CONVERGENCE IFRS AND US

RELEVANT TO ACCA QUALIFICATION PAPER P2

THIS ARTICLE SUMMARISES SOME OF THE KEY CHANGES TO GROUP ACCOUNTING WHICH HAVE BEEN AFFECTED BY THE CONVERGENCE PROCESS, MAINLY THE NEW REQUIREMENTS OF IFRS 3 (REVISED). ADDITIONALLY, THE RELATED TOPIC OF FIRST-TIME ADOPTION OF IFRS HAS ALSO BEEN INCLUDED.

IFRS and US GAAP convergence is a topic which has been periodically examined in Paper P2 exams. It is of continuing importance, both as a potential exam topic and also in a commercial context where companies may be affected by this process.

The topic is worthy of review as there have been developments in recent times, and the Paper P2 syllabus includes current issues with specific reference to convergence between national and international reporting standards. Typically, one of the questions available in Section B of the exam paper has a current issues focus, and will be based on recent developments.

This article also summarises some of the key changes to group accounting which have been affected by the convergence process, mainly the new requirements of IFRS 3 (Revised). Additionally, the related topic of first-time adoption of IFRS has also been included.

BACKGROUND TO CONVERGENCE

In September 2002, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) signed the Norwalk Agreement as the starting point for a project to converge their respective sets of financial reporting standards. Both IASB and FASB stated their commitment to the development of high quality, compatible accounting standards that are suitable for both domestic and cross-border financial reporting. The agreement identified two key objectives:

- to make existing accounting standards compatible as soon as practicable
- to maintain compatibility once convergence had been achieved.

MEMORANDUM OF UNDERSTANDING

In February 2006, the IASB and FASB agreed and published a Memorandum of Understanding (MoU), also called the Roadmap, identifying short-term and long-term convergence projects. This was based on the following three principles:

- Convergence of accounting standards can best be achieved through the development of high quality, common standards over time.
- Trying to eliminate differences between two standards that are in need of significant improvement is not the best use of the FASB's and the IASB's resources. Instead, a new common standard should be developed that improves the financial information reported to investors.
- Serving the needs of investors means that the boards should seek convergence by replacing standards in need of improvement with jointly developed new standards.

Studying Paper P2?
Performance objectives 10 and 11 are linked

BETWEEN GAAP

As a consequence of agreeing the MoU, priorities and milestones were established, including short-term convergence topics which were identified either as high priority for convergence or where convergence could be easily achieved, including the following:

- IAS 23 permitted borrowing costs on the construction of an asset to be either capitalised or written off, whereas US GAAP required such costs to be capitalised. IAS 23 was amended in March 2007 and is now in line with US GAAP; from 1 January 2009, entities have been required to capitalise borrowing costs where specified criteria are met.
- IAS 14 has been superseded by IFRS 8, which deals with segmental reporting. IFRS 8 identifies reportable segments based on a 'managerial approach', which is consistent with the approach adopted under US GAAP, rather than the 'risk and returns' approach adopted by IAS 14.

IFRS AND US GAAP CONVERGENCE IS A TOPIC WHICH HAS BEEN PERIODICALLY EXAMINED IN PAPER P2 EXAMS. IT IS OF CONTINUING IMPORTANCE, AS A POTENTIAL EXAM TOPIC AND IN A COMMERCIAL CONTEXT WHERE COMPANIES MAY BE AFFECTED BY THIS PROCESS.

- IAS 1 was revised in September 2007, with the balance sheet renamed as the 'statement of financial position'. The income statement was renamed as the 'statement of comprehensive income', and now includes items of income and expense that are not recognised in profit or loss but were directly recognised in equity, such as revaluation gains.
- IAS 27 and IFRS 3 were amended in January 2008. The new standards change the calculation of goodwill and also the treatment of piecemeal acquisitions. Along with changes to US GAAP, these amendments bring the accounting treatment for goodwill into line, although some differences still exist, such as the definition of control and fair value. A review is scheduled for 2012, by which date the revised standards would have been applied for two years.

The main changes arising from revision of IAS 27 and IFRS 3 are summarised in **Table 1** on **page 5**.

