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U.S. & International accounting : understanding the differences

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Introduction[1]

Get Ready for IFRS

The growing acceptance of International Financial Reporting Standards (IFRS) as a basis for U.S. financial reporting represents a fundamental change for the U.S. accounting profession. The number of countries that require or allow the use of IFRS for the preparation of financial statements by publicly held companies has continued to increase. In the United States, the Securities and Exchange Commission (SEC) is taking steps to determine whether to incorporate IFRS into the financial reporting system for U.S. issuers and, if so, when and how.

Worldwide Momentum

The international standard-setting process began several decades ago as an effort by industrialized nations to create standards that could be used by developing and smaller nations unable to establish their own accounting standards. But as the business world became more global, regulators, investors, large companies and auditing firms began to realize the importance of having common standards in all areas of the financial reporting chain.

In a survey conducted in late 2007 by the International Federation of Accountants (IFAC), a large majority of accounting leaders from around the world agreed that a single set of international standards is important for economic growth. Of the 143 leaders from 91 countries who responded, 90 percent reported that a single set of international financial reporting standards was "very important" or "important" for economic growth in their countries.

Currently, more than 120 nations and reporting jurisdictions permit or require IFRS for domestic listed companies. The European Union (EU) requires companies incorporated in its member states whose securities are listed on an EU-regulated stock exchange to prepare their consolidated financial statements in accordance with IFRS.[2] Australia, New Zealand and Israel have essentially adopted IFRS as their national standards.[3] Brazil started using IFRS in 2010. Canada adopted IFRS, in full, on Jan. 1, 2011. Mexico will require adoption of IFRS for all listed entities starting in 2012. Japan is working to achieve convergence of IFRS and began permitting certain qualifying domestic companies to apply IFRS for fiscal years beginning April 1, 2010. A decision regarding the mandatory use of IFRS in Japan is to be made around 2012. Hong Kong has adopted national standards that are equivalent to IFRS and China is converging its accounting standards with IFRS. Other countries have plans to adopt IFRS or converge their national standards with IFRS.

In addition to the support received from certain U.S.-based entities, financial and economic leaders from various organizations have announced their support for global accounting standards.

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[1] Source: AICPA. See http://www.ifrs.com/pdf/IFRSUpdate_V8.pdf.

[2] The European Union (EU) has adopted virtually all International Financial Reporting Standards (IFRSs), though there is a time lag in adopting several recent IFRSs. In the EU, the audit report and basis of presentation note refer to compliance with "IFRSs as adopted by the EU."

[3] Israel requires IFRS for all companies, except banks and companies dually listed in the U.S. and Israel. Dually listed companies have the option to use IFRS or U.S. GAAP. Australia and New Zealand have adopted national standards that they describe as IFRS-equivalents.

Leaders of the Group of 20 (G20) called for global accounting standards and urged the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) to complete their convergence projects in 2011. A summary of the IASB and FASB's efforts regarding convergence is subsequently described.

SEC Leadership in International Effort

The Securities and Exchange Commission has for many years been a strong leader in international efforts to develop a core set of accounting standards that could serve as a framework for financial reporting in cross-border offerings. It has repeatedly made the case that issuers wishing to raise capital in more than one country are faced with the increased compliance costs and inefficiencies of preparing multiple sets of financial statements to comply with different jurisdictional accounting requirements. In 2000, the International Organization of Securities Commissions (IOSCO), in which the SEC plays a leading role, recommended that its members allow multinational issuers to use 30 "core" standards issued by the IASB's predecessor body in cross-border offerings and listings.

A few years later, the SEC announced its support of a Memorandum of Understanding — the Norwalk Agreement — between the FASB and the IASB. This agreement, concluded in Norwalk, CT, established a joint commitment to develop compatible accounting standards that could be used for both domestic and cross-border financial reporting. In a subsequent Memorandum of Understanding in September 2008, the FASB and the IASB agreed that a common set of high-quality, global standards remained their long-term strategic priority and established a plan to align the financial reporting of U.S. issuers under U.S. generally accepted accounting principles (GAAP) with that of companies using IFRS.

In 2007, the SEC unanimously voted to allow foreign private issuers to file financial statements prepared in accordance with IFRS as issued by the IASB without reconciliation to U.S. GAAP. Of even greater importance was the SEC's Concept Release seeking input on allowing U.S. public companies to use IFRS when preparing financial statements. In November 2008, the SEC issued a proposed roadmap that included seven milestones for continuing U.S. progress toward acceptance of IFRS. The roadmap generated significant interest and thoughtful comments from investors, issuers, accounting firms, regulators and others regarding factors the SEC should consider.

On Feb. 24, 2010, the SEC issued Release Nos. 33-9109 and 34-61578, Commission Statement in Support of Convergence and Global Accounting Standards, in which the SEC stated its continued belief that a single set of high-quality globally accepted accounting standards would benefit U.S. investors and expressed encouragement for the continued convergence of U.S. GAAP and IFRS. The releases also called for the development and execution of a "work plan" to enhance both the understanding of the SEC's purpose and public transparency in regard to IFRS. The work plan addresses many of the areas of concern highlighted in the comment letters to the 2008 roadmap.

The SEC Work Plan

The work plan includes consideration of IFRS, both as they currently exist and after the completion of the various convergence projects under way by the FASB and the IASB. Among other things, the work plan addresses some of the comments and concerns received in response to the SEC's proposed roadmap issued in November 2008, including the following:

- Determining whether IFRS is **sufficiently developed and consistent** in application for use as the single set of accounting standards in the U.S. reporting system
- Ensuring that accounting standards are set by an **independent standard setter** and for the benefit of investors
- **Investor** understanding and **education** regarding IFRS and how it differs from U.S. GAAP
- Understanding whether **U.S. laws or regulations**, outside of the securities laws and regulatory reporting, would be affected by a change in accounting standards
- **Understanding the impact on companies** both large and small, including changes to accounting systems, changes to contractual arrangements, corporate governance considerations and litigation contingencies
- Human capital readiness—determining whether the people who prepare and audit financial statements are sufficiently prepared, through education and experience, to convert to IFRS

On Oct. 29, 2010, the SEC released a progress report on its IFRS Work Plan. The report provided details on progress and remaining research and analysis to be done as the SEC considers whether to incorporate IFRS into the U.S. financial reporting system for U.S. issuers.

In 2011, assuming completion of the convergence projects and the SEC staff's work plan, the SEC will decide whether to incorporate IFRS into the U.S. financial reporting system for U.S. issuers, and if so, when and how. If the SEC determines to incorporate IFRS into the U.S. financial reporting system, the SEC believes the first time U.S. entities would be required to report under such a system would be no earlier than 2015. This timeline will be further evaluated as part of the work plan. The work plan is included as an appendix at the end of the SEC's release, which is located on the SEC's website at the following address: sec.gov/rules/other/2010/33-9109.pdf.

Additional information, including the SEC's progress report, can be found at the following address: sec.gov/spotlight/globalaccountingstandards.shtml.

FASB and IASB Convergence Efforts

The FASB and the IASB have been working together toward convergence since 2002. The two boards have described what convergence means and their tactics to achieve it in two documents — the Norwalk Agreement issued in 2002 and the Memorandum of Understanding (MoU), originally issued in 2006 and updated in 2008. The MoU originally highlighted several major convergence projects between IASB and FASB scheduled for completion in 2011. In response to the requests from the leaders of the G20, the IASB and FASB published a progress report, describing an intensification of their work program, including monthly joint board meetings and quarterly progress updates on these convergence projects.

On Nov. 29, 2010, FASB and IASB issued a convergence progress report. In the report, the standard setters reaffirmed their priority projects for completion by June 30, 2011, or earlier. Joint priority projects include financial instruments, revenue recognition, leases, presentation of other comprehensive income and fair value measurement. For the IASB, projects scheduled for completion by the end of June 2011 include improved disclosures about derecognized assets and other off-balance sheet risks, consolidations and its project on insurance contracts.

The boards decided to defer until after June 2011 substantive deliberations on four projects including the broader financial statement presentation project, financial instruments with characteristics of equity, emissions trading schemes and the reporting entity phase of the conceptual framework. The boards also agreed that consolidation of investment companies is no longer a priority for June 2011.

The FASB and IASB also deferred deliberations on several of their independent standard-setting projects (such as contingency disclosures for the FASB and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and annual improvements for the IASB).

Of the remaining original projects in the 2006 MoU, Business Combinations has been completed. Intangible Assets has been removed from the active agendas of both boards and Post-Employment Benefits was removed from the list of priority MoU projects in October 2009.

Two Sides of the Story

Growing interest in the global acceptance of a single set of robust accounting standards comes from all participants in the capital markets. Many multinational companies and national regulators and users support it because they believe that the use of common standards in the preparation of public company financial statements will make it easier to compare the financial results of reporting entities from different countries. They believe it will help investors understand opportunities better. Large public companies with subsidiaries in multiple jurisdictions would be able to use one accounting language company-wide and present their financial statements in the same language as their competitors.

Another benefit some believe is that in a truly global economy, financial professionals, including CPAs, will be more mobile, and companies will more easily be able to respond to the human capital needs of their subsidiaries around the world. Recent SEC actions and global trends have increased awareness of the need to address possible adoption.

Differences Remain Between U.S. GAAP and IFRS

Great strides have been made by the FASB and the IASB to converge the content of IFRS and U.S. GAAP. The goal is that by the time the SEC allows or mandates the use of IFRS for U.S. publicly traded companies, many key differences will have been resolved.

Because of these ongoing convergence projects, the extent of the specific differences between IFRS and U.S. GAAP is shrinking. Yet significant differences do remain. For example:

- IFRS does not permit Last In First Out (LIFO) as an inventory costing method.
- IFRS allows the revaluation of assets in certain circumstances.

- IFRS uses a single-step method for impairment write-downs rather than the two-step method used in U.S. GAAP, making write-downs more likely.

- IFRS requires capitalization of development costs, when certain criteria are met.

Perhaps the greatest difference between IFRS and U.S. GAAP is that IFRS provides less overall detail and industry-specific guidance.

What CPAs Need To Know

The increasing acceptance of IFRS, both in the U.S. and around the world, means that now is the time to become knowledgeable about these changes. Most CPAs will somehow be affected. Once a critical mass of non-U.S. companies in a certain industry sector begins to report their financial results using IFRS, there will likely be pressure for U.S. issuers to do the same, to allow investors to better compare their financial results. But this issue will have an impact far beyond just financial reports. It will affect almost every aspect of a U.S. company's operations, everything from its information technology systems, to its tax reporting requirements, to the way it tracks stock-based compensation.

For the CPA profession, the use of IFRS by U.S. publicly held companies will create the need for effective training and education. Companies will use IFRS only if they and their auditors have been thoroughly trained, and if their investors and other users of their financial statements — such as analysts and rating agencies — understand IFRS as well. At the moment, most accountants in the United States are trained in U.S. GAAP, not IFRS. Most specialists, such as actuaries and valuation experts, who are engaged by management to assist in measuring certain assets and liabilities, also are not experienced with IFRS. Consequently, all parties will need to undertake comprehensive training. Professional associations and industry groups will need to integrate IFRS into their training materials, publications, testing and certification programs. Colleges and universities are including IFRS in their curricula. In addition, the Uniform CPA Exam now contains questions related to IFRS.

The bottom line is that CPAs need to begin to prepare for the day in the not-so-distant future when the SEC could designate a date for voluntary, or even mandatory, adoption of IFRS by all U.S. public companies.

Timeline for IFRS Acceptance in the United States

2001: The International Accounting Standards Board (IASB) is established as the successor organization to the International Accounting Standards Committee (IASC), formed in 1973. The IASB's mandate is to develop International Financial Reporting Standards (IFRS).

2002: The IASB and the Financial Accounting Standards Board (FASB) issue the Norwalk Agreement, acknowledging the joint commitment to developing high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. Also, the European Union (EU) announces that its member states will require IFRS in the preparation of consolidated financial statements of listed companies beginning in 2005.

2005: The chief accountant of the Securities and Exchange Commission (SEC) releases a roadmap allowing IFRS filings without U.S. GAAP reconciliation for foreign firms by 2009, or earlier.

2006: The IASB and the FASB agree to work on a number of major projects.

2007: The SEC announces that it will accept from foreign filers in the U.S. financial statements prepared in accordance with IFRS, as issued by the IASB, without reconciliation to U.S. GAAP. Also, the SEC issues a Concept Release asking if U.S. public companies should be given an option to follow IFRS instead of U.S. GAAP.

2008: The SEC issues a proposed roadmap that includes milestones for continuing U.S. progress toward acceptance of IFRS. The roadmap also would allow early adoption of IFRS for U.S. public companies that meet certain criteria. The AICPA's governing Council votes to recognize the IASB as an international accounting standard setter under rules 202 and 203 of the Code of Professional Conduct, thereby giving U.S. private companies and not-for-profit organizations the choice to follow IFRS. Also, the FASB and the IASB issue an updated Memorandum of Understanding that focuses the energies of both boards toward convergence of important accounting standards, such as revenue recognition, leases and consolidation.

2009: The IASB ended its moratorium, set in 2005, on the required application of new accounting standards and major amendments to existing standards. The board had frozen its rules while more countries adopted IFRS. Japan introduces a roadmap that could lead to a decision in 2012 to adopt IFRS, with proposed adoption dates in 2015 or 2016.

2010: The SEC releases a staff Work Plan to evaluate the effect that using IFRS would have on the U.S. financial reporting system. The SEC notes 2015 is currently the most likely first adoption year. Japan allows certain qualifying domestic companies the option to use IFRS for fiscal years ending on or after March 31, 2010.

2011: Canadian and Indian companies begin using the global standards, and Japan is slated to have eliminated all major differences between Japanese GAAP and IFRS. SEC to evaluate feasibility of requiring use of IFRS based on completion of the outstanding MoU items and on results of the 2010 staff Work Plan. In the United States, questions concerning IFRS are included in the Uniform CPA Exam.

2012: Mexico scheduled to adopt IFRS for all listed entities.

2015: Earliest year the SEC would allow public companies to convert their financials to IFRS.

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Chapter 4: Property, Plant & Equipment, and Investment Property

Chapter 5: Leases, Intangibles, and Asset Impairment

Chapter 1

Introduction to International Accounting

Chapter Objectives

- Understand why accounting rules differ across countries.
- Identify the factors that cause accounting rules to differ across countries.
- Describe the structure and operation of the International Accounting Standards Board (IASB) and its predecessor body, the International Accounting Standards Committee (IASC).
- Be aware of the change in global attitudes toward international accounting standards.
- Recognize and differentiate cosmetic from substantive differences between U.S. GAAP and International Financial Reporting Standards (IFRS).

Introduction

This text is intended to provide an overview of differences between accounting rules promulgated in the United States (U.S. GAAP) and international accounting rules established by the International Accounting Standards Board (IASB). These international rules consist primarily of International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS).

The definition of IFRS has both a narrow and broad meaning. Narrowly, IFRSs refers to the new numbered series of pronouncements that the IASB is issuing, as distinct from the IASs series issued by the IASC, the predecessor to the IASB. More broadly, IFRSs refers to the entire body of IASB pronouncements, including standards and interpretations approved by the IASB and IASs and Standing Interpretations Committee (SIC) interpretations approved by the IASC.

As we will see, there are many areas of difference between U.S. GAAP and IFRS. However, the similarities are greater than the differences.

We approach the issue from the perspective of how IFRS differ from U.S. GAAP. We do not significantly address the areas of agreement. This text will be helpful, for example, to a U.S. controller who needs to begin to understand how to prepare financial statements in accordance with IFRS. We also assume that the reader is generally familiar with U.S. GAAP.

Cross-Country Accounting Differences

Accounting rules differ across countries and these differences may be cosmetic or substantive.

An example of a cosmetic difference is the presentation of the balance sheet in many countries that are, or were, members of the British Commonwealth. The balance sheet of a UK company is often presented (1) in reverse order of liquidity and (2) in the form A – L = OE rather than A = L + OE.

Exhibit 1-1 is the 2001 Balance Sheet of GlaxoSmithKline, prepared in accordance with UK GAAP and UK presentation conventions.[4] It starts with goodwill and other fixed assets, then lists current assets and liabilities, which are combined to get net current assets, then subtracts other liabilities, and finally totals to net assets of £8,379 million. The equity section is then provided, which reconciles to the net asset figure.

Exhibit 1-1

Consolidated Balance Sheet

	Notes	2001 £m	2000 £m
Goodwill	15	**174**	170
Intangible Assets	16	**1,673**	966
Tangible Assets	17	**6,845**	6,642
Investments	18	**3,228**	2,544
Fixed Assets		**11,920**	10,322
Equity investments	19	**185**	171
Stocks	20	**2,090**	2,277
Debtors	21	**5,591**	5,399
Liquid investments	25	**1,415**	2,138
Cash at bank	25	**716**	1,283
Current assets		**9,997**	11,268
Loans and overdrafts	25	**(2,124)**	(2,281)
Other creditors	22	**(7,306)**	(6,803)
Creditors: amounts due within one year		**(9,430)**	(9,084)
Net current assets		**567**	2,184
Total assets less current liabilities		**12,487**	12,506
Loans	25	**(2,108)**	(1,751)
Other creditors	22	**(190)**	(143)
Creditors: amounts due after one year		**(2,298)**	(1,894)
Provisions for liabilities and charges	23	**(1,810)**	(1,657)
Net assets		**8,379**	8,955
Called up share capital	27	**1,543**	1,556
Share premium account	27	**170**	30
Other reserves	29	**1,866**	1,849
Profit and loss account	29	**3,938**	4,276
Equity shareholders' funds		**7,517**	7,711
Non-equity minority interest	28	**621**	1,039

[4] Note: Recent GlaxoSmithKline financials are available for public review on their website at http://www.gsk.com/investors/annual-reports.htm. We have retained their 2001 financials as an example due to a merger that occurred that year, which provides for an interesting disclosure discussed below.

Equity minority interests	**241**	205
Capital employed	**8,379**	8,955

Approved by the Board
Sir Richard Sykes, Chairman
12th March 2002

The GlaxoSmithKline statement also provides an example of a substantive difference. In 2000, Glaxo Wellcome plc and SmithKline Beecham plc merged to form GlaxoSmithKline. At the time in accordance with UK GAAP, the combination was accounted for, in effect, as a pooling of interests, so assets and liabilities are shown at historical amounts. However, U.S. GAAP required the transaction to be accounted for as a purchase. Thus, for U.S. purposes, assets and liabilities were restated to FMV and goodwill was recorded. The differences on the balance sheet and income statement between UK and U.S. GAAP were substantive as shown in the following excerpt from the GlaxoSmithKline 2001 Annual Report, Exhibit 1-2.

Exhibit 1-2

GlaxoSmithKline 2001 (amounts in millions of British Pounds)

	UK GAAP	U.S. GAAP
Balance Sheet Items:		
Total Assets	£21,917	£61,496
Net Assets	£8,379	£40,969
Income Statement Items:		
Sales	£20,489	£20,489
Operating Profit	£6,090	£590
Net Income (Loss)	£4,391	£(143)

Source: GlaxoSmithKline 2001 Annual Report, page 63.

In comparison to many countries around the world, the differences between U.S. and UK accounting are considered to be minimal, but at the time and in this instance, such was not the case. The two versions of GAAP resulted in an almost £40 billion difference in total assets and an income statement that changes from a substantive profit under UK rules to a small loss under U.S. rules. Although IFRS now require all business combinations within its scope to be accounted for by applying the purchase method, this example illustrates how financial statements can be radically different depending on accounting rules that may differ from jurisdiction to jurisdiction.

Why Accounting Rules Differ Internationally

An obvious question is why do accounting rules vary across countries? The short answer is that rules are established by governments and/or accounting bodies that have jurisdiction only within the borders of their respective country. Accounting literature suggests that rules differ because the people or institutions that set the accounting rules in a specific country have different experiences that influence and affect their outlook on business and accounting. Thus, they are likely to create accounting rules that are appropriate for their jurisdiction, but that may not be appropriate for somewhere else.

