Countries worldwide face the prospect of changing the accounting standards on which their public financial statements are based. Europe set the pace by mandating International Financial Reporting Standards (IFRS), as published by the International Accounting Standards Board (IASB), for all public companies beginning in 2005. Under current rules in the United States, public companies with U.S. listings domiciled in other countries often use IFRS. The U.S. Securities and Exchange Commission (SEC) recently changed the rules for foreign filers; currently, it allows foreign companies the choice of whether to use IFRS or U.S. generally accepted accounting principles (U.S. GAAP). However, that choice is not available either to domestic U.S. issuers – which are currently required to use U.S. GAAP – or to companies that observe neither U.S. GAAP nor IFRS, but instead use country-specific GAAP that does not fully conform to IFRS. Therefore, in the United States, two competing principal accounting standards currently coexist, and outside the United States, in the absence of full adoption of IFRS, a multitude of “country GAAP” is still in use. Now that the SEC has obtained feedback on the ramifications of potentially permitting – or requiring – U.S. public companies to report their financial statements in accordance with IFRS, the SEC staff has announced it is working on a “road map” for transitioning U.S. companies to the global rules. The road map will be released later in 2008. Meanwhile, the European Union (EU) took another step toward convergence of international accounting standards by announcing in January 2008 that foreign-based companies doing business in EU countries no longer will have to reconcile their financial statements with EU standards.

There are practical issues surrounding the possible future use of IFRS by U.S. public companies or by entities in other countries using a different version of GAAP not conforming to IFRS. This issue of The Bulletin considers these issues and the ramifications of transitioning from country-specific GAAP to IFRS. Although our principal focus is on the United States, we also comment on other countries because the issues around IFRS apply to them as well.

Convergence is the name of the game

The notion of high-quality financial reporting worldwide is evolving because of continuing globalization of capital markets and increasing cross-border investing and capital flows. A single global financial reporting system is built on the premise of consistent application and interpretation of a single set of high-quality accounting standards established by a single independent standard-setter. In a recent speech, Robert Herz, chairman of the Financial Accounting Standards Board (FASB), stated that there also must be, among other things, common disclosures and management discussion and analysis (MD&A), common high-quality auditing standards and practices, common approaches to regulatory review and enforcement, and common delivery mechanisms, such as Extensible Business Reporting Language (XBRL).

So far, the emphasis by standard-setters has been on developing a global set of accounting standards. Having issued several IFRS statements, with a number of exposure drafts pending, as well as having released a discussion memorandum on fair value measurements, the IASB has an active agenda that covers topics such as revenue recognition, consolidations and special purpose entities, post-retirement benefits, leases and performance reporting. For its part, the FASB recently issued new accounting standards (FAS 141R and FAS 160), which will affect business combinations – and perhaps, even the terms to be used in negotiating merger and acquisition (M&A) deals – and the presentation of minority interests. The IASB has responded, in kind, with amendments to IAS 27 and IFRS 3, in order to make IFRS consistent with these two new U.S. GAAP pronouncements.

To further facilitate convergence, the IASB currently is working with the FASB on income taxes, joint ventures, earnings per share and asset impairments over the near term. The longer-term convergence activities focus on developing a clear road map that emphasizes several major projects, including business combinations, consolidations, fair value measurement, liability and equity distinctions, performance reporting, revenue recognition and leases.
And as if this weren't enough, various projects underlying a conceptual framework stand in the wings. That framework is needed to facilitate the resolution of accounting debates in a consistent manner and achieve a principles-based set of standards.

The message is fourfold. First, the U.S. GAAP model, as we know it today, is very likely to change. Second, there is much work to be done to set the foundation for that change. Third, as the United States embraces IFRS consistent with the European Union, other countries are likely to follow. Fourth, other countries also have some work to do. With this in mind, following are a few observations:

• The SEC’s decision in November 2007 to eliminate the requirement for foreign issuers filing with the Commission to reconcile their financial reports with U.S. GAAP sets a clear tone toward convergence of standards.

