IFRS Adoption Compliance Issues

BADM 555

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Introduction

U.S. organizations and businesses use U.S. GAAP (Generally Accepted Accounting Principles) to prepare, present, and report financial statements. Creditors as well as potential and current investors use financial statements to help make investment, credit, and other financial decisions. Other countries either use country-specific GAAP or the International Financial Reporting Standards (IFRS). U.S. Companies that operate in the internationally typically have to report in U.S. GAAP as well as IFRS or other country-specific GAAP because reporting in one standard is not acceptable across all the countries. The advantages of having one global standard are clear as more companies enter the international markets, but the adoption process can be lengthy and costly before benefits are realized.

Currently, IFRS has been adopted in more than 100 countries including the European Union and much of Asia. The International Accounting Standards Board (IASB) is responsible for developing IFRS as the global accounting standard that is more principles based than U.S. GAAP. In prior years, Financial Accounting Standards Board (FASB) collaborated with IASB in an attempt to align U.S. GAAP with IFRS; however, FASB is now steering towards full IFRS adoption. In December 2007, the Securities Exchange Commission (SEC) no longer requires foreign private issuers using IFRS to reconcile to U.S. GAAP.

The SEC agreed to a roadmap that may lead to the requirement that all listed U.S. companies to adopt IFRS by 2014. According to the roadmap, the SEC will determine if that 2014 mandate will stay depending on seven milestones between now and 2011. (AICPA) If significant progress has been made, the SEC will use a phased-in approach to transition into

IFRS. The deadline may seem far away; however, because financial statements require the current year and two years of historic information, IFRS must be implemented by 2011. That only gives organizations and businesses roughly three years to prepare to present financial statements in accordance with IFRS. In the U.S., 110 of the largest publically held companies are allowed to adopt IFRS early at the end of 2009, which means those companies have even less time to prepare. This early adoption is one of the seven milestones. By taking early action, companies may control costs, manage the scope of implementation, and ensure a smooth transition plan. Accelerated filers will begin transition in 2015 followed by non-accelerated filers in 2016.

Other countries besides the U.S. are also transitioning to IFRS. Israel is adopting IFRS in 2008 with Chile and South Korea following close behind in 2009. Brazil’s adoption is set for 2010 while Canada is requiring the use of IFRS for 2011. In addition, Russia is expected to fully transition to IFRS starting in 2011.

IFRS & U.S. GAAP Differences

IFRS Adoption has clear impacts on accounting standards; thus, affecting accountants. Similar to how the Sarbanes-Oxley Act of 2002 (SOX) impacted the technology over internal controls of financial reporting, the IFRS compliance affects IT departments as well. The affects will depend on the differences between IFRS and U.S. GAAP. IFRS is a more principles-based with limited application guidance while U.S. GAAP is more rules-based standards with specific guidance. The two frameworks have many differences that are too numerous to name them all. However, the following are some key differences between the two frameworks that may impact businesses in various ways, especially regarding IT infrastructure and applications.

Revenue Recognition under IFRS has two primary standards and a handful of related interpretations that are generally applied without in-depth elaboration or industry-specific exceptions unlike U.S. GAAP. For example, U.S. GAAP has more specific rules and a higher hurdle for determining fair value and achieving revenue recognition for software related transactions than does IFRS. (PwC 9) Additionally, the differences may impact the timing of revenue recognition in accounting for the provision of services where U.S. GAAP generally prohibits the approach required by IFRS. Loyalty programs are accounted for using the incremental cost model under U.S. GAAP, but cannot use that same model under IFRS.

Expense recognition of share-based payments is different in terms of timing and amount recognized. IFRS may significantly accelerate the expense recognition of certain stock options with graded vesting. The recognition of payroll taxes is generally recognized as the compensation cost is recognized or at grant date under IFRS, but U.S. GAAP requires recognition to occur when the obligating event occurs, which is generally at the exercise of an award.

