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AUDIT SERVICES 2012

Now what? Considering IFRS for U.S. issuers

Implications of the SEC IFRS work plan for private and public companies

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Introduction

Will — and if so, when will — the United States adopt International Financial Reporting Standards (IFRS), the accounting standards used in approximately 125 countries worldwide? Fortunately or unfortunately, the answer is still not definitive, even after the release of the Office of the Chief Accountant of the Securities and Exchange Commission's Final Staff Report on July 13, 2012, *Work Plan for the Consideration of Incorporating International Financial Reporting Standards Into the Financial Reporting System for U.S. Issuers.*[1] Many hoped that the SEC staff's final report would eliminate some of the continued uncertainty regarding the United States' commitment to IFRS as a global accounting standard. While the highly anticipated report is a thorough account of the results of the SEC staff review under its work plan, there is neither a recommendation by the SEC staff to the commission as to whether the United States should move to implement the use of IFRS by domestic issuers, nor a timetable for transition should the commission vote to fully accept it. The lingering question is: Where does this final report leave U.S. public and private companies?

Despite the absence of a recommendation, the SEC staff did seem to tip its hand toward a concept it appears to favor — a long-term "endorsement" approach, with the Financial Accounting Standards Board (FASB) evaluating IFRS on a standard-by-standard basis. Endorsement would involve the United States transitioning to IFRS through a completion of the current joint FASB and IASB projects, followed by gradual FASB evaluation and potential endorsement of IFRS into U.S. GAAP. U.S. GAAP would continue to exist under this scenario, but over time it would come to look like IFRS, and the FASB would still retain its authority to set accounting standards in the United States.

"The report didn't make a decision on next steps, so there really are no concrete action items for public companies, but the SEC staff did show its preference for a longer, more delayed approach to adoption," says Nate Vander Hamm, Grant Thornton's IFRS national practice leader. If the SEC takes a longer, more delayed approach to adoption, they would effectively be rewriting U.S. GAAP, but without formally adopting IFRS. He notes, "There will be ripple effects if U.S. GAAP is adapted to align with IFRS. The financial results companies were expecting under U.S. GAAP may change if U.S. GAAP is adapted to IFRS standards. For instance, the modification of U.S. GAAP would allow a company to continue to comply with a loan covenant requirement to use U.S. GAAP metrics, but then ultimately fail the financial covenant because of a change in the accounting."

[1] Office of the Chief Accountant of the United States Securities and Exchange Commission. "Work Plan for the Consideration of Incorporating International Financial Reporting Standards Into the Financial Reporting System for U.S. Issuers." July 13, 2012. See www.sec.gov/spotlight/globalaccountingstandards/ifrs-work-plan-final-report.pdf.

IFRS in the United States — Why or why not?

The overall case for having common global accounting standards is straightforward — a single set of accounting standards enables easier global comparison of companies in similar industries and analysis of cross-border transactions. It also allows for easier flow of capital globally. A move toward IFRS by the SEC would also put financial reporting on equal footing globally, removing accounting standards from the equation for companies when deciding where to domicile and register or where to raise capital.

Certainly, IFRS is the most commonly used financial reporting standards, which have been adopted by many countries around the world. For instance, Europe transitioned to IFRS in 2005. Canada transitioned as recently as last year. Japan has allowed optional use of IFRS for certain companies since 2010. Most South American countries also adopted IFRS prior to 2011. At this point, most countries have either adopted IFRS, allowed optional use of IFRS or have substantially converged local standards with IFRS. Other countries that are not yet on IFRS, such as India, are still finalizing their adoption approach but have a plan in place.

"Some members of the SEC staff have said that they are not going to recommend a move to IFRS unless it's an improvement on existing U.S. GAAP. While IFRS is widely used, it's not clear enough that it will result in financial information that is of a higher quality than U.S. GAAP," says Scott Ruggiero, partner in Grant Thornton's SEC Regulatory Matters Group. "Most in the United States still perceive U.S. GAAP as being a more developed set of standards than IFRS."