• Many believe that IFRS requires improvements before the convergence process can conclude.

• The recent accounting standards issued by the FASB (as noted above) represent a fundamental and significant paradigm shift from historical U.S. GAAP accounting, and are an indicator that the Board is supporting the convergence process.

• Many believe the IASB process requires enhancements to engender investor confidence that the Board is free of undue influence, as most of the funding for the London-based standard-setter comes from voluntary contributions by fewer than 200 international companies and auditing firms. The IASB is now transitioning to a broad-based funding process to provide credibility for IFRS as a single set of global accounting standards.

• With support from the SEC and FASB, convergence in the United States is just a matter of time; however, the timing of it will depend on continued momentum by the SEC and FASB, the results of the 2008 presidential election in the United States and the resulting appointments, and the pace of efforts to prepare IFRS so that it is in acceptable condition for universal adoption. When the SEC publishes its road map later in 2008, it will hammer home the inevitability of a global standard.

• Speculation centers on a potential change in 2011, as other countries fully adopt IFRS. As discussed further in this issue, there are still differences in how IFRS is being applied in practice in other countries, with so-called “as adopted” versions and “national flavors.”

• In a speech delivered in early 2008, SEC Chairman Christopher Cox said the FASB will not be replaced for “many, many years,” adding that the current push aims to converge the U.S. accounting standards with international ones. In a subsequent speech, Chairman Cox noted that the expanded use of a “single, high-quality accounting standard” will eventually empower investors to make better-informed decisions by giving them more comparable information.

The message is that there is developing and widespread momentum in support of a single set of high-quality global standards. That is the best option for investors and analysts worldwide. It also is the best solution for facilitating capital formation on a global basis.

While the odds of the SEC mandating IFRS soon in the United States are low and, in fact, may be several years away, we believe the elimination of the reconciliation requirement is a “test drive” for at least allowing a choice. Now that the SEC is issuing a timetable later this year, the question arises: When will U.S. issuers be given the alternative to select IFRS over U.S. GAAP? Clearly, this is an issue that bears understanding, monitoring and planning. The viewpoints of U.S. public companies on whether such a choice is preferable likely will vary in many ways, such as by industry, business size and capital structure.

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Convergence concerns may lead to an option period

A mandatory requirement for a single set of global standards is not likely to happen until the SEC obtains complete information about costs and benefits. Many believe that the SEC is likely to gather that information through an option period. Also, mandatory adoption is unlikely to occur until after IFRS becomes more “international” when large countries such as Canada, India, Korea and Japan adopt it in 2011. Providing an option to U.S. public companies to report in IFRS would:

• Enhance competitiveness and provide an opportunity to learn from the experiences of companies – likely large multinationals – that choose to adopt IFRS during the period in which the option is permitted

• Enhance efficiency, increase quality and reduce the cost of compliance with dual reporting frameworks

Assuming the SEC’s road map lays out a timetable for mandatory adoption by a targeted date, with an initial option period, companies can expect a reasonable period of time to address people, process, technology and change management issues in advance. However, many have the following concerns:

• The current state of differences between the two sets of standards in the United States is too significant to merit IFRS becoming the single set of global accounting standards because these differences can result in significant changes in reported numbers. If companies are given a choice, a “two-GAAP” system could emerge for U.S. public companies, adding
unwanted complexity to an already complicated reporting system and reducing comparability among companies. In other words, while removing the need for reconciliation of IFRS to U.S. GAAP for foreign filers is the new rule, a reconciliation of one set of standards to another could become a de facto requirement for purposes of providing the analyst community with comparable data (or could become an off-line effort by analysts, with the result potentially being different formats and conclusions due to different approaches to that activity).