Whether a financial instrument is accounted for as debt or equity can vary between the two frameworks; thus, can affect a company's capitalization profile and reported earnings. One example is a financial instrument with contingent settlement provisions is considered debt under IFRS, but equity under U.S. GAAP. Classification regarding debt or equity impacts net assets and debt to equity relationships as well as increased interest expense.

Under IFRS, consolidation decisions are based on the power a company has to govern the financial and operating policies. U.S. GAAP employs a two-tiered considerations model with often complex evaluation criteria that provide a bevy of exceptions allowing companies to achieve off balance sheet treatment in certain circumstances. Generally more entities will be consolidated under IFRS; therefore, companies will likely be responsible for reporting and explaining the performance of newly consolidated entities. Furthermore, potential affects debt covenants, financing arrangements, and the entities covered by management's SOX certifications.

Technological Impacts of IFRS

Obviously, the major impact of IFRS is on accounting standards and briefly covered above. Furthermore, IFRS will also have secondary impacts on technology. The challenge facing companies is how to capture, analyze, and report new data in compliance with IFRS. Specifically, companies first must understand the detailed end-to-end flow of data, financial reporting processes and differences between IFRS and U.S. GAAP requirements as discussed previously. That understanding helps create technical specifications that would otherwise be more challenging than necessary. To aid that understanding, companies can evaluate the needed system changes with the following questions:

- Are additional reporting requirements necessary?
- Are current systems capable of addressing those changes?
- Does IFRS impact existing data models, consolidated entities, mapping structures and financial statement reporting formats?
- Are systems sufficient enough to enable tax compliance needs?
- Do systems need to support preparation of accounting records under bother IFRS and U.S. or local GAAP prior to the date of conversion? (Deloitte 2)

Because data and systems impact analysis is time consuming, it should happen in the initial planning phases. Additionally, IFRS adoption impacts an organization's IT platforms, specifically upstream systems, general ledger, reporting data warehouse, downstream systems, and infrastructure. Therefore, companies need to determine what changes, if any, are needed during the planning phase to aid in a smoother implementation. Upstream systems include the financial sub-ledgers, financial instrument valuation systems, and interfaces that post financial transactions. The general ledger contains the chart of accounts structure including performance metrics while the reporting data warehouse is responsible for the consolidation and/or allocation tools and engines. The downstream systems include the reporting solutions outside of IFRS regarding compliance and statutory. The infrastructure relates to the support applications. By involving the heads of a company's IT department right at the beginning planning phases will provide the IFRS implementation project team a better understanding of those systems and the affects on a successful implementation.

The extent of the change depends on the size and complexity of the business, strategy for responding to IFRS, characteristics of current infrastructure and capabilities, and the number of applications involved in the collection of data and generation of financial statements. (Deloitte 2) Because the possible changes are numerous, companies need to plan accordingly before implementing IFRS adoption plan. One type of change is new data requirements because of new accounting disclosure and recognition requirements may lead to more detailed information presentation, new data elements or recorded fields, and/or different basis for calculations. A company may find that the existing system is no longer adequate or required for IFRS reporting; therefore, a new system selection and implementation may be necessary. The existing systems may need reconfigurations if they have built-in capabilities for specific IFRS changes such as Enterprise Resource Planning (ERP) systems and high-end general ledger packages. Once the old systems are altered or new systems are implemented, the interfaces and/or mapping tables to the financial system may need changes. Additionally, modifications to existing systems to produce new reports and calculations for IFRS compliance should include spreadsheets and models. The consolidations of the number and type of applicable entities may differ under IFRS; therefore, which financial information is included in the group consolidated financial statements will differ. Changes to the reporting packs that gather additional disclosures and information may be necessary to accommodate additional branches or subsidiaries. The financial reporting tools can either perform consolidation and financial statements or only prepare financial statements. Lastly, changes to chart of accounts related to reclassifications and additional reporting criteria are almost always necessary. (KPMG 35)