Some of the factors that affect accounting standards include the following:

- *Sources of capital*—In the U.S., shareholders provide the majority of capital to businesses. These shareholders often own relatively small ownership stakes and are not involved with company operations. As a result, U.S. GAAP is oriented towards full disclosure and relative transparency. In some countries, Germany for example, the predominant providers of capital are banks. Often the banks own large blocks of stock and hold seats on the board of directors. Transparency and disclosure are not as extensive in such countries because the capital providers are more likely to be privy to operational details.

- *Inflation*—When inflation is very high, financial statements begin to lose their comparability from period-to-period. Countries that have experienced very high levels of inflation, such as Mexico or Brazil, often promulgate rules designed to increase comparability by use of inflation indices or similar mechanisms to adjust prior year amounts to a level equal to current year amounts.

- *Taxation*—In countries such as France or Germany, accounting reports for individual companies are the basis for determining tax liabilities. Accounting rules in these countries are much more detailed and are often driven by tax policy. In countries such as the U.S., tax rules and accounting rules can be, and often are, different.

- *Culture*—Culture is what makes us "us." It is the mental programming that determines who we are, what we believe, how we view right and wrong, and what behavior is acceptable and unacceptable. It is unconscious and not noticed, but it shapes how we act and interact on a daily basis. Since culture gets to the core of beliefs, it will affect the nature and content of accounting rules.

- *Legal system*—In most countries, the legal system is based on either a code or common law foundation. Generally speaking, code countries, such as France and Germany, have accounting regulations that tend to be detailed and comprehensive. In common law countries, such as the UK and the U.S., accounting rules are often less detailed and require companies and accountants to exercise higher levels of professional judgment.[5]

- *Accidents of History*—War, conquest, and colonialism can create or change accounting rules in a country as a result of a change in allegiance. For example, countries that are or were part of the British Commonwealth often have accounting rules that are very similar to the UK. Similarly, former French colonies follow the French model.

- *Business complexity*—Countries with complex business entities are more likely to have complex accounting rules. In addition, complex entities are more likely to participate in cross-border trade and capital seeking.

All these forces can, and do, create accounting differences across countries that can be substantial and that can hinder both trade and capital movement. Some material differences include the following:

[5] In the U.S., the influence of this factor was greater prior to formation of the FASB.

- *Tax-based accounting*—In some countries, the tax treatment of a transaction must also be used for financial accounting purposes. Thus, accounting treatment is not driven by a comprehensive body of accounting theory, but by tax revenue considerations.
- *Asset revaluations*—It is permissible in some jurisdictions to revalue assets to fair value on a periodic basis. For entities owning appreciated assets (real estate ownership in particular), revaluation amounts can be significant. Comparability is reduced when comparing the assets and equity of a revalued balance sheet versus one prepared on the basis of historical cost.
- *Form over substance*—In the U.S. and many other countries, the substance of a transaction, not the form, controls the accounting treatment. An example is the accounting treatment of a leased asset—it does not matter what the transaction is called, the rights, responsibilities, risks, and rewards of the parties will control the accounting result. Some countries, however, account for transactions with reference to the form of the transaction—if the parties call the transaction a lease, it will be accounted for as a lease, and the asset and liability will appear on the books of the lessor.

The Demand for International Accounting Standards

Prior to the 1970s, cross-country accounting differences mattered little because most business transactions and business investment stayed within the borders of a country or region. Further, companies did not prepare financial statements in multiple accounting jurisdictions. Since that time, however, various international forces have increased the need to have similar standards around the globe.

One force for uniform standards has been the rise of multinational corporations. These entities engage in millions of transactions in dozens of countries. Multiple accounting rules increase the cost and time associated with the granting of credit and other business decisions.

Another related factor has been the growth of global capital markets. Equity and debt financing is as likely to come from an international source as from a domestic one. If equity or debt providers need to convert financial information from one standard to another one, costs will rise and capital flows will be constrained.

Other forces for accounting harmonization include increased economic interdependence, more foreign direct investment, and the growth of multinational political organizations (the European Union is one example), and so on.

In the end, most of the demand for international standards can be traced back to the concept of reducing costs—for owners, creditors, preparers, analysts, and the general public.

Impediments to International Accounting Standards

Just because there is a demand for international standards does not mean that such standards will emerge easily or quickly. Twenty years ago (and even today) there were a number of impediments to creation and adoption of worldwide accounting rules.

Possible impediments, most of which are interrelated, include the following issues:

1. Who will create the rules? Creating a comprehensive body of accounting standards is difficult, time consuming, and costly. In the 1970s and 1980s, only a handful of countries in the world had created, or were even in a position to create, such a body of rules.
2. What will the rules be like? If I am concerned that the rules might not be to my liking or to the liking of those who support me, I may be much less inclined to agree to their creation.
3. In the short term, costs will be higher. Initially, the costs will be higher for the entity that creates the rules. Once the rules are promulgated, users will have higher costs as they learn, apply, and use the new standards.
4. National pride. By adopting the accounting rules of another country or an international body, a country may perceive that it is giving up some of its national sovereignty.

Many of these impediments affected the formation, operation, and effectiveness of the International Accounting Standards Committee, the international body established to create a comprehensive body of accounting standards that could be used on a worldwide basis.

The International Accounting Standards Committee

The International Accounting Standards Committee (IASC) was formed in June 1973 by professional accountancy bodies in Australia, Canada, France, Germany, Ireland, Japan, Mexico, Netherlands, UK, and U.S. The IASC published its first International Accounting Standard (IAS) in 1974, approved a conceptual framework in 1989, and established the Standards Interpretation Committee (SIC) in 1997.

The objectives of the IASC were broad and challenging:

a. To develop a single set of high quality, understandable, and enforceable global accounting standards that require high quality, transparent, and comparable information to help participants in capital markets make sound economic decisions;
b. To promote the use and application of those standards;
c. To bring about convergence of national accounting standards and International Accounting Standards.

The IASC and IASB have promulgated about 50 standards and over 40 formal interpretations. A list of the standards and interpretations is provided at the end of this chapter.

The early years of the IASC were difficult. There were a number of reasons for the slow recognition of the organization and its standards, including the following items:

1. Early rules were perceived as somewhat *ad hoc* in that there was no underlying conceptual framework to support standards. This concern was mitigated by the passage of the “Framework” in 1989.

2. Many alternative treatments were permitted. Since the IASC was composed of numerous diverse accounting bodies, there were numerous diverse accounting practices used by those bodies. Often, in order to adopt a rule of any sort, the IASC had to accept a wide range of variations in permitted practices. This also caused various factions to question whether IASC output had any value.

3. Early on, it was not obvious that harmonization of accounting rules was important. Thus, the urgency to have international rules was lacking.

4. As we will discuss later, compliance with IASC rules was voluntary because the body had (and has) no enforcement powers.

Notwithstanding initial travails, public and corporate perception slowly shifted over time, and it became more obvious that a common set of comprehensive standards was needed and would be beneficial to markets, users, and preparers.

The International Accounting Standards Board

The IASC was restructured in March, 2001, and, among other things, the standard-setting body changed its name to the International Accounting Standards Board (IASB). For simplicity, we will use the new name from now onward in this text. The IASB's website can be accessed at www.iasb.org.

At the time the IASB was formed, a new objective was added to the three objectives noted on the previous page. Since then, the objectives have been modified so that, today, the principal objectives of the IASB are

a. To develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions;

b. To promote the use and rigorous application of those standards;

c. In fulfilling the objectives associated with (a) and (b), to take account of, as appropriate, the special needs of small and medium-sized entities and emerging economies; and

d. To bring about convergence of national accounting standards and International Accounting Standards and International Financial Reporting Standards to high quality solutions.[6]

The structure of the IASB is similar in many ways to the structure of the FASB. There is a board that sets accounting standards using a formalized due process procedure. Currently the board has 15 members, to be increased to 16 no later than July 1, 2012. Up to three of the members may be part-time. Members must be drawn from various specified regions of the world to achieve broad geographical representation. The board of the IASB has a function that is similar to the board of the FASB.

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[6] IASC Foundation Constitution, dated February 1, 2009.

The 14-voting-member IFRS Interpretations Committee (formerly the International Financial Reporting Interpretations Committee) develops interpretations of standards for approval by the board. This committee replaced the Standards Interpretation Committee (SIC) effective December 2001.

The IFRS Advisory Council (formerly the Standards Advisory Council), comprised of at least 30 members (currently 47) with an interest in international financial reporting, provides the board with advice concerning board priorities, technical accounting issues, and the implications of proposed standards on users and preparers of financial statements. In addition to the Advisory Council, the IASC has other advisory bodies including the Financial Crisis Advisory Group, the Analyst Representative Group, the Global Preparers Forum, and various working groups.

The IFRS Foundation (formerly the International Accounting Standards Committee Foundation) is a 20-member group of Trustees who oversee the operation of the IASB. A minimum of six trustees must be from the Asia/Oceania region, six from Europe, six from North America, and the remaining four from any area. Among other duties, the Trustees appoint members of the Board, the Interpretations Committee, and Advisory Council and they are responsible for funding the IASB and affiliated entities. This IASC Foundation is similar to the Financial Accounting Foundation in the U.S.

In early 2009, the IASC Foundation created a Monitoring Board, composed of five members and one observer. This Board is intended to provide a formal link between the Trustees and those public authorities that have generally overseen accounting standard-setters (the SEC in the U.S.). It is also responsible for the approval of all Trustee appointments and reappointments.

The IASB issues standards called International Financial Reporting Standards (IFRS), in order to differentiate the new standards from the International Accounting Standards (IAS) set by the predecessor organization.

Adoption of International Standards

One area where the IASB differs substantively from the FASB is in the implementation and enforceability of its pronouncements. Accounting rules have historically been derived by national standard-setting bodies whose pronouncements are officially recognized as authoritative only within the boundaries of the country. Thus, the accounting rules established by the FASB are accepted in the U.S. by the SEC and the AICPA, but those rules are not valid in Germany, South Africa, or Brazil.

The IASB is an international standard-setting body. Until recently, few countries permitted International Financial Reporting Standards (IFRS) to be used. Within the last ten years, IFRSs have become required or a permitted alternative in a number of countries around the world.

IFRS use is increasing and is likely to soon skyrocket as a result of some milestone events.

1. The International Organization of Securities Commissions (IOSCO) is an organization of securities regulators promoting international coordination. The U.S. SEC is a member of the body. In May 2000, IOSCO recommended (with some qualifications) that its member bodies permit the use of IFRS for cross-border filings. Although IOSCO's recommendation will require implementation by member bodies

(which may or may not be forthcoming), it is a step forward in the acceptance of IFRS by a wide range of national regulatory bodies.

2. In June 2002, the Council of Ministers of the European Union (EU) adopted a regulation that requires the use of IFRS for financial reporting for publicly traded companies in the EU no later than January 1, 2005 (with some notable exceptions).

3. Also in June 2002, the Canadian Securities Administrators issued a proposal to permit foreign companies to file financial information in Canada without reconciliation.

4. In July 2002, the Financial Reporting Council (FRC) of Australia endorsed adoption of IFRS for Australian reporting entities by January 1, 2005.

5. In October 2002, the FASB and the IASB announced the issuance of a memorandum of understanding (the Norwalk Agreement) marking a step toward formalizing their commitment to convergence of U.S. and international accounting standards. Some joint projects include the conceptual framework project, the business combinations project, financial performance reporting by business enterprises project, and the revenue recognition project. The FASB and the IASB reaffirmed their commitment in April and October 2005, and issued a detailed document in November 2009 that sets forth the timelines and strategies for joint projects. The two bodies issued an updated memorandum in February 2006 and a progress report in September 2008, June 2010, and November 2010.

6. Standards-setters in additional key countries have announced that their domestic public entities will be required to use international standards. Brazil will require IFRS adoption in 2010, Canada, India, and Korea will require IFRS beginning in 2011, and Mexico will adopt IFRS for listed companies in 2012. Japan will permit use of IFRS by certain qualifying domestic companies for fiscal years ending on or after March 31, 2010, with a final decision on widespread adoption by around 2012.

7. In September 2009, the G-20[7] leaders asked "...international accounting bodies to redouble their efforts to achieve a single set of high-quality, global accounting standards within the context of their independent standard-setting process, and complete their convergence project by June 2011."

8. Recent SEC actions, which are discussed in the following text.

The EU and Australian events, in particular, are seen by many as significant watershed events in the life of the IASB in that they represented the first time that use of IFRS was required of public companies in a major capital market. The EU change alone affected the financial reporting practices of an estimated 9,000 publicly traded companies.

[7] The Group of Twenty (G-20) Finance Ministers and Central Bank Governors was established in 1999 to bring together systemically important industrialized and developing economies to discuss key issues in the global economy. The inaugural meeting of the G-20 took place in Berlin, on December 15-16, 1999, hosted by German and Canadian finance ministers.

FASB/IASB Cooperation

The FASB and the IASC/IASB have been working cooperatively towards international convergence of accounting standards for a long time—the contributions of FASB board members' and staff members' time to the work of the IASC were crucial to the completion of the IASC's "core" standards, which led to the 2000 IOSCO recommendation on acceptance of IFRS for cross-border filings.

More recently, a very significant series of events has increased the visibility, viability, and future acceptance of IFRS. Those events are related to the cooperation of the FASB and the IASB on rulemaking. There has been talk of cooperation for decades, evidenced most recently by the Memorandum of Understanding noted in point #5 of the previous text. However, recent pronouncements and exposure drafts are putting operational muscle behind the talk.

Within the past few years, both the IASB and the FASB have promulgated rules that harmonize (or nearly harmonize) their accounting standards with the standards of the other body. For example, the IASB substantially conformed to U.S. standards for pooling and accounting for goodwill with the issuance of IFRS 3, Business Combinations, to the three-tier approach to valuation of financial instruments previously adopted by FASB, and to requiring capitalization of construction period interest. The FASB changed U.S. standards to conform to IFRS when it issued SFAS 151 on Inventory (incorporated into FASB ASC 330), SFAS 153 on Like-Kind Exchanges (incorporated into FASB ASC 845), and SFAS 154 on Accounting Changes (now FASB ASC 250, *Accounting Changes and Error Corrections*).

Further, in June 2005, the IASB and the FASB issued a *joint* exposure draft on business combinations. This was the first time a joint ED was issued. While such a joint approach is much more common now, this was a watershed event at the time.

The FASB and the IASB issued another memorandum of understanding (MoU) in February 2006. This document was a reaffirmation of the 2002 MoU and, among other items, incorporated the SEC's roadmap for the removal of the 20-F reconciliation requirement for foreign registrants using IFRS (see "SEC Actions" in the following text). The MoU also set workplan milestones through 2008 for the IASB and FASB. Importantly, the two boards agreed that standards in need of improvement might best be addressed by the development of new common standards. This approach has been met with some (limited) success with respect to, for example, business combinations (revised SFAS 141R and IFRS 3), debt instrument disclosure (common exposure drafts in December 2008), and discontinued operations (common IASB exposure draft and FASB proposed staff position in September 2008).

In September 2008, the FASB and IASB issued a progress report on the 2006 MoU. It contained a workplan through 2011 and updates on progress. The workplan is extensive. The FASB's website includes information on joint FASB/IASB projects, including a conceptual framework project, a research project on financial instruments, and 11 active projects related to existing standards encompassing financial instruments, fair value measurement, the statement of comprehensive income, consolidations, financial statement presentation, leases, revenue recognition, and more.

In June 2010, both organizations issued a progress report including a modified work plan and strategy. The new plan prioritizes projects to be completed by June 2011 and limits the number of exposure drafts in any quarter to four. The priority projects are financial instruments, revenue recognition, leases, presentation of other comprehensive income, and fair value measurement.

The IASB and FASB issued an updated progress report on November 29, 2010. The report reaffirmed the priorities set forth in their June 2010 report and made amendments to their collective strategies and plans. The boards deferred work on some projects to enable them to focus on the five key projects noted in their June 2010 report.

During 2010, the IASB and FASB issued three separate joint Exposure Drafts on leases, revenue recognition, and the reporting entity concept.

All exposure drafts, progress reports, and information concerning other joint activities are available on the websites of both organizations.

It is clear that FASB/IASB actions are now speaking at least as loudly as their words. In future years, we expect continued cooperation and increased harmonization of U.S. GAAP and IFRS.

SEC Actions

The U.S. Securities and Exchange Commission (SEC) has recently taken actions that strongly support the use of international standards.

For decades, foreign companies that filed their financial statements with the SEC could either prepare their statements using U.S. GAAP or could use another comprehensive set of standards and also prepare a Form 20-F that reconciled equity and income to U.S. GAAP.

On November 15, 2007, the SEC unanimously approved rule amendments under which financial statements from foreign private issuers in the U.S. will be accepted without reconciliation to U.S. GAAP if (and only if) they are prepared using IFRS as promulgated by the IASB. The rule is effective for fiscal years ending after November 15, 2007. The SEC's Final Rule is provided on their website (www.sec.gov) as Release #33-8879, dated December 21, 2007.

The SEC's ruling is a significant pronouncement, both practically and politically. In effect, this is the first time the SEC has agreed that a comprehensive set of accounting standards other than U.S. GAAP was acceptable and they make a clear statement that the statements promulgated by the IASB meet such a threshold.

Additionally, in August 2007, the SEC issued a Concept Release and Request for Comment (Release #33-8831) that seeks comment as to whether public U.S. issuers should be permitted to prepare financial statements in accordance with IFRS.

Following up on the Concept Release, in November 2008, the SEC issued a Proposed Rule for public comment (Release #33-8982) that sets out a proposed roadmap that could lead to the mandatory use of IFRS by U.S. issuers beginning in 2014. The SEC would decide in 2011 whether to proceed with rulemaking to require IFRS on a phased basis from 2014 to 2016. Early adoption would be allowed for certain SEC registrants beginning in 2010.

The SEC set seven milestones that would influence its decision on whether to require IFRS use. The milestones are

1. Continued improvements to international accounting standards,
2. Improved accountability and stable funding for the IASC Foundation,
3. Improvement in the ability to use interactive data for IFRS reporting,
4. Education and training on IFRS in the U.S.,
5. Limited early use of IFRS to evaluate the adoption process and comparability,
6. The timing of future rulemaking by the SEC, and
7. An implementation plan including possible staging or sequencing.

With the change in presidential and SEC administration as a result of the November 2008 elections, the pace of possible IFRS adoption by the SEC has slowed, but not stopped. For example, in February 2009, the SEC extended the comment period for Release 33-8982. In addition, the financial crisis of late 2008 and numerous high-profile enforcement actions during 2009 (Bernard Madoff being only one) have meant that the Roadmap and accounting standard harmonization have not been as high an SEC priority.

Nonetheless, the SEC's draft strategic plan for fiscal years 2010-2015 (issued October 8, 2009 in Release #34-60799) supports uniform international standards. The draft plan the SEC proposes to "…promote high-quality financial reporting worldwide through, among other things, support of a single set of high-quality global accounting standards and promotion of the ongoing convergence initiatives between the FASB and the International Accounting Standards Board."

Further, in December 2009, SEC Commissioner Elisse Walter told an AICPA conference that she expects further SEC action on the Roadmap sometime in early 2010. In September 2009 remarks to an industry group and to the NY Society of CPAs, the SEC Chairman and the Chief Accountant both reaffirmed their support to refocus on the Roadmap in Fall 2009 and beyond.

At a November 2009 speech to Financial Executives International, SEC Commissioner Kathleen Casey said it was her "…hope and expectation that the Commission will soon articulate the next steps to be taken with respect to the use of IFRS by U.S. issuers—further signaling our commitment to this important goal."

