS improves comparability?

- IFRS requires nine accountants to agree
 - More options
- “Principles-based,” less specific rules
 - More options
- No industry guidance
 - More options
- **More comparability or less?**

IFRS improves comparability?

- One global set of accounting standards
- Applied by different cultures:
 - Confidentiality/secretcy
 - Individualism vs. socialism
 - Achievement orientation
 - Acceptance of unequal power
- Applied in different languages – standards lost in English translation

IFRS as a single global standard reduces costs (for multinationals)

- European and Asian nations may have:
 - Tax basis of accounting
 - Statutory accounting
 - Local country GAAP
- Multinationals deal with multiple sets of accounting rules in multiple countries
 - Consolidate into U.S. GAAP or IFRS if foreign parent
- Some European nations adopted IFRS to replace: local GAAP, statutory and even tax basis (one set of global accounting standards)

IFRS as a global standard reduces costs

- U.S. multinational companies are on multiple standards:
 - U.S. GAAP consolidated
 - Statutory accounting for foreign subs
 - IFRS accounting for some foreign subs
 - Local-country tax basis accounting for some subs
- If the world adopts one global standard, U.S. multinationals will reduce costs and confusion

IFRS cost considerations

- Cost to convert or adopt
- Cost reductions if local country GAAP and statutory accounting are replaced by IFRS: one global set of standards
- Costs created by continuous changes as U.S. GAAP and IFRS converge
- IFRS costs – increased documentation costs caused by reduced guidance?

Convergence and competitive advantage

- IFRS initial purpose to put EU nations on a common standard
- No initial interest in convergence with U.S. GAAP
- SEC permitted foreign registrants to use IFRS, but had to reconcile IFRS with U.S. GAAP
- SEC eliminates reconciliation if convergence milestones met
- IASB meets convergence milestones
- Foreign registrants – use IFRS w/o reconciliation
- U.S. registrants at a “competitive disadvantage?”

Capital markets – competitive advantage

- Foreign registrants use IFRS in SEC reports
- U.S. registrants at a competitive disadvantage?
 - Study indicates IFRS increases earnings, equity for 50-70% of companies
 - Johnson & Johnson study indicates significant earnings increase from IFRS rules that permit capitalization of certain R&D costs

One global accounting standard: “conventional wisdom”

- The future is one set of standards – IFRS is expected to be used worldwide
- By 2011, 50% of the Global 500 will be domiciled in countries that have adopted IFRS (not the U.S.) – the market for perceived “competitive advantage” will drive more
- Must be standards “as promulgated” by the IASB [or will it be “local version” of IFRS?]

IFRS adoption by EU – Impact on U.S. subsidiaries of EU companies

- EU parent does consolidated financials based on IFRS
- IFRS requires all members of consolidated group to be on same accounting methods
- U.S. subsidiaries of EU companies are converting from U.S. GAAP to IFRS

AICPA approves IASB as a standard-setting body

- IASB designated by AICPA as standards-setting body for IFRS
- U.S. GAAS permits auditor to report on conformity with IFRS, in lieu of GAAP, for private and public entities (AU 9508.93)
 - No requirement to report non-conformance with GAAP – “clean opinion” on IFRS financial statements

IFRS adoption

- IFRS adopted in EU by 3,000 public companies
- IFRS adopted by five million private companies
- U.S. has 13,000-17,000 public companies
- U.S. has 22 million private companies

IFRS less specific, more options, so it's less complex? What was the EU experience?

EU adoption of IFRS vs. local GAAP:

- 1/3 reported finding unexpected differences between local GAAP and IFRS
 - If IFRS permitted more options, local GAAP methods would be an acceptable option
- 85% of companies found it more difficult to explain their financial results under IFRS
- Average increase in the length of financial statements was 56% in the first year
 - But IFRS is less complex?

IFRS less specific, more options?