The divide over the use of IFRS in the United States is echoed in a recent Grant Thornton *IFRS Readiness Survey*[2]. When asked whether the United States should move to IFRS, more than four in 10 (43%) respondents said yes, nearly three in 10 (29%) said no, and nearly three in 10 (28%) were unsure.

Do you believe the U.S. should move to IFRS?

Ruggiero notes, "The SEC is in a tough spot. There is the overarching reality of globalization and competitive markets, and everywhere else you look IFRS is being adopted. On paper, it seems easy to make a decision to move over to IFRS, but there does not appear to be a groundswell within the United States of companies and investors eager to move to IFRS due to the general perception that U.S. GAAP is still the best set of standards in the world. Added to that is the tendency of most U.S. stakeholders to focus on the short-term cost of a conversion, rather than the longer-term benefits, particularly in challenging economic times," he says.

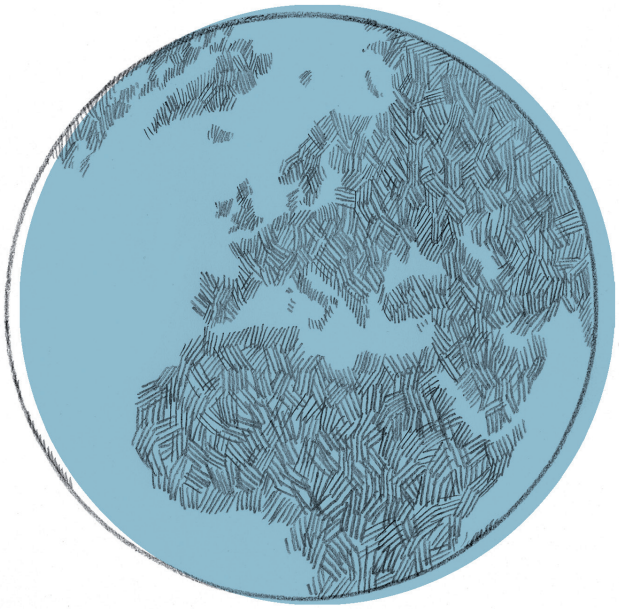
Sheri Fabian, partner in Grant Thornton's IFRS Consulting Group, says, "There is universal support for a single set of high-quality, globally accepted accounting standards. The question is which accounting standards can best serve in that capacity? A growing number believe it to be IFRS."

[2] The *IFRS Readiness Survey* was conducted by Grant Thornton based on data collected between Nov. 28, 2011, and May 3, 2012.

Market forces press the issue

Regardless of the SEC's decision or lack thereof, market forces are driving the need for a single set of global financial accounting standards for publicly accountable entities. "Our SEC clients are investing globally. Frequently, this means buying companies that use IFRS," says Ruggiero. "As such, even if they do not use IFRS for their own financial statements, many public companies are gaining IFRS expertise when they onboard significant acquired businesses that have historically accounted for information using IFRS. In these situations, the acquired company's IFRS financial statements need to be converted to U.S. GAAP for SEC pro forma reporting purposes at acquisition, and if the subsidiary continues to apply IFRS, that conversion would need to happen at each reporting period," Ruggiero explains.

Says Vander Hamm, "IFRS is already here in the United States. It used to be something that only a handful of companies used, generally subsidiaries of foreign companies. Now, IFRS is being used to some extent in almost every company with foreign investments or investors. These include a significant number of SEC registrants, as well as many nonpublic entities. While the SEC staff has been speaking about the concerns of additional costs to convert to IFRS, the fact is that many U.S. companies incur additional costs to maintain two sets of accounting records: one under U.S. GAAP and the other under IFRS."



The exception to the rule: Foreign private issuers

Foreign private issuers are notable exceptions to the SEC's required use of U.S. GAAP. Foreign businesses registered on a U.S. exchange are permitted to apply IFRS as issued by the IASB without reconciliation to U.S. GAAP.