In February 2010, the SEC issued a "Statement in Support of Convergence and Global Accounting Standards" (Release 33-9109). The Statement reiterated the SEC's strong commitment to "a single set of high-quality globally accepted accounting standards." It also included a work plan intended to inform the Commission as it determines whether to allow IFRS for U.S. issuers. The statement and work plan set forth those factors the Commission believes are of particular importance in the decision-making process. These key issues are

- Sufficient development and application of IFRS for the U.S. domestic reporting system,
- The independence of standard setting for the benefit of investors,
- Investor understanding and education regarding,

- Examination of U.S. regulatory environment that would be affected by a change in accounting standards,
- The impact on issuers, and
- Human capital readiness.

A work plan progress report was issued October 29, 2010. All of these documents are available on the SEC website at www.sec.gov.

In August 2010, the SEC requested public comment on their consideration of permitting IFRS to be used by U.S. registrants. The two requests for comment are Release 33-9133 and 33-9134. They are available on the SEC website.

Clearly, the actions of the SEC over the past few years are very supportive of IFRS adoption by SEC registrants, whether foreign or domestic. What remains to be seen, however, is the pace of adoption for U.S. firms. Notwithstanding, we believe there is a high likelihood that the U.S. and the world will inexorably move toward common accounting and reporting standards primarily based on IFRS.

Finally, while current SEC rules may limit the use of IFRS by domestic SEC registrants, there is no such limitation for other companies. In May 2008, the AICPA Council approved a resolution that recognizes the IASB as a standard-setter for purposes of Rules 202 and 203 of the AICPA Code. **In effect, IFRS *are* GAAP**. Thus, financial statements prepared in accordance with IFRS do not require a GAAP exception in an audit, review, or compilation report.

Summary and Conclusions

While the differences in global accounting standards are apparent, there is strong evidence that there is convergence between national standards and international standards. Cross-country accounting differences are less pronounced as countries adopt international standards. Two of the factors responsible for the rise in importance and acceptability of international standards are the rise in the number of multinational corporations and the growth of global capital markets. There are still impediments to wide adoptability of international standards. However, the success of the IASB in working towards a comprehensive set of standards and the movement by standard setters and regulators in major capital markets around the world both combine to clearly indicate that the acceptability of international standards will continue to grow.

IASB Standards and Interpretations	
Standard	**Title**
IFRS 1	*First-time Adoptions of International Financial Reporting Standards (revised in 2008—revisions effective January 2009)*
IFRS 2	*Share-based Payment*
IFRS 3	*Business Combinations (revised in 2008—revisions effective July 2009)*
IFRS 4	*Insurance Contracts*
IFRS 5	*Non-current Assets Held for Sale and Discontinued Operations*
IFRS 6	*Exploration for and Evaluation of Mineral Resources*
IFRS 7	*Financial Instruments: Disclosures*
IFRS 8	*Operating Segments (effective January 2009)*

IFRS 9	*Financial Instruments (effective January 2013 with early adoption permitted beginning with 2009 financial statements)*
IAS 1	*Presentation of Financial Statements (amended in 2008—revisions effective January 2009)*
IAS 2	*Inventories*
IAS 7	*Statement of Cash Flows*
IAS 8	*Accounting Policies, Changes in Accounting Estimates and Errors*
IAS 10	*Events After the Balance Sheet Date*
IAS 11	*Construction Contracts*
IAS 12	*Income Taxes*
IAS 16	*Property, Plant, and Equipment*
IAS 17	*Leases*
IAS 18	*Revenue*
IAS 19	*Employee Benefits*
IAS 20	*Accounting for Government Grants and Disclosure of Government Assistance*
IAS 21	*The Effects of Changes in Foreign Exchange Rates*
IAS 23	*Borrowing Costs (revised in 2007—revisions effective January 2009)*
IAS 24	*Related-Party Disclosures*
IAS 26	*Accounting and Reporting by Retirement Benefit Plans*
IAS 27	*Consolidated and Separate Financial Statements (revised in 2008—revisions effective July 2009)*
IAS 28	*Investments in Associates*
IAS 29	*Financial Reporting in Hyperinflationary Economies*
IAS 31	*Financial Reporting of Interests in Joint Ventures*
IAS 32	*Financial Instruments: Presentation*
IAS 33	*Earnings Per Share*
IAS 34	*Interim Financial Reporting*
IAS 36	*Impairment of Assets*
IAS 37	*Provisions, Contingent Liabilities and Contingent Assets*
IAS 38	*Intangible Assets*
IAS 39	*Financial Instruments: Recognition and Measurement*
IAS 40	*Investment Property*
IAS 41	*Agriculture*
Interpretation	**Title**
IFRIC 1	*Changes in Existing Decommissioning, Restoration and Similar Liabilities*
IFRIC 2	*Members' Shares in Co-operative Entities and Similar Instruments*
IFRIC 4	*Determining Whether an Arrangement Contains a Lease*
IFRIC 5	*Rights to Interests Arising from Decommissioning, Restoration and Environmental Rehabilitation Funds*
IFRIC 6	*Liabilities Arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment*
IFRIC 7	*Applying the Restatement Approach under IAS 29* Financial Reporting in Hyperinflationary Economics
IFRIC 9	*Reassessment of Embedded Derivatives*
IFRIC 10	*Interim Financial Reporting and Impairment*

IFRIC 12	*Service Concession Arrangements*
IFRIC 13	*Customer Loyalty Programmes*
IFRIC 14	*IAS 19—The Limit on a Defined Benefit Asset, Minimum Funding Requirements and Their Interaction*
IFRIC 15	*Agreements for the Construction of Real Estate*
IFRIC 16	*Hedges of a Net Investment in a Foreign Operation*
IFRIC 17	*Distribution of Non-cash Assets to Owners*
IFRIC 18	*Transfers of Assets from Customers*
IFRIC 19	*Extinguishing Financial Liabilities with Equity Instruments*
SIC 7	*Introduction of the Euro*
SIC 10	*Government Assistance—No Specific Relation to Operating Activities*
SIC 12	*Consolidation—Special Purpose Entities*
SIC 13	*Jointly Controlled Entities—Nonmonetary Contributions by Ventures*
SIC 15	*Operating Leases—Incentives*
SIC 21	*Income Taxes—Recovery of Revalued Nondepreciable Assets*
SIC 25	*Income Taxes—Changes in the Tax Status of an Enterprise or its Shareholders*
SIC 27	*Evaluating the Substance of Transactions in the Legal Form of a Lease*
SIC 29	*Service Concession Arrangements: Disclosures*
SIC 31	*Revenue—Barter Transactions Involving Advertising Services*
SIC 32	*Intangible Assets—Web Site Costs*

Note that IAS 3 through 6, 9, 13, 14, 15, 22, 25, 30, 35; IFRIC 3, 8, and 11; and SIC 1 through 6, 8, 9, 11, 14, 16 through 20, 22 through 24, 26, 28, 30, and 33 have all been superseded or rescinded.

A short synopsis of each standard and interpretation may be found on the IASB's website at www.iasb.org.

Self-Test

1. The UK company presentation of the balance sheet is in reverse order of liquidity and in the form of assets less liabilities equals owners' equity. Which type of difference does this represent?

   a. Cosmetic.
   b. Substantive.
   c. Absolute.

2. Which factor that affects accounting standards caused former French colonies to follow the French model?

   a. Business complexity.
   b. Legal system.
   c. Accidents of history.

3. One of the possible impediments to the creation and adoption of worldwide accounting rules is the determination of who will create the rules.

   a. True.
   b. False.

4. When did the IASC publish its first International Accounting Standard?

   a. 1973.
   b. 1974.
   c. 1989.

5. The European Union (EU) currently requires the use of IFRS for financial reporting for publicly traded companies in the EU.

   a. True.
   b. False.

6. Most of the demand for international standards is based on the concept of reducing costs—for owners, creditors, preparers, analysts, and the general public.

   a. True.
   b. False.

7. What are the cosmetic and substantive differences in accounting rules across countries?

8. What are the factors that make accounting rules differ globally?

9. What are the two primary factors that have fueled the demand for international accounting standards?

10. What are the four barriers to the creation and adoption of worldwide accounting rules?

11. How does the International Accounting Standards Board differ from its predecessor, the International Accounting Standards Committee?

Knowledge Application

Peugeot SA disclosed that its financial statements conform to French, U.S., and International Accounting Standards. Critically analyze this statement. Consider whether this statement can be accurate and, if yes, under what circumstances.

Chapter 2

Introduction to Financial Statements Prepared in Accordance with IFRS

Chapter Objectives

- Be able to review international accounting financial statements and identify variances from U.S. GAAP.
- Identify differences in terminology used in non-U.S. financial statements.
- Understand differences between IFRS and U.S. GAAP in the following financial statements:
    - Balance Sheet,
    - Income Statement,
    - Statement of Changes in Equity, and
    - Cash Flow Statement.

Introduction

In this chapter we will provide an overview of the format and structure of a set of financial statements provided in accordance with International Financial Reporting Standards (IFRS). We will also outline some differences between U.S. GAAP and IFRS as they pertain to underlying assumptions and conventions and to financial statement presentation.

Throughout this chapter and the text, we will refer to the 2009 financial statements of four companies that present their statements in accordance with IFRS. These four companies are

1. *Jardine Matheson*—A diversified Bermuda-based company with businesses in supermarkets, drugstores, construction, hotel management and ownership, and property development. The majority of its operations are in Asia and Australia.
2. *Nestlé*—A Swiss company engaged in the food, water, and pharmaceutical sectors.
3. *Bayer*—A German firm with operations in health care, agriculture, polymers, and chemicals.
4. *Nokia*—A Finnish company with businesses in mobile phones, network infrastructure, and related services.

Financial statements and notes of these companies can be found in Appendixes A through D, respectively, which can be found on the CD-ROM that accompanies this book.

It's All in How You Say It

As you examine the financial statements in the appendices, you will notice some unusual language. In many cases, words we use in the U.S. to denote a certain classification of asset, liability, income, or expense are called something different internationally. This is similar to someone from England referring to an elevator as a lift or calling the trunk of a car a boot.

A few of the more-common wording differences you may encounter are as follows. In each case the international term is first, followed by the U.S. term.

- Stocks—Inventory
- Share Capital—Common Stock or Paid-in Capital
- Share Issue Premium—Additional Paid-in Capital
- Outside Interests—Minority Interests
- Debtors—Accounts Receivable
- Creditors—Accounts Payable
- Trading Profit—Operating Profit
- Revenue Reserves—Retained Earnings

Conceptual or Theoretical Accounting Framework

IFRSs are grounded in a theoretical "conceptual framework." As with the Statements of Financial Accounting Concepts (SFAC) in the U.S., the IASB's "Framework for the Preparation and Presentation of Financial Statements" sets forth assumptions underlying financial accounting (for example, materiality, going concern), defines qualitative characteristics of financial statements (for example, relevance, reliability), and defines elements of financial statements (for example, assets, liabilities). These concepts and definitions are similar to those found in U.S. SFACs.

One substantive difference between IFRS and U.S. GAAP is that although transactions are recorded on the basis of historical cost; property, plant, and equipment and some other long-lived assets may be revalued to fair value for IFRS. We will discuss this issue in Chapter 4.

IFRS provides for what some refer to as a "fairness exception." It is similar to a "Rule 203 exception" under U.S. auditing standards. Under IFRS, if management decides that application of a provision of any standard would be so misleading that it would conflict with the objective of financial statements set out in the IASB Framework, management must use a different application to achieve a fair presentation. There is a rebuttable presumption, however, that if other entities in similar circumstances comply with the requirement, compliance with the requirement would not be so misleading that it would conflict with the objective of financial statements set out in the Framework. Furthermore, if such an action is taken, significant note disclosure is required.

IAS 1—Presentation of Financial Statements

This standard sets forth the requirements for presentation of a complete set of financial statements consisting of a balance sheet, income statement, cash flow statement, equity statement (showing either all changes in equity accounts or changes in equity accounts other than transactions with owners), and notes to financial statements.

IAS 1 was substantively rewritten in September 2007. The revised standard is effective for annual periods ending on or after January 1, 2009, with earlier application permitted.

Similar to U.S. GAAP, statements prepared under IFRS are general-purpose financial statements that provide information about an enterprise's financial position, performance, and cash flows. The financial statements will be used by investors and others in making economic decisions.

IFRS requires that the current year and the prior year be presented whereas U.S. GAAP has no specific requirement to present comparatives. However, the U.S. Securities and Exchange Commission (SEC) generally requires three years (current year plus two comparable years) for all statements except the balance sheet for public companies that file with the SEC.

IAS 1 requires the presentation of a statement of financial position, statement of comprehensive income, statement of changes in equity, statement of cash flows, and notes. Comparative prior-period information is required for amounts shown in the financial statements and notes. Recall that under U.S. GAAP, a statement of changes in shareholders' equity can be shown either as a primary statement or in the notes.

We will discuss some of the substantive differences provided by IFRS, and we will examine the manner in which the components of basic financial statements differ in appearance.

IAS 1 generally does not prescribe a particular format for the presentation of the financial statements. Unlike the U.S., where a common format has evolved, statements prepared in accordance with IFRS are presented using multiple formats. As you examine the financial statements presented in the appendices, observe that the primary financial statements all include a separate column titled "notes." This presentation is not required under IFRS, but it has evolved as a way to clearly indicate to statement readers the notes that apply to each item in question.

IAS 1 sets out the requirements for the statement headings. The heading should include the following:

- The name of the statement
- The reporting enterprise
- Whether the statements are for one enterprise or for a group (consolidated)
- The date or time period covered
- The reporting currency

- The level of precision of currency (thousands, millions, and so on)

In the following sections, we will examine some of the presentations with reference to the IFRS financial statements provided in Appendices A through D.

First time adoption is addressed in IFRS 1. IFRS 1 generally requires full retrospective application of IFRSs that are in force at the time of adoption. However, there are exceptions pertaining to some IFRSs.

Financial Statement Presentation—Balance Sheet

The Nestlé balance sheet (Appendix B) is very similar to that presented by a U.S. company. Assets balance to liabilities plus equity and items are listed in order of decreasing liquidity.

The balance sheets of the rest of the companies are in the form A = OE + L (note that equity is listed before liabilities). In addition, the assets and liabilities are listed in increasing order of liquidity, so, for example, goodwill and intangibles appear first in the asset section rather than last. The Bayer and Nestlé statements present an alternative way of disclosing discontinued operations. We will explore this issue later in the chapter.

Companies are permitted to present their balance sheet in the form:

Assets – Liabilities = Equity.

In addition, the long-term financing presentation is allowed:

(fixed assets + current assets – short-term payables = long-term debt + equity)

Post-balance sheet refinancing agreements will often result in classifying applicable debt as long-term under U.S. GAAP. Under IFRS, these agreements are not considered, thus more debt is likely to be classified as current.

Financial Statement Presentation—Statements of Comprehensive Income

IFRS requires the presentation of a statement of comprehensive income. This statement includes all items of income and expense (non-owner changes in equity) as well as other comprehensive income. The information can be presented either as a single statement of comprehensive income (including a subtotal for net income or loss) or as a separate income statement plus a separate statement of comprehensive income (beginning with net income or loss). All of our example companies provide two separate statements rather than one.

The IFRS measurement criteria used to determine revenue and expenses are similar to those used under U.S. GAAP. However, gains and losses are not regarded as separate elements of the IASB framework. These items may or may not arise in the course of the ordinary activities of an enterprise. This differs from U.S. SFAS treatment that states gains and losses are increases or decreases in equity from peripheral or incidental transactions. In practice, gains and losses under IFRS are accounted for in a similar manner as under U.S. GAAP. The presentation of extraordinary items is prohibited under IFRS.

SEC registrants are required to present expenses based on function (for example, cost of goods sold). Under IFRS, expenses may be presented by function or nature (for example, advertising, salaries). Certain note disclosures are required for expenses presented by nature.

The income statements of all four example companies are similar to U.S. presentation. Although each company has significant cost of goods sold, only Nokia and Bayer explicitly disclose gross profit. Gross profit for Nestlé can be calculated from the face of the income statement. Jardine discloses cost of goods sold only in note 6.

Note that Nokia reports impairment costs and recoveries (see notes 6 and 7) as part of operating income. Bayer reports impairment charges in other operating expenses (see the last section of note 4). Nestlé reports impairment "below the line" as other income/expense (see their note 4).

Nestlé discloses the income statement effect of discontinued operations in a separate column on the face of the statement. Bayer provides the amount of income and expense for discontinued operations on a separate line.

Jardine provides separate columns on their income statement for both the underlying business and for non-trading items. As explained towards the end of note 1, non-trading items include gains and losses from revaluation and sales of investments, impairment of non-depreciable intangible assets, and other non-recurring items.

Financial Statement Presentation—Statement of Changes in Equity

The statement of changes in equity must present total comprehensive income for the period, the effects on each component of equity of changes in accounting policy and/or correction of errors under IAS 8, transactions with owners, and a reconciliation between opening and closing balances for each equity component.

All sample companies provide an equity statement that that is very similar in appearance to many U.S.-based statements. The statements have columns for each major equity account category and show details as to how the account balance changed from the beginning of the period to the end.

The example companies also provide additional equity disclosures in the notes—Bayer in note 24, Jardine in notes 27 and 29, and Nestlé in note 21. Nokia has no significant additional disclosures, likely because their statement is comprehensive.

Financial Statement Presentation—Cash Flow Statement

The cash flow statement is a required statement under IAS 7. The requirements of IAS 7 are similar to the requirements of FASB ASC 230, *Statement of Cash Flows*, in the U.S. with a few exceptions.

In the U.S., interest paid, interest received, and dividends received are all accounted for in the operating section and dividends paid are accounted for in the financing section.

Under IFRS, interest paid and interest and dividends received are usually classified as operating as well; however, they may be classified as financing cash flows and investing cash flows respectively, because they are costs of obtaining financial resources or returns on investments. Taxes paid are classified in operating cash flows (similar to U.S. GAAP), unless they can be specifically identified with a financing or investing activity, in which case they are reported in those sections.

Another difference is that IFRS excludes from the cash flow statement investing and financing activities that do not require the use of cash (that is, issuing bonds in exchange for a long-term asset). Under IFRS, such transactions are generally to be disclosed elsewhere in the financial statements. Conversely, these activities are generally reported at the bottom of the cash flow statement under U.S. GAAP (but can be disclosed elsewhere in the financial statements, as well).

Finally, IFRS requires that the cash flow effects of discontinued operations be disclosed separately as arising from operating, investing, or financing activities. U.S. GAAP permits a similar presentation for extraordinary items, but does not require such treatment. Some U.S. companies provide the information in accordance with IFRS rules. See, for example, the 2008 annual report of General Electric (http://www.ge.com/ar2008/pdf/ge_ar_2008_audited.pdf).

Cash flow from discontinued operations is not required to be presented on the face of the statement. Nestlé provides information concerning the cash flow effects of discontinued operations in note 25. Bayer does so in note 6.3.

Each of our four example companies provides a cash flow statement that is very similar in appearance to one prepared under U.S. GAAP. Note a few interesting differences, as shown below.

Jardine (Appendix A) provides a significant amount of additional detailed disclosure of cash flow items in their note 36. It also shows interest income and expense in the operating section.

Nestlé (Appendix B) shows the net change to working capital accounts on the face of the statement and gives details of the changes to individual accounts in note 22.

The operating section of Nokia's (Appendix D) statement is very compact, with details for both non-cash adjustments and most working capital accounts appearing in note 31 and not on the face of the cash flow statement.

Financial Statement Presentation—Notes

The primary rationale for notes is the same for IFRS as for U.S. GAAP—to provide additional disclosure to users not otherwise given on the primary financial statements and assist users in making economic decisions. Thus, the general appearance and content of notes under IFRS is similar to that found in companies who file using U.S. GAAP.