IFRS Compliance Requirements and Business Implications

Data availability in source system determines if a company can meet the necessary IFRS compliance requirements. Process may need to be redesigned to accommodate the capture and report of new data. Depending n the magnitude and extent of adjustments necessary, systems scalability and architecture may be affected. Changes to the organization design may be necessary if there are not enough sufficient trained employees to handle the transition. Controls may need to be modified to comply with regulations such as new consolidated entities. Financial reporting as well as income taxes may be impacted. Regulatory risk and reporting regarding capital requirements and risk appetite may be changed. (KPMG 33) The IT conversion effort in terms of time, complexity, and cost may differ for each topic based on company-specific circumstances. Topics may include fixed assets, inventory, share-based payments, consolidation, revenue recognition, business combinations, and leases. (KPMG 36)

European Union Example

All listed companies in the 15 European Union (EU) are required to use IFRS effective January 1, 2005. The initial response of the EU countries to the shift was positive because the requirement expected. However, they remain relatively unprepared for the 2005 adoption date. In a 2003 survey commissioned by PricewaterhouseCoopers (PwC) found that 34 percent of respondents would be adopting IFRS in 2005, but 45 percent respondents indicated that they would be required meet the 2005 deadline. (Song 38) In that same survey, PwC found that 42 percent of respondents had yet to even start IFRS implementation while a large group waits for IASB to issue final standards. The impacts of IFRS adoption in the EU may be useful in exploring the compliance issues related to IT and how it may affect U.S. companies during their transition to IFRS.

The UK already adopted IFRS in 2005. Their financial statements averaged 50% longer. (Dilks) The first year of adoption was treated as a short-term project where companies relied on tactical fixes, parallel systems, and offline spreadsheets that increased the risk of error and was time-consuming to maintain. After the first year, companies are now shifting from the “get it done” mentality to assuring that their systems are flexible enough to capture new information consistently and timely as well as embedding IFRS processes into the organization. The European experience provided the following lessons: effort was often underestimated because of the misconception that IFRS was solely an accounting change issue, projects often lacked a holistic approach with no consideration for collateral effects such as IT, a late start often resulted in escalation of costs, and many did not achieve “business as usual” state for IFRS reporting. (Deloitte 5)

Important take-aways from experience with conversions in Europe and Asia indicates some challenges that are consistently underestimated by companies are consideration of data gaps and consolidation of additional entities. (PwC 30-31) Data gaps occur when the calculation or collection of information was not done under U.S. GAAP, but is required under IFRS. The consolidation of additional entities requires collection or calculation of data not previously considered. Unfortunately, much of the research since the initial adoption has been to examine the quality of accounting information and not very much regarding IT beyond what has already been indicated above.

IFRS Plans and Software

During the initial SOX compliance years, many companies were not prepared for the effects on IT especially regarding section 404, the effectiveness of internal controls over financial reporting. A mistake many companies made was not to include its IT leaders during the planning stages of SOX compliance in order to have the right controls, documentations, and data storage. Years later, companies now have a better understanding of implementing a larger scale of changes to be IFRS compliant if they learn from the mistakes made regarding SOX. The following are examples of different methodologies and software available for companies to utilize. Beyond hiring external consultants for IFRS adoption, software companies are developing IFRS software to ease the transition.

PricewaterhouseCoopers, one of the Big Four accounting firms, suggests a three-stage IFRS conversion methodology that is customizable to the unique needs of each company. (PwC 15) A close examination of how IFRS will change a company’s accounting policies as well as how those changes will affect general business practices. Because this paper focuses on the technological impacts of IFRS, only the following questions regarding operations and infrastructure are relevant:

Can legacy systems, processes, and controls be consolidated?

Need to buy or implement new systems based on a U.S. GAAP world?

Will those systems provide enough information needed under IFRS? (PwC 16)

The answers to these questions can guide companies in their decision-making process regarding the changes organizations need to make for successful IFRS adoption.