"If you're a foreign private issuer subject to SEC oversight, you have the option to issue IFRS-only financial statements with no explanation as to what your financial reporting would look like in U.S. GAAP. U.S. domestic companies don't have this option," explains Vander Hamm.

"The SEC staff is very vocal about the fact that they have the expertise necessary to understand and comment on the financial information provided by foreign private issuers reporting on U.S. exchanges. Lack of knowledge of IFRS by the SEC staff does not appear to be the issue," notes April Little, Grant Thornton's IFRS Tax practice leader.

While some grumble that offering this option only to foreign filers puts U.S. companies at a disadvantage, Ruggiero notes that there is a distinct reason the SEC's rules are not as restrictive for foreign filers. "The United States wants to be competitive and attract foreign capital to its markets. The rules for foreign filers are written to make it a bit easier for them to enter the U.S. market. Why would you raise capital in the United States if you have to apply U.S. GAAP, in addition to all of the other SEC rules that a U.S. SEC registrant does?"

The report doesn't explore allowing domestic registrants the option to adopt IFRS in lieu of U.S. GAAP. "Many companies want the same option foreign private issuers have," says Fabian. "The SEC is already reviewing the foreign private issuers' filings prepared under IFRS. Allowing optional adoption may resolve some of the SEC's concerns regarding the use of IFRS. It would allow those entities currently required to report in both U.S. GAAP and IFRS to reduce costs of maintaining two sets of accounting records. Also, smaller entities without foreign operations would not be forced to incur the costs to adopt IFRS."

SEC final report highlights: Human capital

The final report highlighted concerns in many areas, including the funding and structure of the IASB, and the sufficient development of IFRS. However, one of the more intriguing themes was whether or not people in the United States have the capacity to handle this change. This impact was considered from the perspective of "all parties involved in the financial reporting process, including investors, preparers, auditors, regulators and educators."

The SEC staff's final report noted that many users of financial statements are already accustomed to IFRS due to the international nature of business and investing. In addition, the report points out that the global accounting firms, due to their client base and international structure, have a greater depth of IFRS resources than accounting firms with a smaller footprint. Some registrants have personnel already familiar with IFRS, and these companies would only require minimal supplementation to transition to IFRS. On the other extreme of the readiness scale are many smaller domestic entities, audit firms and investors that do not have the depth and capacity of expertise in these areas. Smaller companies would almost certainly have to obtain external assistance from international accounting and consulting firms.

A longer, phased-in transition to IFRS using an endorsement approach is noted in the report as one of the possible ways to mitigate these human capital challenges, as it would provide a greater amount of time for personnel to adjust to IFRS. However, clear guidance as to what the changes will be and when they will occur would be necessary for U.S. personnel to prepare accordingly.

"Personnel in the United States could have begun preparing for IFRS years ago, but — understandably — many chose not to due to the lack of direction from the SEC. Companies don't want to spend money to change systems or train their people when they don't know whether those changes will be necessary. Training people now for something they won't use for years can easily become a waste of money," says Fabian.

Reactions to the SEC final report: Frustration, ambivalence and relief

The SEC's final report was greeted with frustration from many and relief from others. The IASB reacted to the report by noting that many of the challenges expressed in the report were challenges that had been faced and overcome by many other jurisdictions, including most of the G-20, or Group of 20, countries. Michel Prada, chairman of the trustees of the IFRS Foundation, expressed regret that the report was not accompanied by a recommended action plan for the SEC, stating: "Given the achievements of the convergence program inspired by repeated calls of the G-20 for global accounting standards, a clear action plan would be welcome." Prada also said: "For the benefit of both U.S. and international stakeholders, the trustees look forward to the SEC resolving the continued uncertainty regarding the U.S.'s commitment to global accounting standards."

Some were not surprised that the SEC staff decided against a clear recommendation to the SEC, noting the competing priorities of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Jumpstart Our Businesses Startup Act, in addition to the uncertainty surrounding the possibility of leadership changes at the commission. "The delay in the final decision will allow the dust to settle a bit at the agency before they have to make this very crucial decision and deal with the aftershocks that will result," notes Ruggiero.