IFRS requires companies to disclose the currency in which the financial statements are presented. There is no requirement that the reporting currency be the predominant operating currency of the enterprise or even a currency used by the company. Each sample company discloses the reporting currency on the face of the financial statements. Jardine uses the U.S. dollar, Nestlé uses the Swiss franc, and Bayer and Nokia use the Euro. It is interesting to note that Jardine uses the U.S. dollar, yet it generates almost no revenue in North America.

Financial Statement Presentation—Earnings Per Share

Both IFRS and U.S. GAAP require calculation and disclosure of earnings per share. IFRS requires disclosure of basic and diluted EPS from continuing operations and from net profit or loss. U.S. GAAP also requires EPS disclosure for discontinued operations and extraordinary items.

In certain circumstances, the number of issued or deemed issued shares used in the denominator of the EPS calculation may differ slightly between U.S. GAAP and IFRS. In August 2008, the FASB and the IASB both issued Exposure Drafts to, among other items, harmonize the calculation of outstanding shares used in the denominator of EPS calculations, with limited exceptions where the underlying accounting differs.

The Exposure Drafts also propose other changes to current practice. For example, using year-end stock price, rather than average, when calculating the number of shares that would be issued for the deemed exercise of dilutive options and warrants (the "treasury stock method"). EPS is not an active project in the current technical plan of the FASB or in the IASB work plan.

Financial Statement Presentation—IASB/FASB Project

In October 2008, the IASB and the FASB issued a joint Discussion Paper titled "Preliminary Views on Financial Statement Presentation." The Discussion Paper is the first step in a joint effort to "organize financial statements in a manner that clearly communicates an integrated financial picture of an entity." The process is intended to culminate in promulgation of common presentation standards for financial statements.

The document focuses on presentation concerns that include (1) no common approach for financial statement presentation, (2) information not linked between the statements, and (3) dissimilar items sometimes aggregated into one number. The Discussion Paper presents suggested new formats for the presentation of financial statements that are in some respects familiar and in others strikingly different.

In July 2010, the FASB and IASB published staff drafts of a possible standard reflecting tentative decisions reached through April 2010. While not approved nor in the form of an Exposure Draft, the staff draft provides insight into current thinking. The draft is available on the websites of both organizations.

The two boards will consider responses to the Discussion Paper and staff draft. Because of joint work on other more-pressing topics (outlined in Chapter 1), the previous timeline estimates for issuance of an Exposure Draft and final standard have been modified. At the time of this writing, no estimated action dates were provided. Visit either board's website for current timelines.

Summary and Conclusions

There are both cosmetic and substantive differences between U.S. and IFRS prepared financial statements. Although the underpinnings of IFRS are similar to U.S. GAAP, there are some significant presentation differences. IAS 1 sets forth the requirements for presentation of financial statements. Required financial statements include the Balance Sheet, the Income

Statement, the Statement of Changes in Equity, and the Cash Flow Statement. Notes to the financial statements are also required.

Quick Reference Guide to IFRS/U.S. GAAP Differences		
Chapter 2—Introduction to Financial Statements Prepared in Accordance with IFRS		
Topic	**IFRS**	**U.S. GAAP**
General Issues		
Basis of recording	Historical cost, except intangible and long-term assets may be revalued. Derivatives and most securities must be valued at fair market value (FMV).	Historical cost with no revaluation, except for certain types of financial instruments.
Reporting currency	Specify the measurement currency.	Not specifically addressed.
Comparative statements	Current year and prior year.	No specific requirement for non-public companies. SEC requires three years for all except balance sheet.
Balance sheet format	Not specified. A number of different formats are used.	Not specified, but has evolved to one format.
Income statement format	Does not specify a particular format, although expenditures are presented in one of two formats (function or nature).	Present as single step or multi-step. Expenses by function.
Extraordinary Items	Prohibited	Permitted if unusual and infrequent.
Cash Flow Statement	Standard headings, but limited guidance on contents.	Standard headings and more specific guidance for items in each category.
Cash flow statement item classification	Interest or dividends paid can be reported as either operating or financing. Interest or dividends received can go in either operating or investing.	Interest paid, interest received, and dividends received all go in operating. Dividends paid go in financing.
Cash flow from discontinued operations	Disclosed under each category either in the statement of cash flows or in the notes.	Separate disclosure not required.
Non-cash items affecting financing or investing activities	Not required to be reported.	Reported at the bottom of the cash flow statement.
Earnings per Share	Basic and dilutes EPS for continuing operations and for net profit and loss.	Same as IFRS plus EPS for discontinued operations and extraordinary items.

Self-Test

1. What is the U.S. term for the international term—Outside Interests?

   a. Common stock.
   b. Minority interests.
   c. External Board Members.

2. Which term represents management's option to choose a different application to achieve a fair presentation if management decides that application of a provision of any standard would cause the financial statements to be misleading?

   a. Option allowance.
   b. Exclusion allowance.
   c. Fairness exception.

3. What topic does IAS 1 set requirements for?

   a. Presentation of a complete set of financial statements.
   b. Cash flow statement.
   c. Business combinations

4. IFRS prescribes a specific format for the presentation of the financial statements.

   a. True.
   b. False.

5. A statement of comprehensive income is required under IFRS.

   a. True.
   b. False.

6. What is the IFRS requirement for any non-cash transactions that affect financing or investing activities?

   a. IFRS does not require disclosure of these activities.
   b. These activities are to be disclosed at the bottom of the cash flow statement.
   c. The non-cash transactions are included in financing and investing activities.

7. Which financial statements are required under IFRS?

8. Are notes required under IFRS?

9. Is one particular financial statement format required for presentation using IFRS? If yes, what is it called?

10. Classified Balance Sheets are commonly prepared by IFRS companies. Is this required or common practice?

11. What are the differences between U.S. GAAP and IFRS pertaining to any distinctions between revenues and gains or expenses and losses on the Income Statement?

12. Name the statement that companies may provide under IFRS that is not used in the U.S.

13. Identify the two differences between U.S. GAAP and IFRS relative to the Cash Flow Statement. Describe any differences between U.S. GAAP and IFRS pertaining to any distinctions between revenues and gains or expenses and losses on the Income Statement.

14. Name the statement that companies may provide under IFRS that is not used in the U.S.

15. Identify the two differences between U.S. GAAP and IFRS relative to the Cash Flow Statement.

Knowledge Application

Balance Sheet—Example of Presentation

(DM million)	*Dec. 31, 20XY*	*Dec. 31, 20XX*
Assets		
Non current assets		
Intangible assets	3,733	2,056
Property, plant and equipment	21,177	20,158
Investments	2,156	1,706
	27,066	23,920
Current assets		
Inventories	11,306	10,608
Receivables and other assets		
Trade accounts receivable	10,899	10,686
Other receivables and other assets	3,249	2,816
	14,148	13,502
Liquid Assets	3,366	4,802
	28,820	28,912
Deferred taxes	754	872
Deferred charges	576	466
	57,216	54,170
Stockholders' Equity and Liabilities		
Stockholders' equity		
Capital stock of Bayer AG	3,652	3,652
Capital reserves of Bayer AG	5,760	5,760
Retained earnings	13,923	12,276
Net income	3,157	2,941
Translation differences	(1,914)	(1,143)
Minority stockholders' interest	413	437
	24,991	23,923
Provisions		
Provisions for pensions and other post employment benefits	9,225	9,144
Other provisions	4,996	5,085

	14,221	14,229
Other liabilities		
Financial obligations	9,012	7,620
Trade accounts payable	3,155	3,134
Miscellaneous liabilities	3,962	3,726
	16,129	14,480
Deferred taxes	1,534	1,208
Deferred income	341	330
	57,216	54,170

1. Is the above balance sheet prepared using U.S. or International accounting standards?
2. What are some cosmetic differences between U.S. GAAP and the above statement?
3. What are some substantive differences between U.S. GAAP and the above statement?

Chapter 3
Current Assets

Chapter Objectives

- Recognize presentation differences between U.S. GAAP and IFRS.
- Identify treatment differences between U.S. GAAP and IFRS for the sale of a receivable or other financial asset.
- Understand the treatment differences in inventory valuation.
- Understand the treatment differences in marketable securities valuation.

Introduction

U.S. GAAP requires that companies list their assets on the balance sheet in order of liquidity beginning with current assets and followed by noncurrent assets. Under IFRS, an entity is required to present current and noncurrent assets (just like U.S. GAAP), although order of liquidity is not specified. However, if an entity that reports under IFRS believes that a presentation based on liquidity provides information that is reliable and more relevant, it has the option of reporting all assets and liabilities broadly (without separating current from noncurrent), in order of liquidity.

Financial Statement Presentation of Current Assets

Cash

There are no substantive differences between IFRS and U.S. GAAP concerning the reporting of cash.

Accounts Receivable

In general, accounts receivable are reported similarly under IFRS and U.S. GAAP. Specifically

1. Accounts receivable are recorded for events that create revenue but have not been settled.
2. Trade accounts receivable are generally distinguished from other categories of receivables in financial statements.
3. The direct write-off method is not used.

4. Bad debts are often estimated using aging methods. (A more sophisticated approach can be used such as the incurred loss model described in IAS 39.)[8]

Bayer and Nokia report trade/accounts receivable separately on the face of the balance sheet while the other two companies combine trade receivables with other receivables. In each case, additional disclosure is provided in the notes. See note 20 for Jardine, note 10 for Nestlé, note 22 for Bayer, and note 19 for Nokia. Nokia discloses the allowance for doubtful accounts on the face of the statement, while the other companies provide that information in the notes.

Bayer discloses the amount of trade receivables due after one year. Note that the amount appears immaterial, yet it is still disclosed. See Bayer's note 22 where they disclose that, of the €6.1 billion of trade receivables, only €8 million is due after one year.

SALE OF TRADE RECEIVABLES

Under U.S. GAAP, FASB ASC 860 provides guidance concerning recording and reporting sales of accounts receivable and other financial assets. The standard focuses on the concept of control and whether that control of the asset has been surrendered. Under FASB ASC 860, control is surrendered if all the following conditions are met:

1. The assets are transferred beyond the reach of the transferor.
2. The transferee can pledge or exchange the transferred assets freely.
3. The transferor has not kept effective control through mechanisms such as a required repurchase provision.

Under U.S. rules, a sale of trade receivables without recourse will normally be deemed to be a sale where control is surrendered with no continuing involvement; thus, a sale would be recorded. A sale of trade receivables *with* recourse will be considered a sale even though there is continuing involvement *if* the three conditions noted above are met (that is, control is surrendered).

Under international standards, IAS 39 governs sales of trade accounts receivable. In IFRS parlance, the sale of a receivable or other financial asset is called "derecognition of a financial asset." In order to report a sale under IAS 39, the entity must lose or give up control of the contractual rights associated with the asset and transfer the risks and rewards of ownership of the asset. Under IFRS, factoring receivables without recourse will qualify as a sale. Factoring with recourse has been previously held to qualify as a sale, but current guidance states that such an approach is no longer permissible if there is no substantive risk assumed by the "buyer" of the receivables. Obviously, the facts and circumstances associated with a recourse sale will govern. However, it is possible that a recourse sale may be accounted for differently under IFRS and U.S. GAAP.

[8] It is instructive to note that IAS 39 prohibits the recognition of losses that have not yet occurred. Thus, recognition of estimated bad debts using the popular aging method or percentage-of-sales method is in conflict with the principle outlined in IAS 39. Our example companies generally use the impairment rules to account for their accounts receivable. Notwithstanding, use of these simpler methods is common for smaller enterprises.

Inventories

IAS 2 is the primary standard for inventory accounting. Both IFRS and U.S. GAAP define inventories in a similar manner—those items either held for sale in the ordinary course of business, or in the process of production, or supplies or materials to be used in production. Cost is defined as all costs necessary to bring the inventory to its present location and condition. Cost accumulation ceases when the item is ready for sale to intended customers.

INVENTORY METHOD

Permitted cost-flow assumptions under IFRS are FIFO and weighted average. LIFO is not allowed under IFRS.

VALUATION

Under IFRS, inventories are valued at cost, not to exceed net realizable value (NRV). Biological assets and agricultural produce are valued at fair value less point-of-sale costs in accordance with IAS 41, Agriculture. (Practice Pointer: Inventories of companies in the bio-tech industry may be subject to IAS 41.) NRV is defined as sales proceeds less additional costs to complete and to make the sale. Under U.S. GAAP, inventories are valued at the lower-of-cost-or-market with market being defined as replacement cost subject to an upper limit (ceiling) of NRV and a lower limit (floor) of NRV minus a normal profit margin. Thus, when replacement cost is below NRV (that is, ceiling), inventory will be valued at a different amount under IFRS and U.S. GAAP. The following examples illustrate this concept.

Conceptual Valuation Example

Under U.S. GAAP, an enterprise must determine the "market" price of the inventory. Market is defined as replacement cost (the cost of another unit of inventory) bounded by a ceiling (NRV) and a floor (NRV minus a normal profit margin). Thus, market under U.S. GAAP cannot be larger than NRV (the ceiling) but could be lower. In the cases where it is lower, a different inventory valuation will occur between U.S. GAAP and IFRS.

Numerical Valuation Examples

Smith Company sells one product. The cost of the product is $5 per unit.

Example 1

NRV (ceiling) = $4.50

Replacement cost = $4.65

NRV minus normal profit margin = $4.10

In this case, the inventory would be valued at $4.50 per unit under both IFRS and U.S. GAAP. For U.S. GAAP purposes, the NRV ceiling is considered to be the market price.

Example 2

NRV (ceiling) = $4.50

Replacement cost = $4.35

NRV minus normal profit margin = $4.10

Here, IFRS would value the inventory at NRV of $4.50 per unit. However, the U.S. GAAP inventory valuation would be $4.35 since market is defined as replacement cost ($4.35) bounded by a ceiling of $4.50 and a floor of $4.10.

Note that, in practice, the fact pattern given in Example 1 would be relatively unusual. Recall that NRV represents the net amount realized from the sale of a unit of inventory and that replacement cost is the cost to the enterprise of acquiring another unit of inventory. If the cost of acquiring another unit of inventory is greater than the net amount realized from sale of that newly acquired unit, it is unlikely that the firm will purchase or manufacture additional inventory, likely leading to a fall in the input price of the inventory item.

IFRS requires that a company disclose the carrying amount of inventories carried at NRV.

SUBSEQUENT INVENTORY WRITEUP

Under U.S. GAAP, if inventory has been written down to market under the lower-of-cost-or-market rules, it may not be written up even if market value increases in a subsequent period. However, IAS 2 states "...when the circumstances that previously caused inventories to be written down below cost no longer exist or when there is clear evidence of an increase in net realizable value because of changed economic circumstances, the amount of the write-down is reversed (that is, the reversal is limited to the amount of the original write-down)..." In a "write-up," the recovery is reported in income.

Let us examine the application of this provision using the information provided in Example 1 above. In the example, inventory cost was written down to $4.50 under both IFRS and U.S. GAAP. Now assume that in a subsequent period the NRV and replacement cost rise above $5. Under U.S. GAAP there would be no change to inventory valuation. Under IFRS, the inventory would be restored to its original cost of $5. If the recovery is not complete (for example, the subsequent period NRV is $4.70), the partial recovery is reported. Reported cost may not exceed actual costs in any circumstances.

Under IFRS, when a company reverses a prior writedown, it must disclose the amount of the reversal and the circumstances or events that led to the reversal.

AGGREGATION

IAS 2 states that "inventories are usually written down to net realizable value on an item-by-item basis." It is permitted to group similar items when those items relate, for example, to the same product line with similar end users, or are marketed in the same area. However, "it is not appropriate to write inventories down based on a classification of inventory, for example, finished goods, or all the inventories in a particular industry or geographical segment."

In U.S. GAAP, FASB ASC 330 permits implementation of the lower of cost or market rule "…to each item or to the total of the inventory (or, in some cases, to the total of the components of each major category)."

Thus, IFRS rules are slightly more restrictive compared with U.S. GAAP as they pertain to aggregation of inventory items or categories.

Note that aggregation on an item-by-item basis will often result in a larger write-down because each shortfall must be recorded whereas aggregation permits items with shortfalls to be offset by items with "excesses."

OTHER DISCLOSURES

Companies must also disclose the carrying amount of inventories pledged as security for liabilities. There is no materiality threshold.

EXAMPLE COMPANIES

Jardine uses the FIFO method as indicated in note 1. Note that they refer to inventory as "stocks." They provide a breakdown of the composition of inventory in note 24. Also in note 24, Jardine discloses that $3 million of inventory is pledged as security on borrowing. While the amount is arguably immaterial, disclosure is still provided.

Nestlé uses FIFO for raw materials and purchased finished goods and weighted average for other inventories, as noted in their accounting policies. They also state that they establish a provision when inventories are written down to NRV. In note 12, they disclose the amount of the write-down provision (CHF 182 million) and also the value of inventory pledged as security for liabilities (CHF 156 million).

In note 4, Bayer discloses that they use the weighted average method and in note 21 they provide further information related to inventories.

Nokia uses standard cost which approximates FIFO (note 1). Additional detail concerning the categories of inventory is given in note 17 and, in note 19, the company provides detail concerning the amount of "excess and obsolete inventory."

As you can see from the notes, since IAS 2 did not preclude a company from using multiple costing methods for different components of inventory, the use of multiple methods is common.

Marketable Securities

Marketable securities are debt and equity investment assets.

Marketable securities are accounted for predominately in accordance with IAS 39. Similar to U.S. GAAP under FASB ASC 320, IAS 39 states that marketable securities are

1. Initially accounted for at cost.
2. Apportioned into trading, available-for-sale, and held-to-maturity categories.
3. Carried at market value or amortized cost depending on the category.

There are a few major, and some minor, differences between IFRS and U.S. GAAP accounting for marketable securities (but see discussion below related to IFRS 9).

To be classified as a held-to-maturity (HTM) asset, the asset must have fixed or determinable payments and a fixed maturity. The entity must also have the "positive intent and ability" to hold the asset to maturity. It is not simply a present intention. HTM securities are recorded at amortized cost (using the effective interest method) at the balance sheet date, and are subject to annual impairment tests. Under IFRS, if an entity sells "more than an insignificant amount" of HTM assets before maturity, it is prohibited from using the HTM classification for two full annual reporting periods (known as tainting) and must reclassify all HTM assets as available-for-sale. "An insignificant amount" is determined with reference to total HTM assets, not total marketable securities or total assets. Any HTM assets reclassified are remeasured to fair value on the date of reclassification. U.S. GAAP also contains a tainting provision, but the "penalty period" is not specified for nonpublic companies (the two-year period generally applies to SEC registrants).

Trading securities are debt and equity securities held for sale in the short term. Derivatives are included in this category unless they are hedges. IFRS and U.S. GAAP are similar in that these securities are to be valued at FMV and that realized and unrealized gains and losses are recognized on the income statement.

Available-for-sale (AFS) securities are debt and equity securities that do not fall into either of the above two categories. These securities are carried at FMV for both IFRS and U.S. GAAP purposes. The offsetting side of the asset revaluation is accounted for in other comprehensive income for both U.S. GAAP and IFRS (effective with revisions to IAS 1 for fiscal periods beginning on or after January 1, 2009).

On March 5, 2009, the IASB issued *Improving Disclosures about Financial Instruments (Amendments to IFRS 7)*. The amendments require enhanced disclosures about fair value measurements and liquidity risks, and are effective for annual periods beginning on or after January 1, 2009. The amendment introduced a three-level hierarchy similar to the hierarchy set out in SFAS 157, *Fair Value Measurements*, and requires expanded disclosures regarding fair value measurements including: (a) the level in the fair value hierarchy into which fair value measurements are categorized; (b) any significant transfers between Level 1 and Level 2; (c) for fair value measurements in Level 3 of the hierarchy, a reconciliation from beginning balances to ending balances with various measures to be disclosed separately; and (d) for fair value measurements in Level 3, the potential effect of changes if another reasonably possible alternative assumption were made.