Given that many of the more recently issued reporting standards eliminate or narrow down the range of permitted accounting treatments, it is possible that, in future, the accounting policy choice for measurement and recognition of goodwill may be narrowed down by:

- requiring entities to adopt a consistent accounting policy for all acquisitions where control is acquired, rather than goodwill accounting policy being decided on an acquisition by acquisition basis, or
- moving towards a single accounting policy of accounting for goodwill at fair value.

Note that where goodwill on acquisition has been accounted for on a gross or fair value basis, and is subsequently found to be impaired, the impairment is allocated between the group and NCI based upon their respective shareholdings in the subsidiary.

ROADMAP 2008

A second Roadmap towards convergence was agreed in November 2008. The objective of this roadmap was to enable companies to file annual financial statements, prepared in accordance with IFRS GAAP, to be accepted by the Securities and Exchange Commission (SEC) in the US. This followed on from an announcement in 2007 that the SEC would no longer require IFRS-compliant financial statements filed with the SEC to also include a reconciliation to US GAAP. Based on the 2008 Roadmap, a small group of companies will begin to prepare their financial statements using IFRS with effect from years starting 15 December 2009 onwards. Companies eligible must be one of the 20 largest in that industry (measured by market capitalisation), and financial reporting by those 20 major companies must have IAS GAAP as the major basis for financial reporting.

This announcement was followed, in January 2009, by an SEC statement that a mandatory two-year dual-reporting period would begin for most companies in 2012, with IFRS only required by 2014. The SEC's decision reflects the increasing acceptance of IFRS as a widely used and high-quality financial reporting language.

A further driver towards convergence in recent months has been the global financial crisis. While there were already proposals to harmonise accounting for financial instruments, this issue has taken on greater significance and priority. Amendments to IAS 39 and IFRS 7 have been approved, and these will become effective during 2009 dealing with derecognition of financial assets and related disclosures.

However, there are still areas where IAS/IFRS differs from US GAAP, and these are summarised in **Table 2** on **page 6**.

There are also a number of longer-term projects to continue the harmonisation process between IFRS/US GAAP, including the following:

- Fair value measurement – the objective is to clarify the definition of fair value and to establish a single source of guidance for fair value measurement.
- Post-employment benefits – IASB and FASB intend to move to a common standard on this topic, but there are currently significant differences between their respective positions.
- Revenue recognition – the objective is to develop a single model for the recognition of revenue which can be applied across industries and geographical regions. This would improve comparability and understanding of financial reporting information.
- Leases – a new standard may result in operating leases being regarded as an asset for the right to use an item, while also recognising the liability to make rental payments. A standard on this topic is not expected until 2011.
- Earnings per share – this has involved both IASB and FASB reviewing proposed amendments to the calculation of diluted earnings per share.
- Conceptual framework – to date, this has focused on the objectives of financial reporting and the qualitative characteristics of financial reporting information.

A FURTHER DRIVER TOWARDS CONVERGENCE IN RECENT MONTHS HAS BEEN THE GLOBAL FINANCIAL CRISIS. WHILE THERE WERE ALREADY PROPOSALS TO HARMONISE ACCOUNTING FOR FINANCIAL INSTRUMENTS, THIS ISSUE HAS TAKEN ON GREATER SIGNIFICANCE AND PRIORITY.

DUE TO THE DRIVE TOWARDS CONVERGENCE OF REPORTING STANDARDS BETWEEN IAS/IFRS AND US GAAP, AND ALSO NATIONAL MOVES TO HARMONISE NATIONAL STANDARDS WITH IAS/IFRS, MANY OF THE HISTORICAL DIFFERENCES HAVE ALREADY BEEN ELIMINATED.

A NATIONAL PERSPECTIVE ON HARMONISATION OF REPORTING STANDARDS

Many national standard setting bodies now have a policy of either convergence or harmonisation with IFRS. The Accounting Standards Board (ASB) in the UK has long held the view that there can be no case for maintaining differences between the principles underlying UK and International Accounting Standards.

Typically, when drafting any new reporting standards for the UK, the ASB will consider any relevant international standards and will incorporate the principal requirements within the approved UK standard. This policy has been mirrored by other national accounting standard setters. In addition, listed companies within the European Union are already required to prepare their annual financial statements in accordance with IFRS.