Says Little, "Many companies are frustrated that they don't have the ability right now to move to IFRS in an efficient manner. Meanwhile, other companies, primarily domestic entities, are probably happy that they don't have to do anything yet and appreciate the delay."

Others continue to urge the commission to permit optional adoption, including AICPA President and CEO Barry Melancon: "We applaud the SEC staff for its robust efforts to review IFRS, and we urge the commissioners to consider the staff report with expediency. … We also urge the commissioners to allow U.S. public companies the option to adopt IFRS."

A closer look at endorsement

If the SEC decides to pursue an endorsement approach, there will be some complex issues ahead. "There are two key challenges to the SEC's endorsement approach," explains Charles Blank, Grant Thornton's IFRS Advisory practice leader. "Despite getting closer to the same standards, U.S. GAAP will still not be identical to IFRS, and application of the endorsement approach would likely be a very lengthy process. The converged projects under the Boards' Memorandum of Understanding (MOU) did get to similar answers, yet key differences remain. Under an endorsement approach, we can anticipate an even greater number of differences, such that the end result may not, over time, result in identical standards for IFRS and U.S. GAAP."

The SEC rules, of course, only apply to public companies, but the commission's ultimate decision will also affect nonpublic companies. Currently, nonpublic companies can choose to prepare their financial statements using any set of standards they choose, including IFRS and IFRS for Small and Medium-Sized Entities. The vast majority of private companies continue to report under U.S. GAAP, though, and the commission's actions may lead to significant changes in U.S. GAAP under the endorsement approach as U.S. accounting standards evolve. This is in addition to the many new accounting standards private companies will need to adopt in the near future due to the major convergence projects that are being finalized over the next year.

Timing is another question mark. "The SEC has suggested endorsement would be a five- to seven-year process, but that timing could be optimistic," says Little. "Once the FASB endorses IFRS as U.S. GAAP, then international standards effectively become U.S. GAAP. At that point, one key complexity is addressed: The nearly overwhelming conformity issues between tax code, contract law and other references to U.S. GAAP effectively go away. While that would deal with contractual issues, it doesn't change the fact that the underlying accounting used for IFRS and U.S. GAAP remains different.

"Some aspects of IFRS create synergies for companies' financial reporting and tax compliance, while others can create new and complex differences that did not exist previously," concludes Little.

A great example of the challenges faced with an endorsement approach is accounting for inventory with the use of the last-in, first-out (LIFO) inventory method. LIFO isn't permitted under IFRS, and the IASB currently has no plan to address the matter. In order to converge on matters such as these, the FASB would need to endorse the IFRS language as U.S. GAAP. There isn't obvious middle ground on issues such as LIFO, when one standard accepts a particular practice while another standard prohibits it. If the IFRS language were to replace the U.S. GAAP language, then U.S. companies would have to give up their use of LIFO. This would have further complications beyond book accounting due to the LIFO conformity rule, which requires companies that use LIFO for federal income tax purposes to also use LIFO for financial reporting purposes. Eliminating LIFO, consequently, could result in a substantial tax liability for certain companies.

The potential elimination of LIFO through modification of accounting standards is likely to trigger intense political debate, because if LIFO is eliminated legislatively, that tax revenue can be used to offset the costs of tax reform and other significant legislation. But, if the Treasury Department exercises its authority to modify the LIFO conformity rule, companies may be able to avoid the increased tax liability.

What are U.S. companies doing to prepare?

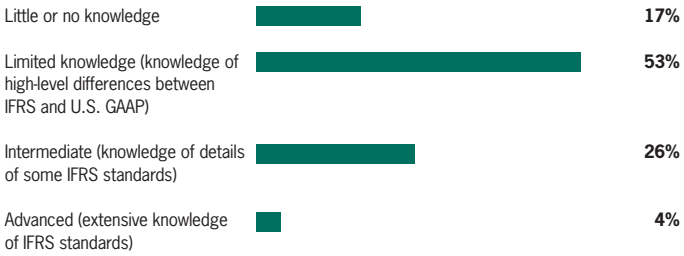
Despite the absence of a clear decision from the commission about IFRS, what are U.S. companies doing to prepare?