On April 9, 2009, the FASB completed its project on "Interim Disclosures about Fair Value of Financial Instruments" with the issuance of FASB Staff Position (FSP) FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*. This FSP is effective for interim reporting periods ending after June 15, 2009 and applies to all financial instruments within the scope of FAS 107 held by publicly traded companies. The FSP requires entities to disclose in the body or notes of its financial information for interim and annual reporting periods the fair value of all financial instruments (when practicable to estimate), whether it is recognized or not in the statement of financial position. Entities are also required to disclose the method(s) and significant assumptions use to estimate fair value, as well as any changes to methods and significant assumptions during the period.

In November 2009, the IASB issued IFRS 9—Financial Instruments, containing requirements for financial assets. In October 2010, requirements for financial liabilities were added. These two events represent the first phase of a three-phase project to completely replace IAS 39. At the time of this writing, remaining phases were expected to be completed in 2011. IFRS 9 is effective January 1, 2013 (yes, 2013), with early adoption permitted beginning with 2009 financial statements. This statement is part of the joint FASB/IASB program. At the time of this writing, the FASB anticipated issuing one comprehensive statement in early 2011. For updated timelines (which have been moving), see either board's website.

The intent of the IASB and FASB is that their collective efforts will reduce differences in accounting for financial instruments but, until completion of the project, differences will remain, if for no other reason than timing and possible differing effective dates. For the next few years, this topic will remain an area of considerable interest with a near-certainty of significant additional changes by both the FASB and the IASB.

Some of the significant changes in IFRS 9 are as follows:

- IFRS 9 applies only to financial assets within the scope of IAS 39.
- A business model test is introduced for valuation of debt instruments. If the business model is to hold the debt instrument with the intent of collecting the contractual cash flows *and* if the cash flows are solely payments of principal and interest, then the instrument can be accounted for at amortized cost. If the business model is to hold the debt instrument with the intent of selling it prior to maturity, then the instrument is valued at fair value with any gain or loss going to the income statement.
- If the financial instrument is an equity investment it is valued at fair value with any gain or loss going to other comprehensive income, unless the equity investment is held for trading in which case the gain or loss goes to the income statement.
- The existing IAS 39 classifications of held-to-maturity and available-for-sale are eliminated.
- The IAS 39 tainting provisions are eliminated.

Exposure Drafts have been published for the remaining two phases of the IFRS 9 project—Amortized Cost and Impairment in November 2009, and Hedge Accounting in December 2010.

IMPAIRMENT

Companies must evaluate their HTM securities for impairment. Indicators of impairment are similar between IFRS and U.S. GAAP. If a security is deemed to be impaired, it must be written down to its estimated recoverable amount (present value of future cash flows discounted at the original effective interest rate).

Under IFRS, if a HTM security has been written down and subsequently some or all of the impairment loss is reversed, the reversal is reflected in the income statement. The asset may not be written back up to more than the amortized cost at the time of the original impairment calculation. Reversals of prior impairment charges are not permitted under U.S. GAAP.

If an available-for-sale asset is derecognized under IFRS, the cumulative gain or loss in equity must be removed and recognized on the income statement. Under U.S. GAAP, the adjustment is between the income statement and other comprehensive income.

EXAMPLE COMPANIES

Jardine accounts for changes in FMV of AFS securities in other comprehensive income (Principal Accounting Policies). During 2009, Jardine recorded a $165 million increase in AFS assets resulting from revaluing the assets to FMV (note 19 and the statement of comprehensive income).

Nestlé also accounts for changes to AFS assets in other comprehensive income (Accounting Policies Note). The vast majority of Nestlé's liquid and noncurrent financial assets (not including receivables) are classified as AFS (note 19). Note 21.6 indicates that the fair value reserve includes gains and losses on remeasuring AFS securities. At the balance sheet date, the reserve was CHF 241 million, although the portion attributable to AFS securities is not provided.

Bayer has only €212 million of AFS securities and these are included as part of "other financial assets" on the balance sheet. Note 20 provides detail related to these assets. During the year, Bayer took a €15 million impairment charge for AFS securities.

Finally, Nokia accounts for changes in AFS securities in fair value and other reserves as part of shareholders' equity (Accounting Principles Note; Note 15 provides additional disclosures). For 2009, the AFS revaluation resulted in a €42 million increase in equity on the shareholders equity statement.

Summary and Conclusions

There are form differences between IFRS and U.S. GAAP for current assets, but for IFRS companies that use a classified balance sheet, the differences are minimal. The substantive differences for current assets include derecognition of a financial asset, inventory valuation and subsequent revaluation, treatment of held-to-maturity securities and impairment of a security's value.

Quick Reference Guide to IFRS/U.S. GAAP Differences		
Chapter 3—Current Assets		
Topic	**IFRS**	**U.S. GAAP**
Inventory methods allowed	FIFO or weighted average.	FIFO, LIFO, weighted average.
Inventory valuation	Lower of cost or NRV. Reversal of writedown required for subsequent increase.	Lower of cost or market where market is replacement cost bounded by ceiling (NRV) and floor (NRV—profit margin). Reversal of prior writedown is prohibited.
Inventory aggregation	Individual inventory items or	In general, at any level

groupings for LCM purposes	groups of related items.	(individual items, groupings, or inventory in total).
Marketable Securities	AFS, HTM, and Trading categories similar between IFRS and USG.	AFS, HTM, and Trading categories similar between IFRS and USG.
Accounting for AFS securities	For AFS, FMV revaluation changes are recognized in other comprehensive income, except for impairment losses and foreign exchange gains and losses.	For AFS, FMV revaluation changes go only to comprehensive income.
Impairment	Assets written down because of impairment may be subsequently written back up.	Impairment writedowns may not be reversed.

Self-Test

1. In practice, accounts receivable are recorded and reported similarly under U.S. GAAP and IFRS.

   a. True.
   b. False.

2. Under IFRS, what is termed "derecognition of a financial asset"?

   a. Write-up of a financial asset.
   b. Write-down of an impaired financial asset.
   c. Sale of a receivable or financial asset.

3. Under IFRS which inventory method is not allowed?

   a. LIFO.
   b. Weighted average.
   c. FIFO.

4. Under IFRS, inventories are valued at cost, not to exceed __________.

   a. Market, with upper and lower limits.
   b. Net Realizable Value.
   c. Selling price.

5. Under IAS 2 what is the basis that inventories are written down to net realizable value?

   a. On an item-by-item basis.
   b. In aggregate based on a classification of inventory.
   c. Either on an item by item basis or in the aggregate. It is the option of the company.

6. What category are derivatives, except for hedges, included in?

   a. Available-for-sale securities.
   b. Trading securities.
   c. Neither AFS nor trading securities.

7. What is the different treatment between IFRS and U.S. GAAP related to the sale of accounts receivables?

8. What are the circumstances under which inventory valuation can differ between U.S. GAAP and IFRS?

9. Detail the different requirements regarding inventory write-up between IFRS and U.S. GAAP.

10. How does IAS 39 relate to the impairment of trading, available-for-sale, and to held-to-maturity marketable securities?

Knowledge Application

Bob's Shoes, a Bermuda based company, currently uses IFRS standards to prepare their financial statements. Bob is considering changing to U.S. GAAP and has come to you for help in assessing the effect this change will have on his current assets.

Sub-case A

Bob has 2,000,000 pairs of shoes in stock that cost $12 per pair. You are also able to determine the following amounts:

NRV = $11.25

Replacement cost = $11.10

NRV minus normal profit margin = $10.85

Calculate the value of the inventory under both IFRS and U.S. GAAP.

In changing from IFRS to U.S. GAAP, would a write-down or a write-up of inventory be required? If so, by how much?

Would subsequent revaluations be possible of the market value of the shoes increases under U.S. GAAP? Under IFRS?

Sub-case B

Bob has factored $1,500,000 of his accounts receivable to generate a positive cash flow. In the agreement with the factor, Bob restricted the factor from being able to further transfer the receivables without his agreement. In effect, the receivables have been transferred with recourse.

Would the treatment be different under IFRS and U.S. GAAP? If yes, how so?

Sub-case C

Bob has recently liquidated a significant amount of the company's bond portfolio (held-to-maturity). The company auditor required Bob to reclassify the remaining bonds to available-for-sale securities. The reclassification allowed Bob to recognize a significant gain on the income statement.

Would the treatment have been different under IFRS and U.S. GAAP? If yes, how so?

Chapter 4

Property, Plant & Equipment, and Investment Property

Chapter Objectives

- Recognize the differences between IFRS and U.S. GAAP for Property, Plant, and Equipment (PPE) transactions.
- Understand the treatment differences between IFRS and U.S. GAAP for interest incurred on self-constructed assets.
- Understand the revaluation transactions and financial statement effects when valuing PPE at fair value under IFRS.
- Distinguish PPE from Investment Property and understand the treatment differences between IFRS and U.S. GAAP.

Introduction

This chapter discusses accounting for Property, Plant & Equipment (PP&E), and for Investment Property.

Assets that benefit the enterprise over multiple financial periods are capitalized. The costs associated with these assets are normally allocated to expense over the periods benefited.

Accounting issues surrounding long-lived assets include the determination of the amount of initial measurement, the methods by which to allocate asset cost to expense over time, and the amount to report at the end of subsequent reporting periods.

Property, Plant & Equipment (PP&E)

IAS 16 defines PP&E as tangible assets that are

1. Held by an enterprise for use in the production or supply of goods or services, for rental to others, or for administrative purposes, and
2. Are expected to be used during more than one period.

Initial Valuation

PP&E is initially measured at cost. The amount includes all directly attributable costs to acquire the asset and prepare it for its intended use.

Note that IAS 16 states that start-up and pre-production costs are not capitalized unless the costs are a necessary part of bringing the asset to working condition.

Construction Period Interest

Companies often construct long-term assets, such as buildings. If a company borrows money and incurs interest expense during the construction period of a long-term asset, some or all of the interest cost may need to be capitalized in accordance with the provisions of FASB ASC 835-20. Under IAS 23, two methods of accounting for construction period interest are allowed. The firm may expense it in the period incurred or capitalize interest cost in a manner similar to U.S. GAAP, if certain criteria are met. The accounting policy adopted for borrowing costs should be included in the disclosures. Under IFRS, but not U.S. GAAP, borrowing costs include the exchange rate effect on foreign currency borrowings.

IAS 23 was amended effective January 1, 2009, to require that borrowing costs directly attributable to a long-term asset acquisition or construction must be capitalized. Thus, U.S. GAAP and IFRS are now substantially the same. The January 2009 change is generally applied on a prospective basis. Thus, previously expensed interest does not need to be capitalized. Further, ongoing projects that commenced before the effective date can be accounted for under the old rules.

Exchange of Assets

IFRS and U.S. GAAP are now similar in their treatment of exchanged assets. Unless the transaction lacks commercial substance, dissimilar and similar asset exchanges are recorded at fair value and a gain or loss is recorded.

The fair value (FV) of an asset received in an exchange of similar assets can provide evidence of value for purposes of determining whether an asset impairment has occurred. For example, if a company exchanges an asset with a carrying amount of $50,000 for a similar asset (no boot) and the asset received has a fair value of $40,000, it is likely that an impairment loss of $10,000 should be recorded. Impairment rules are covered in Chapter 5.

Asset Exchanges

APB 29 states that exchanges of nonmonetary assets should be recorded at the FV of the assets exchanged. However, the standard previously set out an exception in the case that the assets were similar and a gain would otherwise be recorded. In such case, the exchange would be recorded at cost and no gain would be recorded.

SFAS 153 modified APB 29 (FASB ASC 845) and conformed U.S. GAAP to IFRS by eliminating the exception and requires exchanges to be recorded at the fair value of the assets exchanged with the reporting of any associated gain or loss. However, if the exchange transaction does not have commercial substance (defined as there being no material difference between the future cash flows of the old and new asset), no gain is recognized.

Depreciation of PP&E

Generally, IFRS and U.S. GAAP account for depreciation similarly.

IFRS requires component depreciation to be used if the components of an asset have differing patterns of benefit. U.S. GAAP permits, but does not require, component depreciation.

IAS 16 explicitly provides that the depreciation method should be reviewed periodically and, if the previously expected pattern of economic benefits changes, the method should also be changed. Under both IFRS and U.S. GAAP, a change in depreciation method is accounted for prospectively as a change in estimate. FASB ASC 250 now requires that a change in depreciation, amortization, or depletion method for long-lived, nonfinancial assets be accounted for as a change in accounting estimate effected by a change in accounting principle.

Revaluation of PP&E

Under IAS 16, PP&E is reported at cost net of depreciation and potential impairments.

Alternatively, PP&E can be revalued to fair value. Companies may use "highest and best use" to determine fair value.

IAS 16 provides that, once a company begins to revalue PP&E, it must continue to do so "...with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date." Further, when an item of PP&E is revalued the entire class of PP&E to which that asset belongs needs to be revalued as well. Classes of assets might include land, machinery, vehicles, furniture and fixtures, office equipment, and similar classifications.

The offsetting side of the revaluation journal entry will be to "revaluation surplus" in the equity section as shown in Example 4-1.

> **Note:** IAS 1 was revised in September 2007. Effective January 1, 2009, the increase/decrease from a revaluation is to be recognized in other comprehensive income and accumulated in equity under the heading "revaluation surplus."

Example 4-1

In 2008, ABC Company purchased a parcel of land that it used for a parking lot for its employees. The original purchase price was $100,000. In 2010, the Company decided to revalue its land in accordance with IAS 16. The Company hired an appraiser who determined that the land had a fair value of $150,000. ABC Company would record the following journal entry:

Land	$50,000	
Revaluation Surplus		$50,000

The credit is referred to by various names such as "revaluation equity," "revaluation reserve," "property revaluation equity," or similar.

Accumulated depreciation for a revalued asset can be either

- Restated proportionally so that the carrying amount of the revalued asset equals its revalued amount, or

- Eliminated against the gross carrying amount.

The following example illustrates how an asset is revalued using the two methods.

Example 4-2

XYZ Company purchased a building for $300,000 at the beginning of 2005. The building was being depreciated at $10,000 per year (straight line over 30 years) so that, at the end of 2009, the Company had recorded $50,000 of accumulated depreciation on the building. Thus, the carrying amount for the building is $250,000. The Company decided to revalue its assets and received a fair value appraisal of $375,000 on the building as of January 1, 2010. The entries below are as of that date.

Using the proportional method we note that the appraised value of $375,000 suggests a 50 percent increase in value over the historical cost carrying amount ($125,000 increase in value divided by the $250,000 historical cost carrying amount). This suggests that the gross asset amount and the accumulated depreciation should both be written up by that proportion, as follows:

Building ($300,000 × .5)	$150,000	
Accumulated Depreciation ($50,000 × .5)		$25,000
Revaluation Surplus		125,000

After the entry is posted, the gross asset will be $450,000, accumulated depreciation will be $75,000 and carrying amount will be $375,000. The equity section will show revaluation surplus of $125,000 representing the increase in carrying amount from $250,000 before revaluation to $375,000 after revaluation.

Using the second method noted above, the accumulated depreciation account will be reduced to zero and the gross asset will reflect the entire fair market value appraisal. Our entry would be:

Building	$75,000	
Accumulated Depreciation	50,000	
Revaluation Surplus		$125,000

After the entry is posted, the gross asset will be $375,000, accumulated depreciation will be zero, and the carrying amount will be $375,000. Again, the equity section will show the revaluation equity of $125,000 determined in the same manner as above.

Ongoing depreciation charges must reflect the new asset value. Using the information from Example 4-2, recall the Company had an asset with an original life of 30 years that had been depreciated for five years. After revaluation, the $375,000 fair value must be depreciated over the remaining 25-year life at the rate of $15,000 per year.

If the appraisal determines that the useful life changed from its originally estimated amount, then the new depreciation charge must reflect the new useful life. This would be accounted for prospectively as a change in estimate in accordance with IAS 8. Using Example 4-2, if the appraisal determined that the remaining useful life was 30 years (that is, an additional 5 years), the annual depreciation charge would be $375,000 / 30 = $12,500.

Deferred Taxes on Revaluations

Revaluation of assets may give rise to deferred taxes. Generally, if the revaluation for book purposes is matched by a revaluation for tax purposes, no temporary difference will exist. If, as is more common, a difference exists between the asset's value for books and tax, a deferred tax asset or liability must be determined. Standing Interpretation Committee Interpretation (SIC) No. 21 states that deferred taxes must be calculated on nondepreciable assets since the recovery of the carrying amount of such assets will be realized through eventual sale, not depreciation charges. The applicable tax rate would be based on a capital gains rate, if such a distinction is appropriate in the taxing jurisdiction.

Downward Revaluations

As noted above, once companies begin to revalue their assets, they must continue doing so. It is entirely possible for a company to experience a downward revaluation adjustment when assets are initially or subsequently revalued. If a downward adjustment is warranted, the revaluation equity account is reduced to the extent it exists (through comprehensive income per revised IAS 1 starting January 1, 2009) and, if any excess remains, it will be recognized in expense. Similarly, if a downward revaluation resulted in reporting an expense in a prior period, and the asset increases in value in the current period, the increase would be reported in current income to the extent of the prior expense with any excess being reported as revaluation equity.

The following example illustrates the concepts.

Example 4-3

In 2003, Jones Company purchases a parcel of land for $400,000. In 2006, the Company revalued its land assets and determined that the land was now worth $450,000. In 2008, another valuation was performed that showed the land was worth $325,000. Again, in 2010 a valuation determined the new FMV to be $425,000.

The result of the FMV determinations would be as follows:

In 2006, revaluation equity would be $50,000 and there would be no income statement effect.

In 2008, the decrease in value means that the revaluation equity would be totally reversed (new balance of zero) and an expense of $75,000 ($400,000 - $325,000) would be reported on the income statement.

In 2010, the increase in value would create $75,000 income (equal to the expense previously recorded) and revaluation equity of $25,000.

If the 2010 value was, say, $375,000, the Company would have reported a $50,000 income item and no revaluation equity. The $50,000 represents the increase from $325,000 to $375,000. There would still be $25,000 of income that could be recognized on the income statement for any future valuation increases.

The revaluation adjustment process indicated above is calculated on an asset-by-asset basis, not by asset class. Thus, an income statement effect can occur if an asset decreases in FMV even though the asset class to which the asset belongs experiences an overall increase (or vice versa).

Disclosure Requirements for Long-Term Assets

Required disclosures for long-term assets are more extensive under IFRS than under U.S. GAAP. In addition to disclosure of depreciation method and lives, IFRS require companies to provide a reconciliation of beginning and ending balances of long-term assets including, among other things, additions, dispositions, increases or decreases from asset revaluation, and other material reconciling items. The reconciliation is required only for the current period even though multiple periods are shown on the balance sheet.

IAS 16 (for property, plant, and equipment) and IAS 38 (for intangibles) provide for similar reconciliation disclosures.

Sample companies have extensive disclosure concerning long-term tangible and intangible assets. This disclosure is presented in multiple reconciliation notes: Jardine in notes 14 and 15; Nestlé in notes 13 and 15; Bayer in notes 17 and 18; and Nokia in notes 12 and 13.

If PP&E is revalued, additional disclosures are required, including

1. The effective date of the revaluation;
2. Whether an independent valuer was involved;
3. The methods and significant assumptions applied in estimating the items' fair values;
4. The extent to which the items' fair values were determined directly by reference to observable prices in an active market or recent market transactions on arm's-length terms or were estimated using other valuation techniques;
5. For each revalued class of property, plant, and equipment, the carrying amount that would have been recognized had the assets been carried under the cost model; and
6. The revaluation surplus, indicating the change for the period and any restrictions on the distributions of the balance to shareholders.