Protiviti is a global consulting and internal audit firm that offers help to help companies to converge with IFRS. IFRS implementation requires modification of processes and systems to support the new accounting and reporting requirements; therefore, their approach recommends a solid foundation with support from the top and rigorous project management that involves all affected sectors of the company. Their suggested approach is displayed in Exhibit A describing the following five phases:

I. Foundation Activities

II. Envisaging Desired State

III. Project Implementation with Project Management and Change Management

IV. Embedding Sustainable Infrastructure

V. Ongoing Compliance, Monitoring and Review (Protiviti 1)

The second phase is where initial diagnostic analysis is performed and key accounting policy selection and application decisions are made with consideration to IFRS. Phase three is especially important because that is when the project is actually implemented with regard to policies and procedures, process and workflow, people and capabilities, awareness and training, data, information and reporting, and technology enablement. Because conversion can be significant project, an early start can make a difference.

Because IFRS IT conversion effort differs from company to company and even from industry to industry, some software solutions are aimed at a particular sector. “From January 1, 2008, the Luxembourgish Supervisory Authority ‘Commission de Surveillance du Secteur Financier’ (CSSF) introduced the FINREP and COREP regulations as uniform reporting requirements using a complete XBRL taxonomy for European banks." (FERNBACH 1) In other words, European banks need to comply with IFRS requirements. Mizuno Trust & Banking (Luxembourg) S.A.'s core banking system was based on Luxembourg GAAP and had a limited time frame for implementation as their project began in July 2007 while the regulations take effect the following January. Christophe Coutelet, head of Mizuno Trust & Banking's IT department, decided that FERNBACH's IFRS solution named FlexFinance® IFRS was the only complete solution on the market as other solutions did not provide everything required. (FERNBACH 2) FlexFinance® IFRS uses raw data imported into the software and forms the basis for compiling IFRS-compliant balance sheets and P&L accounts. In addition, the software includes implementation templates that use the experience of other banks to help enable rapid implementation based on proven best practice. The templates cut implementation time and risk in meeting the tight deadlines. Mizuno Trust & Banking is able to file under Luxembourg GAAP as well as be prepared for any further transition into IFRS.

Another software to aid in IFRS compliance for the banking industry is SAP® Accounting for Financial Instruments. SAP's software application was designed specifically to help banks prepare for IFRS compliance that was designed with the help of more than 20 major financial institutions. Companies can prepare local IAS-compliant financial report and create a parallel financial statement based on a central data pool fed by the bank's existing system landscape. (SAP) After IFRS-compliant values are created, the values replace the original results on the financial statement. As a result, companies avoid parallel and redundant data storage.