"At this point, many U.S. companies are doing little to prepare," explains Blank. "Until the commission indicates its decision and timeline, entities have little motivation to plan for such a significant change, and many have little or no reason to prepare and lack actionable items to accomplish. One of the biggest questions I get from clients is: 'Is there something I should be doing to prepare that will not cause me to waste money?'"

Even if many are not taking action, most do believe IFRS is coming down the pike. According to Grant Thornton's *IFRS Readiness Survey*, nearly three-quarters (72%) say they anticipate that the SEC will require public companies to adopt IFRS, while, at this time, about 70% of survey respondents have either limited or no knowledge of IFRS. In spite of all the anticipation, more than three-quarters (76%) of respondents say their organizations have yet to begin preparation for the use of IFRS.

Do you anticipate the SEC will ultimately require the adoption of IFRS for U.S. public companies?

How would you describe your organization's current knowledge of IFRS?



Has your organization begun to prepare for a conversion to IFRS?

Among those companies that have begun the conversion process, the most frequently cited reason they are beginning to convert is the "anticipation of the SEC permitting or requiring" IFRS by U.S. public registrants (48%). Other motivations include foreign parent company IFRS reporting requirements (14%) or a future significant transaction such as a merger or acquisition (14%).

Should companies be getting ready anyway?

Even in the absence of a formal decision from the SEC, companies need to start thinking about IFRS and what it will mean for them. Given the global nature of business, IFRS is going to be important for a growing number of companies in today's environment. Investors and other stakeholders will demand this type of information to inform their decision-making. For example, investors may ask what the operating results of a potential acquisition might have looked like, or what impacts IFRS will have on key performance indicators. If an SEC registrant acquires a foreign business, the registrant may have to present both the historical financials of the target under IFRS without reconciliation to U.S. GAAP and the foreign target's financial statements in U.S. GAAP for purposes of the required pro forma financial statement presentation in filings with the SEC. Ultimately, market forces may tip the scales toward IFRS before U.S. regulators do.

U.S. companies with international subsidiaries that already present financial information using IFRS, for now, are still required to maintain two sets of accounting records, which can be quite costly. These companies, as well as many others with a stake in the future of financial accounting and reporting, must continue to monitor the SEC's position to determine if and when substantial changes will loom on the U.S. accounting horizon.

Ultimately, market forces may tip the scales toward IFRS before U.S. regulators do.

Actions steps for a logical, cost-efficient readiness plan

Build the organization's knowledge base

Most companies with foreign operations reporting under IFRS generally have a leg up. The dilemma is that, notwithstanding transactions that force their hand, many companies don't want to invest in sending staff to in-depth IFRS training given the lack of certainty surrounding when the skills will be needed and what will be required. Companies can begin to prepare by building some IFRS training into the existing continuing education curriculum, but they also need to strike a balance between the investment and the anticipated results, particularly when training people who may no longer be with the organization or may not retain the skill set by the time IFRS knowledge is needed.

Apply a public-company approach to onboarding a foreign entity

An SEC registrant that acquires a significant business has certain reporting obligations, including a requirement to file historical pre-acquisition financial statements of the target and a pro forma presentation of the most recent annual and interim periods of the registrant and target on a combined basis. If the target company meets the SEC's definition of a foreign business, the historical financial statements of the target may be presented in IFRS as issued by the IASB without a reconciliation to U.S. GAAP, but a conversion to U.S. GAAP is necessary before the target company's financial statements can be combined with U.S. GAAP financial statements of the registrant for the pro forma presentation.

"If you are a nonpublic company acquiring foreign operations that use IFRS, it may be a useful exercise to take a public company approach by answering the question: 'What would our financial statements have looked like had we bought this company at the beginning of the prior year?'" explains Ruggiero. "This additional information can be beneficial in evaluating the target during the due diligence process and allows for greater comparability and understanding of the impact of acquisitions. It has the added benefit of being helpful in building up IFRS expertise within your company, as the accounting staff can use a 'live' example to understand some of the differences between U.S. GAAP and IFRS at a fairly granular level beyond what they are learning in their CPE sessions.