- As noted earlier, there are differences in how IFRS is being applied in practice, with “as adopted” versions and “national flavors.” The skepticism over whether a principles-based system will work in the United States has prompted some to wonder whether a “U.S. version” of IFRS will emerge. Thus, with momentum building for convergence, there also is potential that, with the current variant sets of rules, there first will be a need to “put the 'I' in IFRS” or risk a scenario whereby there will be multiple sets, rather than one set, of standards. Multiple sets of standards will not be sustainable.

- The IASB has broader governance, independence and funding issues that remain to be resolved (e.g., how will it be funded, staffed and governed?).

- The pace of IASB and FASB convergence is slow. Permitting U.S. public companies to report in IFRS might even slow down convergence efforts, particularly by the IASB. Although the EU is considering whether to continue to permit U.S.-based public companies to file in Europe using U.S. GAAP, the EU is not considering permitting European companies to file in U.S. or country-specific GAAP.

For all of these reasons, the debate appears to favor an option period in the United States, which would allow more time for companies that don’t yet want to adopt IFRS to take advantage of the learning experience of companies electing to early adopt; it would also allow IFRS to improve and evolve in the eyes of its critics. This approach buys time for companies domiciled outside the United States to evaluate the implications of transitioning to IFRS and make the necessary preparations.

**People ramifications**

Without a doubt, transitioning from U.S. or country-specific GAAP to IFRS would modify dramatically the current competencies, structure and management of a company’s finance and accounting staff. For example, more technical expertise would be needed in key areas where IFRS differs from U.S. GAAP, such as fair value accounting, revenue recognition, segment reporting, cash flows and the rules around certain derivative transactions. Companies must assess the ability of their personnel to adapt and implement this significant change in accounting policies and practices.

The war for talent could present a challenge in recruiting and retention as employers seek to hire the best people – and could pit companies, their external auditors and other third-party service providers against each other competitively in a significant way. The inevitable effects on compensation are not difficult to imagine. Compensation strategy and recruiting methods must support the finance function’s transition to, and sustain compliance with, the more complex and globally accepted accounting practices. Training investments, in terms of time and money, will be significant.

Internal audit functions also will be impacted in similar ways. So, too, will financial planning staff, because preparation of budgets and forecasts is significantly different under IFRS. Human resources functions will need to understand the change, so they can provide the necessary business support around performance management, recruiting, training and career development, and incentive compensation.

**Process ramifications**

From a process viewpoint, there are several important considerations. First, there is the technical accounting assistance needed to convert from U.S. or country-specific GAAP to IFRS, along with related changes to internal financial reporting that supports external reporting. Then there is the question around who manages the process and key controls over financial reporting and evaluates the design effectiveness of the key financial controls with respect to compliance with IFRS. Finally, there are other questions:

- How will IFRS affect the control environment, and who will validate the operating effectiveness of the key financial control activities?
• Going forward, who performs the top-level reviews, manages functional activities and information processing systems, owns the physical controls, tracks performance indicators, and establishes the appropriate segregation of duties?

Overriding all of the above is the need to evaluate the simplification, standardization and automation of the financial reporting process under IFRS, so that the transition is not merely an overlay on established practices. Clearly, fresh thinking is necessary.

What’s the message? Management should identify the key risks and key financial controls, evaluate the design effectiveness of the controls, and make an overall assessment as to whether the existing business infrastructure is sufficient. Management also should question whether or not the company has effectively designed and put into place key financial controls to address risks associated with the financial reporting process under the IFRS framework. To the extent that complying with new financial standards requires new or different supporting information, the determination of which controls are “key” – along with the owners of those controls – will likely have to change during a transition period.

The audit committee plays an important oversight role in this assessment. It should ensure sufficient awareness of IFRS requirements, receive reports on the progress and decisions taken, and provide feedback on issues encountered during implementation. One important area for the committee to watch for is the inappropriate selection of accounting policies and inadequate records and audit trails.

There are other reporting considerations and documentation implications:

• Accounting policies and procedures – The related process and information flows will require modifications. Job descriptions and duties will have to be reframed. Spreadsheets and databases will require updates.