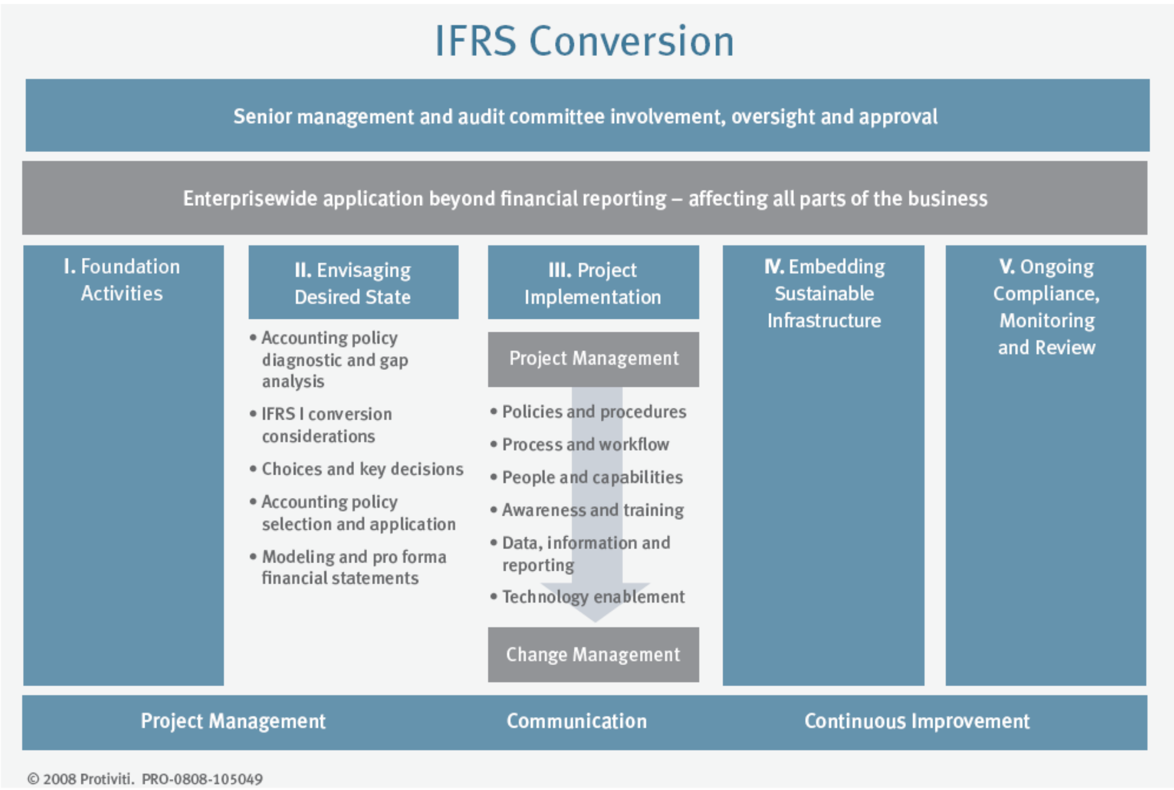
The previous two software applications are tailored specifically to meet the needs of banks; however, other software exists that can be applicable to more industries. CaseWare is a Canadian audit and accounts production software house that has introduced a new model for handling IFRS. CaseWare UK managing director Simon Warren noted that “UK GAPP can be wizard-driven. IFRS is far more opinionated.” (Stokdyk) The reason is because there are so many variables among the large range of industries. The CaseWare IFRS module has a content management engine and an editing toolkit to customize the entity structures and consolidation workflows. With the editing toolkit, companies can more easily create complex schedules or deal with segmental analysis. Additionally, the program has a transaction import system that links the general ledger to smart worksheets.

Companies do not need to use software specifically designed for IFRS compliance. For example, Microsoft Business Solutions Axapta 3.0 is a customizable, scalable, and global ERP solution that can aid companies to focus on IFRS compliance process that Microsoft promoted to help EU companies. Microsoft Business Solutions Axapta 3.0 was subsequently renamed Microsoft Dynamics AX with the newest version being 2009. This software helps secure business data by efficiently providing access control to features and data. Companies operating in global markets can use the built-in multi-site, multi-language, and multi-currency capabilities in 36 countries and 40 languages to meet local tax, regulatory, and market requirements. (Advanced Systems Integration, Inc.) The consolidation of entities where language might use a multi-bit character set like China is made easier with this software. Most importantly, at least for this paper, is that Microsoft Dynamics AX increases regulatory adherence to SOX and IFRS regulations by providing a single integrated information database that updates in real time.

Conclusion

As companies experienced with SOX, compliance impacted IT and information trust, especially regarding internal controls. Similarly, IFRS adoption will affect more than just accounting principals, but what kinds of information companies’ IT systems should gather and if that information is trustworthy within the current IT infrastructure. If U.S. companies allow the IFRS deadline to creep up without preparations, the adoption process will be more costly and time consuming than necessary for IT departments to bridge the gap between U.S. GAAP and IFRS requirements. Fortunately companies can use tools such as software and consultants to formulate an adoption plan based on the experiences and lessons learned from other countries. The key is to plan early and involve all business sectors that may be affected, including the IT department.

Exhibit A



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