"I wouldn't suggest that for everyone, but if you are a private company concerned about IFRS, taking a public company approach to onboarding new foreign operations may make sense," continues Ruggiero. "There are good business reasons to take this approach too, as supplemental pro forma information would provide the users of the financial information with more meaningful trending data and key performance indicators than they will find in historical U.S. GAAP financial statements alone."

Take a long-term approach when undertaking significant projects and making hiring decisions

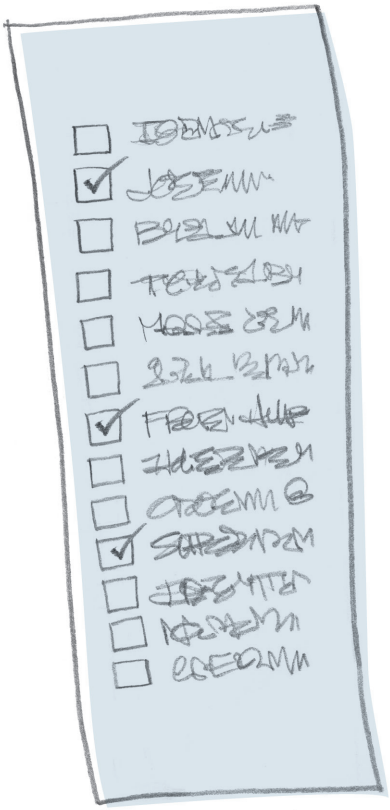
As U.S. companies undertake new projects such as the implementation of a new software system, a little extra effort can go a long way toward ensuring the system is compatible with IFRS. If done right, this will likely be a small, incremental cost now, rather than the significantly larger expenditure required to modify or overhaul a system for IFRS-compatibility later, potentially even in the near term. If companies are changing a key accounting system, they need to consider how and to what extent compatible IFRS information may be available from that same system. For example, will the new system be compatible with IFRS and retain full functionality, or will additional resources be needed to manually reconcile information between accounting systems?

Dynamic organizations should also be forward-looking. For example, when structuring or negotiating long-term contracts, companies should have an understanding of how the contract would be modified if IFRS is used, the impacts of any references specifically to U.S. GAAP and the comparable metrics required under IFRS.

Companies also should take note of IFRS knowledge when making hiring decisions, even if IFRS is not immediately required in the individual's anticipated role. In fact, most college accounting programs and even some high school accounting courses are introducing accounting students to international accounting standards in preparation for the CPA exam, as well as the students' long-term career opportunities. While IFRS skills shouldn't be the sole driver of decision-making, having a handful of professionals with experience in IFRS will generally benefit the organization down the road — often when the need is unexpected.

Conduct a high-level assessment of how IFRS would affect your company

One of the primary concerns with IFRS in the United States is the vast expanse of unknown effects on individual companies — where the challenges will be; how financial results will be impacted; what new technology will be needed; and a host of other open questions. The impact on each company will be different. Most companies will benefit from a high-level assessment of current operations and financial reporting and the requirements of presenting the same information using IFRS. Identifying the gaps gives an organization a bird's-eye view of potential traps, pitfalls, complexities and even — surprise — areas requiring very little investment for a smooth transition. While not a required action item for your company



at the moment, performing a gap assessment will enable the organization to assess the potential obstacles and may affect some of the decisions the organization makes going forward.

"Most companies have heard about issues, such as the requirement to use consistent accounting policies and methods across all subsidiaries, or the requirement to componentize fixed assets. But that understanding can be very superficial," explains Vander Hamm. "Before a company can really assess the potential effects of IFRS, it needs to dig in and get a more concrete understanding of the international standards and the company-specific implications that will apply.