Jardine is the only example company that revalues its property, all others use cost. In its Principal Accounting Policies note Jardine provides some of the disclosures related to the revaluation. Independent valuations are performed every three years, changes in value are normally reported in other comprehensive income and a revaluation reserve in equity, and depreciation is calculated on the revalued amount. There was a net $13 million decrease in tangible assets from revaluation (note 15). The asset revaluation reserve in the equity statement increased by $12 million. This reserve account is affected by more than just the tangible asset revaluation. The text in note 15 indicates that the tangible asset properties were revalued by the independent appraisers as of the end of 2008.

Investment Property

IAS 40 defines investment property as property held to earn rentals or for capital appreciation or both. Investment property is distinguished from PP&E in that PP&E is used in the production or supply of goods or services or for administrative purposes or for sale in the ordinary course of business. Rental property (but not rentals where significant services are provided, such as a hotel) and land held for investment are examples of investment property.

Investment property may be accounted for using either a "fair value model" or a "cost model." Under the fair value model, investment property should be measured at fair value and changes to fair value are recognized on the income statement. If the fair value model is used for some investment property, it must be used for all investment property (there are some specific exceptions noted in the standard). The cost model is the same as the benchmark treatment under IAS 16—property is measured at cost less accumulated depreciation. If the cost method is used, the company must disclose the fair value of the investment property in the notes.

Note that under IAS 40, the preferred treatment is to record investment property at fair value, not cost. Thus, it would be highly unlikely that a company that chose fair value model as its accounting policy could justify a subsequent change to the cost model.

Various disclosures are required, including

- Whether the company applies the fair value model or cost model.
- If it applies the fair value model, whether, and in what circumstances, property interests held under operating leases are classified and accounted for as investment property.
- When classification is difficult, the criteria it uses to distinguish investment property from owner-occupied property and from property held for sale in the ordinary course of business.
- The methods and significant assumptions applied in determining fair value.
- The extent to which an independent appraiser was used. If there has been no such valuation, that fact is to be disclosed.
- The amounts recognized in profit or loss for
    - Rental income from investment property;
    - Direct operating expenses arising from investment property that generated rental income during the period;
    - Direct operating expenses arising from investment property that did not generate rental income during the period; and,
    - The cumulative change in fair value recognized in profit or loss on a sale of investment property from a pool of assets in which the cost model is used into a pool in which the fair value model is used.

- The existence and amounts of restrictions on the realizability of investment property or the remittance of income and proceeds of disposal.
- Contractual obligations to purchase, construct, or develop investment property or for repairs, maintenance, or enhancements.

There are no corresponding fair value provisions under U.S. GAAP, and investment properties are accounted for at depreciated cost. In addition, disclosure requirements are not as detailed in U.S. GAAP as compared with IFRS regarding this topic.

Jardine owns investment properties that they account for under the fair value methods outlined in IAS 40. They also have a significant ownership interest in, primarily, Hongkong Land Holdings and other wholly or partially owned subsidiaries. All these entities revalue their investments in accordance with IAS 40 with any increases or decreases recorded on the income statement. For 2009, Jardine reported a decrease in the fair value of investment properties, held through associates and joint ventures, of $356 million (see note 8). They also recorded a $1.91 billion revaluation gain from investment properties (see note 16 and the "non-trading items" column on the income statement). For plantations that Jardine holds directly, they had a $64 million loss (see note 17). The plantation revaluation losses are recognized in profit and loss (see note 1).

Summary and Conclusions

There are some substantive differences between U.S. GAAP and IFRS when accounting for PPE and Investment Property. Differences in accounting for PPE include the treatment of interest on self-constructed assets, revaluation of PPE, and disclosure requirements for long-term assets. The primary difference in accounting for Investment Property includes the preferred use of the fair value model under IFRS.

Quick Reference Guide to IFRS/U.S. GAAP Differences		
Chapter 4—Property, Plant & Equipment, and Investment Property		
Topic	**IFRS**	**U.S. GAAP**
PP&E		
Valuation	Benchmark is cost minus accumulated depreciation. Alternative treatment is to revalue at FV (may use highest and best use). Revaluation increase goes directly to equity. Deferred taxes are recognized in equity on the revaluation amount. Revaluation decrease is expensed (after recovering any increases for the asset). Revaluation can be used for tangible and intangible assets (not goodwill).	Cost minus accumulated depreciation.

Interest during construction period	Required to be capitalized as of January 1, 2009, although interest of projects existing at that time can continue to be expensed if that method was used previously.	Required to be capitalized.
Investment Property		
Defined	Property held to earn rentals or for capital appreciation.	No provisions.
Valuation	Fair value is benchmark. Cost is permitted. For fair value, report value changes on income statement.	No provisions.
Interest during construction period	Expensed or capitalized—prior to 1/1/09; after 1/1/09 must be capitalized.	Required to be capitalized.

Self-Test

1. Which International Accounting Standard is the authoritative literature that defines property, plant, and equipment for IFRS?

   a. IFRS 3.
   b. IAS 16.
   c. IAS 14.

2. Under IFRS, how is the exchange of dissimilar assets recorded?

   a. At cost.
   b. At fair market value with a gain or loss recorded.
   c. At fair market value with no gain or loss recorded.

3. What is the offsetting side of the revaluation journal entry with a debit to equipment for an increase in equipment value?

   a. Revaluation surplus.
   b. Gain on revaluation.
   c. Accumulated depreciation.

4. For which type of asset must deferred taxes be calculated for the unrealized increase in asset value?

   a. Depreciable equipment.
   b. Land.
   c. Must be calculated for all assets.

5. A company must continue to revalue their assets once it begins even if a company experiences a downward revaluation adjustment.

   a. True.
   b. False.

6. Which disclosure is an additional requirement of IFRS over U.S. GAAP requirements?

   a. Depreciation method.
   b. Reconciliation of beginning and ending balances of long-term assets including additions, dispositions, increases, or decreases from asset revaluation and other material reconciling items.
   c. There are no additional requirements of IFRS over U.S. GAAP.

7. ABC Company purchased a building for $600,000 in 2006. The building was being depreciated at $20,000 per year (straight line over 30 years) so that, at the end of 2010, the Company had recorded $100,000 of accumulated depreciation on the building. Thus, the carrying amount for the building is $500,000. The Company decided to revalue its assets and received a fair market value appraisal of $750,000 on the building as of January 1, 2011. What are the journal entries as of that date under all allowable methods of treatment of accumulated depreciation for revalued assets?

Proportional Method:

Gross Method:

Knowledge Application

1. On January 1, 2007, the Best Use Company, an IFRS compliant company, purchased a parcel of land for use as a recreation area for its employees. The original purchase price of the land was $150,000. The company uses the alternative treatment of asset valuation under IAS 16. At December 31, 2008, the company engaged an appraiser who determined that the land has a fair value of $225,000. Appraisal at December 31, 2009, and December 31, 2010, determined that the FMV of the land was $230,000 and $252,000, respectively.

    a. What journal entries, if any, would Best Use Co. make at December 31, 2008, December 31, 2009, and December 31, 2010?

    b. What would be the Balance Sheet and Income Statement effects of the above entries?

Chapter 5

Leases, Intangibles, and Asset Impairment

Chapter Objectives

- Understand the similarities and differences between IFRS and U.S. GAAP in accounting for leases.
- Recognize the treatment differences between IFRS and U.S. GAAP in accounting for the impairment of long-lived assets.

Introduction

This chapter completes the analysis of long-lived assets started in Chapter 4 by examining the accounting for leases, intangible assets, and asset impairment.

Leases

Leases are covered under IAS 17. Under IAS 17, a lease is classified as either an operating lease or a finance lease. Note that finance leases are referred to as capital leases under U.S. GAAP. We will use the IFRS nomenclature in this discussion.

IAS 17 defines a finance lease (again, "capital lease" in U.S. parlance) as a lease that "…transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred." Conceptually, this is similar to the provisions of U.S. GAAP.

IFRS gives the following examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease:

1. The lease transfers ownership to the lessee,
2. The lessee has a bargain purchase option,
3. The lease term is for the "major part" of the economic life of the asset,
4. The present value of the minimum lease payments "amounts to at least substantially all of the fair value of the leased asset,"
5. The leased assets are of a specialized nature such that only the lessee can use them,
6. If the lease is cancelable by the lessee, the lessor's costs associated with the cancellation are borne by the lessee,

7. Gains or losses associated with fluctuations in the leased asset FMV are borne by the lessee, and
8. The lessee can continue to lease the asset for a secondary period for a substantially lower rent than market rent.

There are two very important issues associated with the above criteria.

First, criteria 5 through 8 are not provided in U.S. rules. In each case, the rule gets to the concept of a transfer of the risks and rewards of the asset to the lessee. It should be noted that IFRS rules imply that points 6 through 8 are not determinative in nature, but are suggestive. IAS 17 states that the final three criteria "could lead" to classification of an asset as a financing lease.

The second difference is that, although the first four criteria are similar to the criteria under U.S. GAAP rules, they are not identical. Specifically, in the case of points 3 and 4, U.S. rules provide for numerical "bright lines" that differentiate between capital and operating status. Such approach is not taken by IFRS.

Taken together, these two issues point out a fundamental underlying philosophical difference between IFRS and U.S. GAAP as concerns leases—U.S. rules follow a bright-line approach while IFRS leans more to a "facts and circumstances" approach.

Some may say that using facts and circumstances can lead to differences in accounting outcome with similar leases. However, it is also instructive to point out that there is nothing magic about the numerical benchmarks of U.S. GAAP. After all, it can be easily argued that a lease for 74 percent of an asset's useful life with payments equal to 89 percent of the asset's FMV is, in substance, a financing/capital lease.

We do not suggest that one approach is better or worse than the other. Both standards seek to record as financing/capital leases those transactions that transfer the risks and rewards of ownership to the lessees. U.S. GAAP has chosen to be more procedural and IFRS has selected a route that is less rigid. There are advantages and disadvantages to both approaches.

The upshot of the IFRS/U.S. GAAP approaches is that leases can be classified as operating under one standard and financing under the other. This will often occur where a lease is structured (or happens) to miss the U.S. GAAP bright lines but will still meet IFRS capitalization criteria.

An example will illustrate the concept. ABC Company leases an asset with an economic life of 10 years under a 7-year lease that does not transfer ownership or contain a bargain purchase option. The asset has a fair market value of $50,000, and payments under the lease have a present value of $43,000. Under U.S. GAAP, the lease would be classified as an operating lease since none of the four criteria in FASB ASC 840 are met. Under IFRS, it is likely that the lease would be classified as a financing lease because the lease term is for a "major part" the economic life and the present value of the payments can be considered to be equal to "substantially all" of the fair value of the leased asset.

Lease Disclosures

Lessees must provide a general description of significant financing or operating leasing arrangements. Additional disclosures for finance leases include

- The net carrying amount of each class of assets;
- A reconciliation between gross minimum lease payments and their present value;
- The minimum lease payments due within one year, between one year and five years, and over five years;
- Contingent rents paid or accrued;
- The total of future minimum sublease payments expected to be received under noncancellable subleases; and,
- A general description of the lessee's material leasing arrangements, including the basis on which contingent rent is payable, the existence and terms of renewal or purchase options and escalation clauses, and restrictions imposed.

For operating leases, disclosures include

- Future payments in a manner similar to that for finance leases; and
- The amount of lease and sublease payments recognized as an expense in the period, with separate amounts for minimum lease payments, contingent rents, and sublease payments.

Lessor disclosures generally mirror lessee disclosures. Lessors must also report any impairment losses recognized or reversed during the period.

Leased assets and liabilities are subject to the provisions of IAS 32 concerning financial instruments.

Other Lease Issues

In the case of a lease of land and buildings, if title to both components transfers by the end of the lease term, the lease is normally accounted for as a financing lease. If title to the land does not transfer, the lessee allocates the minimum lease payments to the land and building elements on the basis of relative fair values at the inception of the lease. The land element is normally accounted for as an operating lease and the building element is either a financing lease or an operating lease determined in accordance with normal criteria.

Under IFRS, if the amount allocated to the land is immaterial, the land and buildings can be treated as a single unit for purposes of lease classification. Under U.S. GAAP, the land and buildings are treated as one unit if the value of the land is less than 25 percent of the value of the leased property.

Under IFRS, the interest rate used to compute the present value of minimum lease payments is the rate implicit in the lease; the lessee's incremental borrowing rate may be used if the rate implicit in the lease is impracticable to determine. Under U.S. GAAP, the implicit rate is used only if it is less than the lessee's incremental borrowing rate. Practically, the difference may not matter. If the lessee's rate is less than the implicit rate, the lessee is likely to borrow and buy the asset directly to lower its net cost.

Minimum lease payments under both U.S. GAAP and IFRS include, among other things, any guarantee of the residual by the lessee. Under IFRS, minimum lease payments also include a guarantee of the residual value by a third-party that is capable of honoring the guarantee. However, under U.S. GAAP, a third-party guarantee is not included. Thus, if a third party residual guarantee exists, minimum lease payments will be higher under IFRS.

If an asset is part of a sale and leaseback transaction, the accounting treatment can differ. If the leased asset is accounted for as a finance (or capital) lease, the seller/lessee will recognize any gain over the lease term under IFRS and over the useful life of the asset under U.S. GAAP. If the leased asset is accounted for as an operating lease, the seller/lessee will immediately recognize any gain under IFRS. Under U.S. GAAP, the gain is recognized over the lease term.

Under FASB ASC 840, a lessor will classify a lease as capital if it meets one or more of the four basic criteria *and* if it meets two additional points (lease payment collectability is reasonably assured and there are no uncertainties concerning unreimbursable costs). IAS 17 does not contain these two additional criteria.

Lessees of investment property held under financing leases should be accounted for under the provisions of IAS 40—Investment Property (see discussion in Chapter 4).

There are a number of areas covered under U.S. GAAP that are not discussed under IFRS. These areas include accounting for termination of a lease, renewal or extension of an existing lease, leases between related parties, and accounting for subleases. Although U.S. GAAP provides the most comprehensive guidance in these areas, it represents only one possible approach and is not authoritative guidance under IFRS.

Leveraged leases are covered extensively under U.S. GAAP, but are only briefly outlined in IFRS. Other lease accounting provisions are materially the same under IFRS and U.S. GAAP.

Leases are one of the main joint projects for the IASB and FASB. Both boards have issued discussion papers on March 19, 2009, regarding their preliminary views of leases. The discussion papers discuss lease accounting issues, specifically from the lessee's perspective. The Boards concluded that whether classified as an operating lease or a finance lease, lease contracts always create rights and obligations that meet the definition of assets and liabilities. As a result, the Boards are thinking that lease contract "assets" and "liabilities" be recognized in the financial statements of lessees, for both operating and finance (capital) leases. The asset recognized would be the lessee's right to use the leased item, and the liability would be the lessee's obligation to pay for the leased asset.

On August 17, 2010, the IASB and FASB issued a joint Exposure Draft (ED) on Leases. The ED is generally consistent with the discussion papers. The ED eliminates the capital/operating distinction and, instead, introduces the "right-of-use model." Lessees would record an asset and liability for all leases. Lessors would recognize an asset representing the right to receive lease payments. They would also either recognize a lease liability, while continuing to recognize the underlying asset or would eliminate the underlying asset. Short term leases (12 months or less) would have simplified accounting.

The FASB and IASB anticipate promulgating identical final rules during 2011.

Example Companies

The example companies used in this text have relatively minimal disclosure about their leases, generally because the valuations are relatively small. Those with financing leases include the asset amounts in their Property, Plant & Equipment (PP&E) classification.

Jardine (Appendix A) owns leasehold properties that it accounts for as tangible assets and investment properties, discussed in notes 15 and 16, respectively. Generally, Jardine's leasehold properties are related to real estate and are accounted for as operating leases (see note 1).

Nestlé (Appendix B) discloses they have CHF 262 million of finance lease assets as part of its CHF 21.6 billion of net PP&E (note 13) and CHF 329 million of finance lease liabilities (note 26.2).

Bayer (Appendix C) has net PP&E of €9.5 billion that includes €469 million total net value of assets under finance leases (note 18). These assets carry a €550 million net lease liability as reported in note 27.

Nokia (Appendix D) has operating leases, but no material financing leases (see Leases under note 1).

Intangible Assets

Under IAS 38, an intangible asset is "an identifiable non-monetary asset without physical substance." Intangible assets include patents, copyrights, brand names, customer lists, trade names, and other rights that generally can be conveyed from one owner to another without transferring physical assets. Goodwill is not included in the definition of intangible assets because it is not identifiable, that is, because it cannot be separated or divided from the entity and transferred from one owner to another and does not arise from contractual or other legal rights.

Intangible assets are included as one of the projects covered by the MoU between the IASB and the FASB, and the IASB has already issued a revised IAS 38 as a result. The revised IAS 38 is effective for annual periods beginning on or after March 31, 2004. This course includes changes made by this revised standard.

Intangibles must meet the general asset recognition criteria. These criteria include the following:

- It is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and
- The cost of the asset can be measured reliably.

Intangibles can be acquired in a variety of ways, including

- By separate purchase.
- As part of a business combination.
- By a government grant.
- By exchange of assets.

- By self-creation (internal generation).

Purchased Intangible Assets

Purchased intangible assets are capitalized at the fair value of the consideration paid, which should be the "cost" of the purchased intangible assets. The treatment subsequent to acquisition for these assets is the same as other intangible assets.

Self-Created Intangible Assets

Most self-created (internally-generated) intangible assets are expensed as incurred. Many self-created intangibles would be eligible for capitalization treatment if they were purchased. Primary roadblocks to capitalization are difficulty in determining that amounts expended will result in probable future economic benefits and that the cost of a self-created intangible is often difficult or impossible to measure.

In the case of self-created research and development (R&D), IFRS and U.S. GAAP differ somewhat. IAS 38 states that the costs are to be split into a research phase and a development phase. Research and development carry definitions similar to that found under U.S. GAAP.

Costs in a research phase are to be expensed. Costs during the development phase can be capitalized under IAS 38 if the company can demonstrate *all* of the following:

- The technical feasibility of completing the asset so it will be available for sale or use.
- The intention to complete the asset and either use or sell it.
- The ability to use or sell the asset.
- How the asset will generate probable future economic benefit (that is, the existence of a sales market or the usefulness of the asset for internal use).
- The availability of adequate resources to complete and use or sell the asset.
- The ability to reliably measure the expenditures during development.

Subsequent expenditures on purchased in-process research and development are capitalized if they meet the definition of development.

Internally generated brands, mastheads, publishing titles, and customer lists should not be recognized as intangibles that can be capitalized. The Standard takes the view that such assets cannot be distinguished from the cost of developing or maintaining the business as a whole.

Under U.S. GAAP, all costs of research and development are expensed, including subsequent expenditures on purchased in-process research and development.

Revaluation of Intangible Assets

Subsequent to initial recognition, IAS 38 permits intangible assets to be measured under one of two methods.

Intangibles may be reported at cost, less any accumulated amortization and accumulated impairment losses (if any).

Alternatively, intangibles may be reported at the revalued amount less any subsequent accumulated amortization and accumulated impairment losses (if any). This treatment is only permitted if fair value can be determined with reference to an active market for the intangible asset. This restriction suggests that it will be unusual for the vast majority of intangible assets. The Standard states that an active market might exist for taxi licenses, fishing licenses, or production quotas. The Standard also suggests that patents, trademarks, brands, and similar assets do not have an active market since each asset is unique.

Any revaluation amount should be shown in revaluation surplus using the procedures noted in Chapter 4 concerning PP&E. If the revaluation method is chosen, revaluations must be made regularly.

U.S. GAAP does not permit revaluations.

Measurement Subsequent to Acquisition

Like U.S. GAAP, intangible assets are classified under IFRS as

- *Indefinite life*—No foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.
- *Finite life*—A limited period of benefit to the entity.

For intangible assets with finite lives, the cost, less the residual value of an intangible asset with a finite useful life, should be amortized over that life:

- The amortization method should reflect the pattern of benefits.
- If the pattern cannot be determined reliably, amortize by the straight-line method.
- The amortization charge is recognized in profit or loss unless another IFRS permits or requires that it be included in the cost of another asset.
- The amortization period should be reviewed at least annually.