EU adoption of IFRS vs. local GAAP:

- Required significant system changes
- Impacted contracts with banks, management (bonuses based on profits)
- Did it in three years but many companies underestimated the effort and waited too long to start

Changes to U.S. GAAP to move to IFRS

- If IFRS is coming to the U.S., how extensive might the changes be?
- Norwalk agreement with FASB on convergence – U.S. GAAP is changing to converge with IFRS
- IASB and FASB picking between IFRS or U.S. GAAP, topic by topic?
- IASB and FASB starting over on many accounting topics – “do-overs”

U.S. GAAP items subject to change

- If IFRS is less specific, with more options than U.S. GAAP, then wouldn't most GAAP conventions be acceptable under IFRS?
- Convergence would be simple?
- Reality is that there are many differences between IFRS and U.S. GAAP that would have to change – IFRS provides **less guidance but many specific rules, often with less options than U.S. GAAP**

U.S. GAAP items subject to change

- Inventory – no LIFO, fewer options on LCM, LCM must be NRV, not NRV – profit
- Consolidation – subsidiaries must use same accounting policies as parent under IFRS
- Consolidation – SPEs, less guidance vs. GAAP
- PP&E – Impairment rules differ, IFRS impairments recognized more frequently and requires restoration if value recovered
- Depreciation – IFRS requires depreciation calculations based on asset components

U.S. GAAP items subject to change

- Presentation of financials – IFRS presents long-term assets first. “Do-over” for both standards
- PP&E – IFRS permits revaluation
- Revenue recognition – IFRS has general principles; less specific and no industry guidance
- Impairment of intangible assets differs
- Accounting for leases differs, IFRS more general
- Debt vs. equity treatment rules differ
- IFRS permits capitalization of some R&D
- Deferred taxes are classified differently

U.S. GAAP items subject to change

- Liability provisions under IFRS are established if obligation is “more likely than not” vs. “probable” under U.S. GAAP
- Restructuring provisions recognized when plan established – prohibited under GAAP
- Related-party disclosures under IFRS include disclosure of key management compensation, not required by GAAP
- Discontinued operations are defined differently
- IFRS requires comparative financial statements
- And many, many more differences

IFRS for private entities vs. GAAP

- IFRS for PEs is based on IFRS and has most of the same differences vs. GAAP
- IFRS for PEs is “simplified,” this simplification eliminates some accounting options
- Subsequent events: if LTD is current at year-end, then subsequent refinancing and covenant cures do not change classification to LT
- LIFO prohibited
- Components approach to depreciation

Private company financial reporting

- U.S. is part of the global economy
- A global economy needs a global accounting standard
- Changes in standards will accelerate
- “Tough” topics have been deferred
- Are there other options for U.S. PEs?
 - OCBOA financials
 - U.S. GAAP with exceptions

Other options for U.S. PE's

- OCBOA financial statements
 - Tax basis, cash basis
 - Regulatory basis for some industries
- Tax-basis accounting for financial reporting purposes
 - With exceptions for depreciation?
 - Other exceptions?
 - “One accounting standard” for a U.S. PE?

Other options for U.S. PE's

- U.S. GAAP with “exceptions?”
 - PCFRC reports that banks/users are more commonly accepting PE financial statements with GAAP exceptions
 - FASB thinks that’s a good thing, PEs are finding acceptable options
 - PCFRC thinks it’s a bad thing, reflects that U.S. GAAP is not suited for private entities
 - Works while we have U.S. GAAP, but what happens when U.S. GAAP becomes IFRS?

Other options for U.S. PE's

Adopt IFRS early:

- PEs with international operations may find it beneficial to use “one global standard”
- Adopting IFRS early may reduce the “pain of (ongoing) change” and uncertainty
- Allows the private company accounting staff to become knowledgeable about accounting options under IFRS – expertise
- If you can't beat them, join them!

How will IFRS affect U.S. tax reporting?

- When the U.K. and Spain adopted IFRS for financial reporting, they adopted it for tax reporting purposes (“one standard”)
- If your revenue recognition changes because of IFRS, will that be a tax accounting change? Require a 3115 & IRS consent?
- There is currently a proposal in committee to repeal LIFO for tax purposes, effective 2011.
- IRS has added staff with expertise in financial accounting to track potential changes to code and identify enforcement issues.

Private company financial reporting

- One global accounting standard is coming
- The standard will not be the current version of U.S. GAAP.
- The focus of the standard will be multinational public companies
- Financial reporting for U.S. private companies will be dramatically affected by this change

Private company financial reporting

- U.S. public company accounting standards under IFRS may be even less suitable for U.S. private companies than current U.S. GAAP, but may be more suitable for some private companies
- Private companies that have multinational operations may benefit from early adoption
- Private companies that seek to avoid change may need to consider non-GAAP options
- Change may be unavoidable

Questions?

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