• Documented support – The transition to principles-based standards also will result in the increased exercise of management judgment. Because reasonable people can differ in the application of accounting principles, auditor disagreements are likely to increase, especially as the external audit community learns and becomes comfortable with the “new rules.” The national – or international – offices of the external audit firms may not be staffed or prepared for the consultative processes that would naturally emanate from a more “principles-based” set of standards. Consequently, management’s conclusions in applying IFRS will require careful thought and documentation, and new issues will require sufficient time for deliberation and final conclusions.

• Internal management reporting – Regular monthly management reports, budgeting and forecasting processes, and key performance indicators (KPIs) and metrics all will require review and possible revision. The new reporting also may affect bonus, commission and other incentive plans.

• Contractual agreements – There is also the need to review existing contracts, loan covenants and other legal documents to determine whether a change in the company’s basis of accounting has an impact.

• International location reporting – Statutory reporting requirements will change if IFRS is different from country-specific GAAP and disclosure conventions, necessitating reconciliations to local reporting requirements, if different. Transfer pricing (and other in-country or international tax issues) and consolidation considerations are also factors.

• Transition reporting – Parallel reporting processes and systems are a definite possibility during transition. Management can expect pro forma calculations and presentations, non-GAAP disclosures and supporting reconciliations, as well as a variety of efforts to simplify, standardize and automate the processes affecting financial reporting.

Technology ramifications

There are many issues in the technology space that could arise due to changes in accounting requirements, potentially driving a change in the information technology (IT) staff support needed as well as the investment in hardware and software. For example, systems modifications may be required to define and assess hedge effectiveness in the absence of the availability of the so-called “shortcut” method. A systems update might be necessary to track offsetting amounts between unrelated parties where offsetting is allowed. Issues arising from these and other systems modifications include the adequacy of systems capabilities and controls, the data reliability for new models, and internal and external resources required for execution and testing.

If current applications cannot support the organizational changes required to become IFRS-compliant, companies will need to either (a) look to software vendors to develop updates that would put the organization in compliance with the new standards, or (b) develop software changes internally to become compliant. This conversion process will take time, as software changes will require testing through the system development life cycle before implementation.

Change management issues

We are aware of large public companies dedicating resources to analyze the potential impacts on key reporting areas, such as revenue recognition and income taxes, as well as the effect of a transition to IFRS on KPI metrics. We believe this initial review is important. Change management is one of the most frequently overlooked areas as companies adjust to new requirements in their business environment. Following are a few observations to consider.
As companies follow the regulatory dictates in this space, they need to consider four key elements to properly address change management – organizational structure and accountability, setting the foundation, training and execution, and communication. From an organizational standpoint, someone needs to be accountable for driving the process. Initially, this may entail using a program management office (PMO); however, once the foundation is set and stabilized, it is not uncommon to assign responsibility to a single process owner.

This structure is analogous to what most companies used to successfully implement their Sarbanes-Oxley Section 404 compliance programs. The PMO leadership should lay down the scope, rules and requirements and involve all of the appropriate stakeholders through an effective project, resource and communications plan. That plan should encompass the process and protocols for ongoing updates and improvements.

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During this stage, the PMO communicates the vision, requirements and timelines to stakeholders and outlines the expectations for various roles. Checkpoints and performance metrics are set and measured to ensure expectations are met. There also are initial and ongoing components of infrastructure to consider at this stage. In addition, periodic communications are needed to exchange status updates and insights between the transition process owner and stakeholders.

An effective communications plan explains why change is needed, describes what is changing, outlines the new skills and behaviors required to facilitate the change, articulates the specific steps for making the change happen, engages the audience and alters attitudes by creating a desire to support and participate in the change process, and provides continual reinforcement to sustain the change. Effective communication underpins the entire change management process.

Pay attention to planning and cost considerations

When planning the project, companies are advised to apply the lessons of Sarbanes-Oxley Section 404 adopters. For example, the appropriate training, head count and external resources need to be considered. Consideration also must be given to the appropriate design of processes and system enhancements, along with the need for enterprise resource planning (ERP) and financial systems modifications and/or upgrades. The transition to IFRS will require strong, focused project management discipline.