The asset should also be assessed for impairment in accordance with IAS 36.

For intangible assets with indefinite lives, the intangible asset should not be amortized. The intangible asset's useful life should be reviewed each reporting period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite should be accounted for as a change in an accounting estimate in accordance with IAS 8. The asset should also be assessed for impairment annually, in accordance with IAS 36.

Goodwill

Goodwill is potentially created in a business combination. These transactions are covered in more detail in Chapter 8. IFRS 3 (Revised in 2008) is the primary Statement concerning goodwill.

In general, goodwill created in a business combination is capitalized and, just like under U.S. GAAP, goodwill is not amortized, but is examined at least annually for impairment.

Example Companies

Disclosures concerning intangible assets are relatively straightforward for our sample companies. Jardine discusses intangibles in its principal accounting policies (note 1) and numerically in note 14. Nestlé discusses intangibles in the summary of accounting policies and numerically in note 15. Bayer explains its intangible accounting in note 4 and note 17 (quite extensively in the latter note). Nokia takes an approach similar to Nestlé by explaining the accounting in the accounting principles note and providing numerical detail in note 12.

Impairment of Long-Lived Assets

Long-lived assets have a value that is based, in large part, on the economic value an enterprise expects to receive from the use of the asset. This economic value is often based on expected discounted cash flows. Sometimes, events occur that change the expectations as to economic value. These changes often cause a reduction in the value of the asset. An example might be a machine that is purchased to manufacture a product. The enterprise expects that the machine will produce a certain number of units and that those units will be able to be sold for a certain profit. If subsequent events show that either expectation is materially overstated, it is entirely likely that the machine will fall in value (beyond normal expectations).

IAS 36 and FASB ASC 360 were promulgated to formally account for impairment in the value of long-lived assets. An asset may be impaired if its carrying amount is not recoverable. There are some material differences between IFRS and U.S. GAAP when accounting for asset impairment.

Under IFRS, as of each balance sheet date, an entity must determine whether there are conditions that would indicate that an impairment may have occurred. Signs of possible impairment include, but are not limited to, the following:

1. Asset market value has declined significantly more than would normally be expected as a result of passage of time or normal use.
2. Adverse changes in the technological, market, economic, or legal environments of the enterprise have occurred or are expected to occur in the near future.
3. Market interest rates have increased during the period and those increases are likely to affect discount rates used in asset valuation.
4. For public enterprises, the carrying amount of the net assets of the company is more than its market valuation.

5. Evidence exists concerning obsolescence or physical damage to an asset.
6. An adverse effect has occurred in the extent to which or manner in which an asset is used or is expected to be used. Examples include plans to discontinue an operation or dispose of an asset.
7. Evidence indicates that the economic performance of an asset is, or will be, worse than expected.

Impairment indicators are also provided in FASB ASC 360. While the two lists are not identical, they both represent a non-exclusive list of conditions under which impairment is suggested.

Under IFRS, if any of the above conditions are present, a company is required to make a formal estimate of the recoverable amount of the asset(s) affected. Note that there is not a requirement to formally determine impairment of all long-lived assets at each balance sheet date, only if indicators suggest that impairment risk is possible.

IAS 36 defines recoverable amount as the greater of fair value less costs to sale or value in use. Value in use is the present value of the future cash flows from the asset.

Future cash flows include cash inflows and outflows associated with the asset, including future expenditures necessary to maintain or sustain the asset and any net cash flows from disposal. Cash flows should be estimated for the asset in its current condition. Cash flows should not include cash inflows or outflows from financing activities or any tax payments pertaining to the asset or its operations.

The discount rate to be used should be a pre-tax rate that reflects the “current market assessments of the time value of money and the risks specific to the asset.” If the cash flow estimates have been adjusted for future risks, the discount rate should not incorporate those same risks. The discount rate for impairment purposes should pertain to the asset(s) in question, not the rate appropriate for the capital structure of the company, because it is likely that the cash flow and risk associated with an asset are not the same as those faced by the enterprise as a whole.

As a practical matter, fair value less costs to sale should reasonably approximate value in use.

If the carrying amount is greater than the recoverable amount, the asset is written down to the recoverable amount and an impairment loss is recorded unless stipulated otherwise by another IFRS statement. This loss is reported on the income statement.

If the enterprise revalues long-lived assets to fair value under the provisions of IAS 16 (see Chapter 4), the impairment loss is not reported on the income statement but, instead, is reported as a reduction in revaluation surplus in the equity section of the balance sheet to the extent sufficient revaluation surplus exists for that asset. If insufficient revaluation surplus exists for that asset, any excess is reported as an impairment loss on the income statement.

After recording an impairment loss, future depreciation charges associated with the asset should be adjusted taking into account the new carrying amount.

Comparison with U.S. GAAP

Note that under IFRS, impairment is suggested if one of the indicators occurs. Then the asset carrying amount is compared with its recoverable amount, determined using the present value of net cash flows or net selling price.

Under U.S. GAAP, a company will determine if one of the indicators indicates that an asset might be impaired. If there is such an indication, the company performs a recovery test whereby the asset's net carrying amount is compared to the *undiscounted* future net cash flows from the asset. If the undiscounted cash flows are greater than the carrying amount, no impairment is recorded. However, if the undiscounted cash flows are less than the carrying value, a loss must be recognized. The loss to be reported is the difference between the carrying amount and the asset's *fair value*.

Since the fair value of an asset reasonably approximates the present value of future cash flows, it is easy to see that impairments determined under IFRS may not result in an impairment loss under U.S. GAAP. Such a situation would arise when the carrying amount is less than the undiscounted future cash flows but more than the discounted future cash flows.

Here is an example. Assume that XYZ Company holds an asset with a carrying amount of $100,000. The company believes the asset might be impaired. The company determines the future net cash flows from the asset will be $11,000 per year for 10 years ($110,000 total). Under U.S. GAAP, no impairment is recorded because the undiscounted cash flows are greater than the carrying amount of the asset.

Under IFRS, the company must compare the carrying amount with its recoverable amount, in this case assumed to be the present value of the net cash flows. In this example, the present value is $84,939, using a discount rate of 5 percent. Thus, under IFRS, the company would record an impairment loss of $15,061.

Clearly, as the discount rate increases and/or the number of future periods increases, the likelihood of recording an impairment loss under IFRS will increase as well.

The FASB and IASB are currently working on a joint impairment project. At the date of this writing, staff work was in progress to determine whether major differences should be eliminated.

Subsequent Reversals of Impairment Losses

Under IFRS, an enterprise is required to reverse a previously recorded impairment loss in certain circumstances.

If an impairment loss is reported in a prior period, and if there has been a change in the estimates used to determine the impairment loss, then the carrying amount of the asset should be increased to its new recoverable amount. A change in discount rate does not qualify as a change in an estimate used.

The new asset value cannot exceed the carrying amount that would have been in place for the asset (net of depreciation) had no impairment loss been recognized in the first place. The following example illustrates this concept.

Example 5-1

Assume an asset was purchased for $10,000. The asset was to be depreciated over 10 years using straight-line with no salvage value. At the end of year two (when the carrying amount was $8,000) an impairment loss was recorded that reduced the carrying amount to $5,000. At the end of year three (the following year), it was determined that the estimates used to calculate the impairment loss had changed and the new fair value of the asset was $8,500. Had no impairment loss been recorded at the end of year 2, the asset would have had a carrying amount of $7,000 at the end of year three ($10,000 initial cost minus three years of depreciation at $1,000 per year). Thus, the impairment reversal would increase the carrying amount to a maximum of $7,000.

Any impairment reversal should only be recognized if there has been a change in the estimates used to determine the recoverable amount of the asset since the impairment loss was recorded. However, the asset value might become greater than the carrying amount simply because the present value of the future cash flows increases as the cash flows become closer and more determinable.

Any appropriate reversal of a previously recorded impairment should be recognized on the income statement. If long-lived assets are revalued to fair value in accordance with IAS 16 (see Chapter 4), the impairment reversal is reported as an increase in revaluation equity on the balance sheet. After January 1, 2009, this reversal for revalued assets will also affect other comprehensive income.

As with impairment decreases, future depreciation charges must be adjusted to account for the effect of any impairment reversals.

U.S. GAAP does not permit the reversal of impairment decreases previously recorded.

Impairment of Goodwill

Goodwill created in a transaction accounted for under purchase accounting must be evaluated for impairment in accordance with the provisions of IAS 36.

Per IAS 36, upon acquisition date, goodwill is to be allocated to each of the acquirer's cash-generating units, or groups of cash generating units, that are expected to benefit from the acquisition/business combination. Each unit or group of units to which goodwill is allocated should represent the lowest level within the entity at which the goodwill is monitored for internal management purposes, and not be larger than an operating segment.

Under IAS 36, goodwill is to be tested for impairment annually and whenever there is an indication that the unit may be impaired, by cash generating unit. The impairment test is to be performed at the same time every year; however, different cash generating units can be tested at different times during the year. In addition, reversals of goodwill impairment losses are prohibited. Recognition of internally generated goodwill is also prohibited.

Under IAS 36 an impairment loss is first absorbed by goodwill and, if no goodwill remains, then by the asset or assets in the appropriate grouping.

Under U.S. GAAP, goodwill is evaluated annually and whenever there is an indication that the unit may be impaired at the reporting unit level. A reporting unit is an operating segment or one unit below. A reporting unit under U.S. GAAP is often a higher level than a cash-generating unit under IFRS. This can result in the offsetting of impairment in one cash-generating unit by allowing for "extra headroom" in other cash-generating units. Thus, reported impairment may be lower under U.S. GAAP.

RESEARCH & DEVELOPMENT

Under IFRS 3, purchased in-process R&D can be recognized as an acquired finite life intangible asset (amortized) if the project meets the definition of an intangible asset and its fair value can be measured reliably; otherwise, it is recognized as part of goodwill. R&D is currently expensed in the U.S.; however, FASB ASC 805 requires that acquired R&D be recognized as a separate intangible asset. This asset is subject to impairment testing under FASB ASC 350.

Impairment Disclosures

IAS 36 requires companies to disclose the amount of impairment loss and/or reversal reported in earnings (or in equity for assets recorded at fair value) for each class of long-lived assets. Note that there is no materiality threshold for these disclosures.

If the impairment loss or reversal is material to the financial statements taken as a whole, the company should disclose the following for each material impairment loss recognized or reversed during the period for an individual asset:

- The events that led to recognition or reversal
- The amount recognized or reversed
- The nature of the asset and the segment to which the asset belongs
- The description of the asset grouping or unit when impairment determinations are not made on the basis of individual assets
- Whether the company used net selling price or value in use
- If net selling price was used, the basis by which it was determined
- If value in use was applied, the discount rates used in the current estimate and the previous estimate (if any)

Other Impairment Issues

For both IFRS and U.S. GAAP, assets should be grouped at the lowest level at which there are identifiable cash flows. This might be at the level of an individual asset, but could be a product line or set of assets where, for example, machine 1 produces output for machine 2, that produces output for machine 3 that is then sold. If the machines have no particular value individually, but only as a group, the appropriate analysis might be for the three machines together.

IFRS and U.S. GAAP both require that if a long-lived productive asset is intended to be disposed of in a future reporting period rather than be held for use, the carrying amount of the asset should not exceed the fair value less selling costs. Any impairment should be reported on the income statement. Impairments on revalued assets are recognized in other comprehensive income per the revised IAS 1, effective for annual periods beginning on or after January 1, 2009.

Under IFRS, effective January 1, 2010, the largest cash generating unit to which goodwill should be allocated for impairment testing is an operating segment as defined in IFRS 8.

Example Companies

Jardine reports impairment losses in multiple places. The impairment losses (most of them very small) are in notes 6, 8, 13, 14, and 15.

Nestlé reports impairment losses of CHF 170 million pertaining to PP&E in the body of note 13, and CHF 57 million goodwill impairment in note 14.

Bayer reports a €61 million intangible asset impairment in note 17. A €88 million PP&E impairment write-down is discussed in the text of note 18.

Nokia accumulates information related to impairments in note 7. They recorded a total of slightly more than €1 billion of impairments across various assets, predominately goodwill.

As noted above, impairments or recoveries of prior impairments must be disclosed under IFRS regardless of materiality. The disclosures of our example companies are consistent with that approach.

Deferred Tax Assets

Under U.S. GAAP, if a company has deferred tax assets (DTA), it needs to determine whether a valuation allowance is needed. Since an asset is presumed to have future economic benefit, the DTA must be tested, in effect, for that future benefit. A valuation allowance is required if it is "more likely than not" that some or all of the DTA will not be realized. Thus, under U.S. GAAP, a company would report the DTA at gross and then record a valuation allowance, if needed, to report the net DTA at the amount expected to be realized in the future. Both the gross DTA and the allowance are reported in the notes.

Under IFRS, the end result is the same as under U.S. GAAP, but the execution is different. IFRS rules state that a DTA is to be recorded only if there is expected to be sufficient future profit to realize the DTA; otherwise the DTA is ignored (in whole or in part, as appropriate). The test for future realization is substantially the same under IFRS and U.S. GAAP. Thus, IFRS will report only the net amount of a DTA, not the gross and the allowance. The following example will illustrate the issues presented.

Example 5-2

XYZ Company has determined that it has a DTA in the amount of $60,000. The Company has determined that there will be sufficient future profit to realize $40,000 of the DTA. Under U.S. GAAP, the Company will record a DTA of $60,000 and a valuation allowance of $20,000 (net DTA of $40,000). Under IFRS, the Company will report a DTA of $40,000 with no allowance.

Summary and Conclusions

The accounting for leases under U.S. GAAP and IFRS are similar, however, the IFRS pronouncement is more of a principles-based approach whereas the U.S. GAAP approach provides more detailed implementation guidance. Other differences between IFRS and U.S. GAAP for leases include the treatment of real estate leases, the discount rates used in the lease calculations, leases involving investment property, and various other issues that are covered under U.S. GAAP and not referred to under IFRS. Intangible assets are largely similar across the two sets of authoritative literature with the exception of the treatment of goodwill, development costs, and the revaluation of intangible assets. Impairment of long-lived assets is considered under both IFRS and U.S. GAAP as is asset impairment. Accounting for deferred tax assets is similar under IFRS and U.S. GAAP although IFRS reports tax assets on a net basis while U.S. GAAP reports at gross with a valuation allowance.

Quick Reference Guide to IFRS/U.S. GAAP Differences		
Chapter 5—Leases, Intangibles, and Asset Impairment		
Impairment of Assets	**IFRS**	**U.S. GAAP**
Existence of	Carrying amount in excess of “recoverable amount.” This amount is the greater of (a) the asset’s selling price or (b) its value in use (PV of future cash flows).	Carrying amount in excess of undiscounted future cash flows.
Amount of loss (if impairment exists)	Difference between carrying amount and recoverable amount.	Difference between carrying amount and fair value. Fair value is either the market value or the PV of future cash flows.
Reversal of prior impairment	Yes, except for goodwill.	Prohibited.
R&D	Research costs are expensed. Development costs can be capitalized if certain criteria met.	Research and development costs are expensed.
Lease Accounting	Similar to U.S.GAAP except that “bright line” criteria are not used. Examines risks and rewards of ownership. Eight criteria. Amount initially recorded on a capital lease is the lesser of the asset FMV or the PV of the minimum lease payments (MLP).	Four criteria. Amount initially recorded on a capital lease is the PV of the MLP.
Deferred Tax Assets	DTA is recorded only if it is probable that sufficient future profit will be available to utilize the DTA.	DTA is recognized in full. Valuation allowance may be required if it is more likely than not that some or all of the DTA will not be realized.

Self-Test

1. Which term for leases is the same under IFRS and U.S. GAAP?

    a. Finance lease.
    b. Operating lease.
    c. Capital lease.

2. Lessee disclosures generally mirror lessor disclosures in IFRS.

    a. True.
    b. False.

3. Under IFRS, the lease payment collectability must be reasonably assured as an additional point to classify a lease as a finance lease.

    a. True.
    b. False.

4. What is an identifiable non-monetary asset without physical substance held for use in the production or supply of goods or services, for rental to others, or for administrative purposes?

    a. Goodwill.
    b. Intangible asset.
    c. Land.

5. In which phase of research and development may cost be capitalized under IFRS?

    a. Costs may be capitalized in both phases under IFRS.
    b. Research phase.
    c. Development phase.

6. Under IAS 36, when determining the recoverable amount, what term is used for the fair value less costs to dispose?

    a. Net selling price.
    b. Value in use.
    c. Gross value.

7. List at least two treatment or definitional differences between IFRS and U.S. GAAP for each of the following accounting items:

    a. Leases
    b. Long-lived asset impairment
    c. Reversal of asset impairment
    d. Intangible assets

8. What is the difference in treatment, between U.S. GAAP and IFRS, for internally-generated intangible assets and for the revaluation of intangible assets?

9. What are the signs of possible impairment of long-lived assets under IFRS?

Knowledge Application

1. Use the given information to classify the following as either a capital or operating lease (U.S. GAAP) and as either a financing or operating lease (IFRS). XYZ Company leases an asset with an economic life of 30 years under a 22-year lease that does not transfer ownership or contain a bargain purchase option. The asset has a fair market value of $100,000 and payments under the lease have a present value of $86,000.

2. Assume an asset was purchased for $100,000. The asset was to be depreciated over 10 years using straight-line with no salvage value. At the end of year two (when the carrying value was $80,000) an impairment loss was recorded that reduced the carrying value to $50,000. At the end of year three (the following year), it was determined that the estimates used to calculate the impairment loss had changed and the new fair value of the asset was $85,000. Had no impairment loss been recorded at the end of year 2, the asset would have had a carrying value of $70,000 at the end of year three ($100,000 initial cost minus three years of depreciation at $10,000 per year). An impairment reversal would increase the carrying value to what maximum amount?

Chapter 6

Liabilities

Chapter Objectives

- Understand the accounting differences between U.S. GAAP and IFRS for the following items:
  - Balance sheet presentation of liabilities
  - Contingent liabilities
  - Deferred taxes
  - Pensions
  - Employee stock compensation
  - Convertible debt
  - Preferred stock

Introduction

The accounting for liabilities is surprisingly similar under IFRS and U.S. GAAP. Some differences include the presentation of liabilities on the balance sheet, terminology differences in contingent liabilities, the tax rates used to determine deferred taxes, the treatment of the minimum pension liability and past service cost for pensions, measurement of employee stock compensation, treatment of convertible debt, and the treatment of mandatorily redeemable preferred stock.

General

The definition of a liability is similar under IFRS and U.S. GAAP, that is,

- A present obligation,
- That will require a future transfer of an asset or provision of a service (U.S. GAAP), or outflow of resources embodying economic benefits (IFRS),
- The obligation cannot be avoided, and
- The obligating event has occurred.

IFRS and U.S. GAAP also define current liabilities similarly (the liability will be settled within the operating cycle or twelve months).

Presentation of the liability section of the balance sheet is covered in detail in Chapter 2. Under IFRS, multiple presentation formats are used and are outlined in Chapter 2, including order of liquidity, reverse order of liquidity, or balance to equity rather than assets.

Liability disclosures for entities using IFRS are often quite extensive particularly pertaining to currencies in which borrowings are made. For example, Jardine discloses the amount and interest rate for borrowings in eleven different currencies in an extremely comprehensive note 33. Nestlé provides significant disclosure concerning bonds payable in note 19.4, as does Bayer in note 27.

Contingencies

IAS 37 covers provisions and contingent liabilities and assets.

The standard defines a "provision" as a liability of uncertain timing or amount. If a company has a present obligation as a result of a past event and the outflow of resources is probable and can be reasonably estimated, a provision must be recorded. Thus a provision is similar to a probable contingency as defined in FASB ASC 450 under U.S. GAAP.