"We work with clients converting to or adopting IFRS who are very surprised to find that certain issues were not ultimately very difficult to work through. On the other hand, areas anticipated to be more basic can result in more challenges than expected. Companies can start to learn about IFRS now and determine if there are major complexities that must be managed down the line," Vander Hamm says.

Looking ahead

There are certainly benefits to taking a patient, thoughtful and meticulous approach to decision-making when planning for IFRS. A very positive note from the SEC's final report is the diligence of the SEC staff in considering the possible impacts of using IFRS on issuers and users of financial statements. Some other jurisdictions have moved forward with adoption approaches that did not always thoroughly consider the morass of complicated issues that can arise.

The SEC staff final report outlines several obstacles to using IFRS that appear, as a whole, to be monumental. However, what is not evident in the report is that many U.S. entities not currently registered with the SEC have already successfully navigated these complexities, without assistance or guidance from the SEC and other standards-setters.

"The challenges are far from insurmountable. Both Europe and Canada had relatively smooth transitions to IFRS," says Fabian. "There are some complexities unique to the U.S. market, but the report portrays some issues as difficult to overcome, when the solutions are relatively straightforward. As the SEC staff points out, many will be addressed through development of a well-thought-out IFRS implementation plan."

For example, the SEC staff noted concerns regarding certain accounting topics that are not currently addressed in IFRS, such as accounting by a company emerging from bankruptcy. However, there are IFRS companies in the United States that have found sufficient, appropriate guidance within the IFRS framework to determine how to properly account for such circumstances.

Similarly, the SEC staff noted the concern over the ability to comply with contractual requirements, such as debt covenants, that are currently structured using U.S. GAAP metrics. Some companies may be required to renegotiate these contractual terms or modify the agreement to allow comparable options in the manner of each metric. Sufficient lead time, allowed to negotiate acceptable comparable measurements, is likely all that is necessary. It may take time, but various private companies that currently utilize IFRS have done it successfully.

In addition, the SEC staff noted concern that allowing optional adoption of IFRS would result in a lack of comparability. An advantage of optional adoption is that it would allow individual companies to make the decision on whether the benefits of a conversion outweigh the business challenges and costs they may face. Optional use of IFRS wouldn't require the SEC staff to resolve all possible complexities that may be faced by companies before a decision to adopt IFRS is made. For optional adopters, resolution would be left to the discretion of each company that chooses to exclusively use IFRS.

"If the SEC staff believes that more clarity on the guidance for certain types of transactions would be beneficial, the United States could develop an 'add-in' guidance approach similar to what has been done in other jurisdictions. The entire body of literature would not need to be re-evaluated in order to satisfy the desires for additional clarity in a small number of instances," says Vander Hamm. "In any event, these open questions can be resolved if the SEC makes a decision one way or the other."

But the SEC's lack of a decision now does not mean that companies, either public or nonpublic, should ignore IFRS. Companies are conducting business globally, acquiring foreign companies and operating in international markets. Even without a timely SEC decision, market forces may push the SEC to at least consider allowing optional use of IFRS. Given this very real global motivation and pressure, companies would be well served to consider a potential action plan to facilitate transitioning to IFRS should the SEC finally require the incorporation of IFRS into U.S. GAAP. More imperative, though, is the need to be prepared for the unanticipated, such as an acquisition by a foreign entity, investment in foreign operations or expansion into the global marketplace, which would necessitate immediate understanding of a company's path toward IFRS.

Contact information

Charles Blank
IFRS Advisory Practice Leader
T 212.542.9725
E charles.blank@us.gt.com

Sheri Fabian
Partner, IFRS Consulting Group
T 732.516.5543
E sheri.fabian@us.gt.com

April Little
IFRS Tax Practice Leader
T 832.476.3730
E april.little@us.gt.com

Scott Ruggiero
Partner, SEC Regulatory
Matters Group
T 202.861.4147
E scott.ruggiero@us.gt.com

Nate Vander Hamm
IFRS National Practice Leader
T 816.412.2427
E nate.vanderhamm@us.gt.com

www.GrantThornton.com

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