Companies having a majority of their operations in countries requiring IFRS and/or whose principal competitors are using it might decide the benefits exceed the costs.

Initially, the Section 404 compliance projects did not draw sufficient management attention and resources. There was a general lack of planning, understaffing and overwork. Activities were largely ad hoc and chaotic. Many companies were caught flat-footed because they waited too long to begin. As a result, estimates to complete these projects were grossly understated. Overall, there was a lack of appreciation by senior management and the board of directors for the initial effort.

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Summary – Take the first steps

Much of the world has declared that IFRS is the standard of choice and has either adopted it or committed to transition to it. Now, all heads are turned to the United States. With the SEC setting the proverbial “northbound train” of convergence squarely on the rails and starting it rolling toward its inevitable destination, management of U.S. companies are well-advised to begin understanding and assessing now the impact of a change from U.S. GAAP to IFRS. Amid the uncertainty as to timing, one thing is clear: Companies, both large and small, are going to need sufficient time to prepare for the transition. For example, large companies with diverse operations may need as long as two years.

The IFRS momentum appears irreversible. Management of companies domiciled in and outside the United States should consider the implications of a transition to IFRS. The first step is for management to develop a point of view around the perceived benefits and costs of implementing IFRS, if given the choice to adopt it. For example, companies having a majority of their operations in countries requiring IFRS and/or whose principal competitors are using it might decide the benefits exceed the costs. If companies conclude that the benefits outweigh the costs, then – so they can begin planning for implementation – they should understand the impact of the change on their people, processes and technology.
Key Questions to Ask

Key questions for board members:
• Are you taking steps to educate appropriate members of the board (e.g., the audit committee and perhaps the finance committee) on the principal differences between U.S. GAAP and IFRS and the implications to internal and external financial reports?
• Have you asked for and reviewed management’s assessments of the perceived benefits and costs of IFRS convergence to the company, as well as the potential impacts on people, processes and technology?
• Have you asked management for its assessment of the change management issues associated with the transition to IFRS to gauge the extent of the company’s readiness for whatever transpires over the next 18 to 24 months? For example, has management considered, among other things:
  – The impact on key reporting areas, such as revenue recognition?
  – Changes required in reporting methodologies and systems and data?
  – The impact on internal management reporting, including key performance measures and metrics, and the related effects on the incentive compensation structure?
  – The impact on contractual agreements, loan covenants and other legal documents with provisions tied to financial performance?
  – Changes required in the finance function organization?
  – Organization of a PMO structure to drive the change process?
  – Development of an effective communications plan?

Key questions for management:
• Have you developed a point of view around the perceived benefits and costs of implementing IFRS, if given the choice to adopt it? Have you immersed yourself into the details as they relate to your company and its industry? Have you discussed your point of view with the audit committee?
• Have you evaluated the impact of a change to IFRS on people, processes and technology, and the program that should be put in place to manage and control the change process? For example:
  – Have you evaluated the change readiness and resiliency of your financial staff to take on the change?
  – Have you thought about the PMO leadership structure that would plan, organize and manage the transition process?
  – Have you considered the implications of the transition around accounting policies and procedures, documented support, internal management reporting, contractual agreements, international location reporting and transition reporting?
  – Have you considered the potential systems changes that may be needed to provide the required information and make the calculations necessary to prepare financial reports in accordance with IFRS?

Need help evaluating what transitioning to IFRS means to your organization? Whether you are identifying resource needs, assessing system capabilities or considering the impact on your internal control structure, Protiviti can help. In our work with clients all over the world on internal controls, we have developed solutions to assist companies in managing change. Call 1-888-556-7420 to speak with one of our Managing Directors about the change management and internal controls ramifications of this transition, or to learn more about the information discussed in this issue of The Bulletin.