FIRST-TIME ADOPTION OF IFRS

Due to the drive towards convergence of reporting standards between IAS/IFRS and US GAAP, and also national moves to harmonise national standards with IAS/IFRS, many of the historical differences have already been eliminated. Where differences remain between IAS/IFRS and a particular set of national reporting standards, they are not as significant as they may have been, say, 20 years ago. Consequently, the importance of first-time adoption of IFRS, and the application of IFRS 1, may be perceived to be less important than it has been in the past. However, it is still of importance for several reasons:

- Entities who expect to seek a listing for the first time still need guidance on how the adoption process should be managed, accounted for, and disclosed in the financial statements.
- Entities who have no expectation of seeking a listing may choose to adopt IFRS if they perceive that IFRS is more relevant to their situation.
- Unlisted multinational corporate groups may choose to adopt IAS/IFRS as the basis for financial reporting throughout the group. This may save time and resources in the preparation of management information throughout the group, and streamline group annual financial reporting requirements.
- Entities may believe that adoption of IFRS could assist in their efforts to raise capital; if potential capital providers are familiar with IFRS, it may ease their evaluation of any capital investment opportunity.
- Entities may believe that they are 'doing the right thing' by adopting IFRS as it is already used by other, usually listed and often larger entities.

The above commentary demonstrates the significant progress to date made by the IASB and FASB towards achieve their desired outcome of producing high quality, compatible accounting standards that are suitable for both domestic and cross-border financial reporting. While there is still some way to go, and numerous obstacles to be negotiated, there appears to be a momentum which will ensure that progress continues in the coming years.

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TABLE 1: SUMMARY OF CHANGES ARISING FROM REVISION OF IAS 27 AND IFRS 3

Topic	IFRS 3	IFRS 3 (Revised)
External professional acquisition costs	Part of cost of gaining control and capitalised	Now expensed to income statement
Contingent consideration	Recognised if it was probable that it would be paid: ie in accordance with IAS 37	Fair value of contingent consideration now part of cost of gaining control
Goodwill	Recognise only parent entity share of goodwill in the acquired entity	Choice of accounting policy, which can be made on an aquisition by acquisition basis – either: ¤ parent share of goodwill, or ¤ fair value of goodwill for the entity as a whole (so parent and non-controlling interest share goodwill, expressed as a single figure) Measure and recognise goodwill only at the date control is acquired; derecognise goodwill when control is lost
Non-controlling interests (NCI) (previously minority interest)	NCI based upon their proportionate interest in the net assets of the subsidiary at the reporting date	Depending on the choice of goodwill accounting policy, NCI at the reporting date may be stated at either: ¤ fair value (being fair value at acquisition plus share of post-acquisition transactions/profits or losses less share of goodwill impairment) or ¤ their proportionate interest in the net assets of the subsidiary
Transactions between group and NCI without a change in control	A piecemeal transaction resulted in either an incremental addition to goodwill, or a gain or loss arising on partial disposal	Regarded as a transaction between equity holders; such transactions do not change goodwill, but result in an increase or decrease in the equity of the group
Step acquisitions where control is acquired by more than one transaction	Use the cost of each purchase to identify the cost of gaining control	Re-measure the cost of earlier purchases of shares at date control is acquired; any gain or loss on re-measurement is taken to income and also reflected in the cost of gaining control

A SECOND ROADMAP TOWARDS CONVERGENCE WAS AGREED IN NOVEMBER 2008. THE OBJECTIVE OF THIS ROADMAP WAS TO ENABLE COMPANIES TO FILE ANNUAL FINANCIAL STATEMENTS, PREPARED IN ACCORDANCE WITH IFRS GAAP, TO BE ACCEPTED BY THE SECURITIES AND EXCHANGE COMMISSION (SEC) IN THE US.

TABLE 2: SUMMARY OF DIFFERENCES BETWEEN IFRS/IAS

Topic	IFRS/IAS GAAP	US GAAP
Inventory valuation	LIFO not permitted	LIFO permitted
Development costs	Capitalise when criteria met	Expensed
Non-current assets	Historical cost or valuation	Historical cost
Extraordinary items	Prohibited	Permitted under specific circumstances
Joint ventures	Equity accounting or proportional consolidation	Equity accounting
Fair value	The value at which an asset or liability can be exchanged in an arm's length transaction	Exit or disposal value