Provisions must be recorded at discounted present value if the effects of discounting are material, with increases in the provision due to the passage of time being recorded as interest expense. IFRS requires that the amount recognized for the contingency be the estimate of the amount required to "settle the present obligation at the end of the reporting period." In contrast, U.S. GAAP permits discounting of contingent liabilities only if the amount and timing of payments are fixed or reasonably determinable.

Under IFRS, a restructuring provision is only recorded if the company has either (a) started to implement the plan or (b) communicated the plan to those affected by it "in a sufficiently specific manner to raise a valid expectation in them that the enterprise will carry out the restructuring." U.S. GAAP is similar. For both IFRS and U.S. GAAP, the literature is clear that a restructuring provision must meet the definition of a liability (see paragraph 35 of SFAC 6) before it can be recorded.

IAS 37 defines a contingent liability as

1. A possible obligation arising out of past events and "whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events," or

2. A present obligation arising from past events that has not been recognized because it is not probable or it cannot be measured with sufficient reliability.

IAS 37 states that contingent liabilities should not be recognized. Contingent liabilities should be disclosed, unless the likelihood of payment is remote.

At first glance, it appears that IAS 37 and FASB ASC 450 treat contingent liabilities in a dissimilar manner. In reality, such is not the case. Recall that IFRS requires companies to record a provision if it is probable that a liability has been incurred and the amount can be estimated. Thus, accounting for a provision under IFRS is similar to that of a probable contingent liability under U.S. GAAP. Note, however, that "probable" under IFRS means greater than 50 percent likelihood while "probable" under U.S. GAAP is a higher threshold (as much as an 80 percent likelihood). Thus, a liability could meet the IFRS threshold but not be recorded under U.S. GAAP.

IFRS and U.S. GAAP account for possible (called "reasonably possible" under U.S. GAAP) and remote contingencies in a similar manner.

Under IFRS, if the amount of a provision or contingent liability can only be estimated over a range of likely outcomes with each number in the range as likely as any other, a provision is recorded or a contingent liability is disclosed using the mid-point in the range. This treatment is different than under FASB ASC 450 wherein the lower end of the range is used.

Each of the example companies provides disclosure of provisions or contingencies: Jardine in note 35, Nestlé in note 18, Bayer in notes 31 and 32 (which are quite extensive), and Nokia in notes 26 and 28.

Deferred Taxes

In general, deferred taxes are accounted for similarly between IFRS and U.S. GAAP. There are a number of specific differences, however. For example:

- Under U.S. GAAP, the tax rates used to determine the amount of deferred tax are the rates that have been enacted at the balance sheet date. IAS 12 requires the use of rates that have been enacted or substantively enacted. The latter provision might occur in a country where an announcement of a future rate has the substantive effect of enactment, even though actual enactment may follow the announcement by a period of time. In these cases, announced rates are used. Such an arrangement would be unusual in the U.S. because future rates are subject to negotiation and possible adjustment between Congress and the Executive Branch up until the date a bill is passed and signed into law. Such a process is not followed in all jurisdictions in the world, thus a "substantively enacted" provision is included in IFRS.
- Under U.S. GAAP, deferred tax assets and liabilities are classified as current or non-current based on the classification of the asset or liability from which the item arises. For example, if there was a difference between the carrying amount of accounts receivable between taxes and books, the resultant deferred tax liability (or asset) would be reported as short-term. Under IFRS, all deferred tax assets and liabilities are reported as long-term when a classified balance sheet is presented.
- Under U.S. GAAP, deferred tax assets (DTA) are recognized in full and then reduced by a valuation allowance if it is more likely than not that a portion of the DTA will not be recovered. Under IFRS, the DTA is recognized only to the extent that it is more likely than not that the asset will be recovered. Ultimately, U.S. GAAP and IFRS get to the same number—one does it by recording the gross amount and an allowance; the other by recording just the net figure.

For U.S. GAAP, FASB ASC 740 requires evaluation and possible disclosure of uncertain tax positions. IFRS does not have similar language.

A project to reduce differences between IAS 12 and FASB ASC 740 is included in the MoU between the IASB and the FASB. The IASB is considering a revised plan for the income tax project. No deadlines have yet been set. FASB has no plans to issue an amendment to FASB ASC 740, but may revisit this topic after the IASB replaces IAS 12.

Pensions

Accounting for pension expense and liability is complex, whether under IFRS (predominately IAS 19) or U.S. GAAP (predominately FASB ASC 715). Although IFRS and U.S. GAAP provide for similar treatment in most instances, there are two differences of note.

First, FASB ASC 715 now requires recognition of the funded status of a benefit plan, measured as the difference between plan assets at fair value and the benefit obligation, in the statement of financial position. Any pension gains or losses and any prior service cost must be recognized as a component of other comprehensive income, net of tax. IFRS also requires a provision, but net unrecognized actuarial gains or losses and any past service costs are netted against the asset/obligation difference.

Second, under IFRS, the past service cost component of pension expense (called prior service cost under U.S. GAAP) is recognized over the remaining vesting period of the benefit. If benefits have already vested, past service cost is recognized immediately. Under U.S. GAAP, prior service cost is recognized over the remaining service lives of active employees. This difference can have a significant effect on the pension expense reported under IFRS or U.S. GAAP.

Example 6-1

Accounting for past/prior service cost under IFRS and U.S. GAAP

MNO Company has a pension plan that provides each employee a pension payment equal to 1.5 percent of final salary for each year of service. Employees vest in the plan after five years of service. On January 1, the Company modifies the plan to provide for pension payments equal to 2 percent of final salary. The average remaining service life of employees is 15 years. The Company has determined that the present value of the additional benefits is as follows:

Employees with more than 5 years' service as of January 1	$6,000,000
Employees with less than 5 years' service as of January 1	3,000,000
Total Past/Prior Service Cost	$9,000,000

The average period until vesting for employees with less than five years of service is three years.

Under IFRS, MNO Company would immediately recognize the $6 million for fully vested employees. In addition, it would recognize the remaining $3 million over the remaining vesting period of 3 years on a straight line basis ($1 million in the current year). Thus, total past service cost for MNO Company under IFRS would be $7 million.

Under U.S. GAAP, MNO Company would recognize the $9 million prior service cost over the average remaining service life of its employees (15 years). Thus, the prior service cost would be $600,000 per year for 15 years.

Many companies using IFRS will report the net assets of overfunded pension plans and the net liabilities of underfunded plans as assets and liabilities, respectively, on the balance sheet. See, for example, the balance sheet of Jardine, where pension assets of $92 million and pension liabilities of $179 million are separately listed on the face of the balance sheet. Jardine provides additional detail in note 22. Nestlé discloses employee benefit assets and liabilities of CHF 230 and CHF 6,249, respectively, on the face of their balance sheet. As indicated in note 16, these amounts are related both to pensions and to post-employment medical benefits. Bayer lists a €6,517 provision for pensions and other post-employment benefits, and provides additional detail in note 25. Nokia provides information about its pension plans in note 5, but does not provide separate data on the face of the balance sheet.

Employee Stock Compensation

IFRS 2, *Share-based Payment*, prescribes the accounting for a transaction in which an entity receives or acquires goods or services either as consideration for its equity instruments, including employee stock compensation, or by incurring liabilities for amounts based on the price of the entity's shares or other equity instruments of the entity. In general, the issuance of shares or rights to shares requires an increase in a component of equity. IFRS 2 requires the offsetting debit entry to be to an expense when the goods or services received do not qualify for recognition as an asset. The expense should be recognized as the goods or services are consumed.

In December 2004, the U.S. FASB published a revised version of SFAS 123, *Share-Based Payment*. FASB ASC 718 requires that compensation cost relating to share-based payment transactions be recognized in the entity's financial statements. While FASB ASC 718 is largely consistent with IFRS 2, some differences remain, as described in a Q&A document FASB issued along with the new Statement. The more significant areas identified in question 22 of this Q&A document are briefly described below.[9]

- IFRS 2 generally requires the use of the modified grant-date method for share-based payment arrangements with nonemployees. In contrast, FASB ASC 505 (U.S. GAAP) requires that grants of share options and other equity instruments to nonemployees be measured at the earlier of (1) the date at which a commitment for performance by the counterparty to earn the equity instruments is reached or (2) the date at which the counterparty's performance is complete.

- IFRS 2 contains more stringent criteria for determining whether an employee share purchase plan is compensatory or not. As a result, some employee share purchase plans for which IFRS 2 requires recognition of compensation cost will not be considered to give rise to compensation cost under FASB ASC 718.

- IFRS 2 applies the same measurement requirements to employee share options regardless of whether the issuer is a public or a nonpublic entity. IFRS 2 and FASB ASC 718 contain the same accounting treatment for financial instruments granted under share-based payment arrangement if the entity concludes that fair value cannot be reasonably

[9] Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 123 (Revised 2004), *Share-Based Payment*, *Frequently Asked Questions*, December 16, 2004, available on FASB's website at http://72.3.243.42/project/123r_faq.pdf.

estimated at the grant date. The IASB noted that share options granted by a nonpublic (or newly public) entity may fall into that category.

FASB ASC 718 requires that a nonpublic entity account for its options and similar equity instruments based on their fair value unless it is not practicable to estimate the expected volatility of the entity's share price. In that situation, the entity is required to measure its equity share options and similar instruments at a value using the historical volatility of an appropriate industry sector index.

- The FASB and IASB reached different conclusions on certain aspects of accounting for income tax effects of equity instruments awarded to employees. In tax jurisdictions such as the United States, where the time value of share options generally is not deductible for tax purposes, IFRS 2 requires that no deferred tax asset be recognized for the compensation cost related to the time value component of the fair value of an award. A deferred tax asset is recognized only if and when the share options have intrinsic value that could be deductible for tax purposes. Therefore, an entity that grants an at-the-money share option to an employee in exchange for services will not recognize tax effects until that award is in-the-money. In contrast, FASB ASC 718 requires recognition of a deferred tax asset based on the grant-date fair value of the award. The effects of subsequent decreases in the share price (or lack of an increase) are not reflected in accounting for the deferred tax asset until the related compensation cost is recognized for tax purposes. The effects of subsequent increases that generate excess tax benefits are recognized when they affect taxes payable.

  FASB ASC 718 requires a portfolio approach in determining excess tax benefits of equity awards in paid-in capital available to offset write-offs of deferred tax assets, whereas IFRS 2 requires an individual instrument approach. Thus, some write-offs of deferred tax assets that will be recognized in paid-in capital under FASB ASC 718 will be recognized in determining net income under IFRS 2.

Convertible Debt

A company may issue a debt instrument that can be converted into equity of the company. If the convertibility feature can be separated from the debt feature (such as a bond with detachable warrants), then the debt and equity components are split apart and are accounted for separately under both IFRS and U.S. GAAP.

However, if convertible debt cannot be separated into its component parts, IFRS and U.S. GAAP will account for the instrument differently.

Under U.S. GAAP, convertible debt that is not separable is generally accounted for completely as debt in accordance with FASB ASC 470. Upon conversion, either the book value method or the fair value method is used. The book value method records the newly issued stock at the book value of the bonds converted whereas the fair value method reports the new stock at its fair value, which normally results in a conversion loss that is reported on the income statement.

Under IFRS, the convertible debt is accounted for on a split basis—allocating proceeds between the debt and equity portions in accordance with IAS 32. The liability component is measured at its fair value, and the equity component is measured as the residual.

The residual allocation method determines the market value of the debt component and allocates the residual to the equity component. Normally, the debt component can be reasonably measured by determining its fair value using a market discount rate for non-convertible debt.

Example 6-2

ABC Company sold €1,000,000 face value of convertible bonds at a price of 101, realizing proceeds of €1,010,000. The 10-year bonds carry an interest rate of 6 percent. Interest is paid semi-annually. The market rate for equivalent non-convertible bonds is 8 percent. The fair value of the bond component is €864,097 determined as follows:

Present value of interest payments at 8 percent	€407,710
Present value of principal repayment	456,387
Fair value of bond at 8 percent	€864,097

The entry to record the bonds under IFRS would be:

Cash	1,010,000	
Discount on Bonds Payable	135,903	
Bonds Payable		1,000,000
Share Issue Premium (APIC)		145,903

Under U.S. GAAP, the entry would be:

Cash	1,010,000	
Bonds Payable		1,000,000
Premium on Bonds Payable		10,000

Note that if the convertibility feature were separable from the bonds, the accounting treatment under IFRS and U.S. GAAP would have been the same.

Upon conversion, any remaining discount is credited and the amount of additional paid-in capital is debited. In effect, the APIC created at the time of bond issuance increases stockholders' equity both at the time of bond issuance and after conversion.

At the time of conversion, IFRS recommends using the book value approach under the notion that transactions with capital accounts do not normally give rise to income statement effects. As noted above, U.S. GAAP permits both the book value method and the fair value method on conversion.

Preferred Stock

Under IAS 32, mandatorily redeemable preferred stock is generally reported as a liability. Under U.S. GAAP, FASB ASC 480 provides for similar treatment. Non-redeemable preferred stock is reported as equity under both IFRS and U.S. GAAP.

Summary and Conclusions

This chapter detailed differences of both substance and form between IFRS and U.S. GAAP in accounting for liabilities. Items discussed include the presentation of liabilities on the balance sheet, terminology differences in contingent liabilities, the different rates used to determine deferred taxes, treatment of the minimum pension liability for pensions, treatment of past service cost for pensions, measurement of employee stock compensation, treatment of convertible debt, and the treatment of mandatorily redeemable preferred stock.

Quick Reference Guide to IFRS/U.S. GAAP Differences		
Chapter 6—Liabilities		
Topic	**IFRS**	**U.S. GAAP**
Contingencies	When the amount of the contingency is not a point estimate, but is a range of estimates, record a contingency based on the mid-point of the range.	When a range of estimated contingency is used, record a contingency based on the low end of the range.
Deferred Tax Rates	Deferred taxes are determined using the tax rates enacted or substantively enacted in the period when the timing difference will reverse.	Tax rates are based only on enacted rates.
Deferred Taxes—current or non-current	Always recorded as non-current.	Classified as current or non-current based on the classification of the related asset or liability.
Convertible Debt	Use split accounting. Record liability at FMV of similar non-convertible debt and record equity for remainder.	Record all as liability unless convertible portion can be split out (for example, bonds with detachable warrants).
Employee Stock Compensation	Cost of Stock award to I/S over compensation period. Cost determined by fair value.	Cost of stock award to I/S over compensation period. Cost figured using FMV under FASB ASC 718. Disclose FMV costs in any event.
Prior Service Cost Component of Pension Expense	Expensed using the remaining vesting period pertaining to the benefit.	Expensed over the average remaining service life of active employees.
Minimum Pension Liability	No such requirement.	Reporting of minimum pension liability may be required if plan is significantly underfunded.

Self-Test

1. Under IFRS part of the definition of a liability is that it is an obligation that cannot be avoided.

   a. True.
   b. False.

2. How should contingent liabilities be reported under IFRS?

   a. Neither disclose nor record contingent liabilities.
   b. A provision should be recorded for the contingent liability.
   c. The contingent liability should be disclosed unless the likelihood of payment is remote.

3. Under IFRS, what period is the past service cost component of pension expense recognized?

   a. Over the remaining vesting period of the benefit.
   b. Over the remaining service lives of active employees.
   c. Do not recognize a pension expense until the employee has retired and the amount is known.

4. Which IAS covers convertible debt?

   a. IAS 16.
   b. IAS 32.
   c. IFRS 4.

5. Which component of convertible debt that is not separated into its component parts is normally more reasonably measured?

   a. Debt component.
   b. Equity component.
   c. Both debt and equity components can be equally reasonably measured.

6. Where is mandatorily-redeemable preferred stock generally reported under IFRS?

   a. Asset.
   b. Equity.
   c. Liability.

7. Under IFRS, which one of the following statements about an intangible asset is false?

   a. It is identifiable.
   b. It is nonmonetary.
   c. It cannot arise from contractual rights.

8. Under IFRS, an asset is impaired if its carrying value is greater than its

   a. Fair value less costs to sell.
   b. Recoverable amount.

c. Value in use.

9. Under IFRS, provisions must be recorded at discounted present value if

a. The timing of the payments is fixed or reasonably determinable.
b. The amount of the payments is fixed or reasonably determinable.
c. The effects of discounting are material.

10. Name one similarity and one difference between IFRS and U.S. GAAP for each of the following liabilities:

Contingencies

Deferred taxes

Pensions

Employee Stock Compensation

Convertible Debt

Knowledge Application

ABC Company sold €10,000,000 face value of convertible bonds at a price of 102, realizing proceeds of €10,200,000. The 10-year bonds carry an interest rate of 7 percent. The market rate for equivalent non-convertible bonds is 8 percent. The fair value of the bond component is € determined as follows:

Present value of interest payments	€4,756,500
Present value of principal repayment	4,563,870
Fair value of bond at 8 percent	€9,320,370

The entry to record the bonds under IFRS would be?

Under U.S. GAAP, the entry would be?

Chapter 7

Accounting Changes, Discontinued Operations, Derivatives and Hedging, Segment Reporting, and Interim Financial Statements

Chapter Objectives

- Differentiate between IFRS and U.S. GAAP accounting for the following items:
    - Accounting changes
    - Error corrections
    - Discontinued operations
    - Long-term constructions contracts
    - Derivatives and hedging instruments
    - Segment reporting
    - Interim reporting

Introduction

This chapter compares the accounting for IFRS and U.S. GAAP for a number of topics. The topics covered include accounting changes and error corrections, discontinued operations, long-term construction contracts, derivatives and hedge accounting, segment reporting, and interim financial statements.

Accounting Changes and Error Corrections

Accounting changes and error corrections are accounted for in accordance with the provisions of IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, and FASB ASC 250. FASB ASC 250 generally adopts the approach set forth in IAS 8.

Change in Estimate

Both IFRS and U.S. GAAP account for a change in estimate prospectively (that is, from this day forward) with no restatement of prior periods presented. Prior to FASB ASC 250 under U.S.

GAAP, a change in depreciation method was accounted for as a change in accounting principle, but with the issuance of FASB ASC 250, the FASB has adopted the IASB approach.

Change in Accounting Principle

Prior to FASB ASC 250, a change in accounting principle was accounted for under U.S. GAAP by including the cumulative effect in current year net income (net of tax) as a separately stated item after discontinued items and extraordinary items. Prior year financial statements were not adjusted, but the company would provide *pro forma* statements for all prior years presented, as though the new principle was used in the those years. With the issuance of FASB ASC 250, U.S. GAAP now requires a change in accounting principle be applied by the retrospective method unless it is impracticable to determine either the cumulative effect or the period-specific effects of the change. The statement defines retrospective application as the application of a different accounting principle to prior accounting periods as if that principle had always been used or as the adjustment of previously issued financial statements to reflect a change in the reporting entity.

The benchmark treatment under IAS 8 is to apply the change retrospectively. Thus, a firm will adjust beginning retained earnings by the cumulative effect of the change (net of tax) and will restate all prior years presented. Under IFRS, the cumulative effect of the change does not pass through the income statement.

All of our example companies adopted new IFRS standards and/or interpretations or discuss upcoming new standards during 2009.

Jardine (Appendix A) adopted several standards in 2009 (see note 1), but the changes had no material impact on their beginning balance of retained earnings or their financial statements, other than some reclassifications for presentation purposes.

Nestlé (Appendix B) adopted standards as discussed in its note 1.

Bayer (Appendix C) adopted many new standards as outlined in note 3. None of the standards will have a material impact on their financial statements.

Nokia (Appendix D) provides information as to new standards at the beginning of note 1.

Correction of an Error

A correction of an error under U.S. GAAP is accounted for in beginning retained earnings by a prior period adjustment (net of tax) and a restatement of prior periods presented. The primary treatment under IFRS is the same as under U.S. GAAP.

Under IFRS, when it is impracticable to determine period-specific effects of an error on comparative information, the entity can treat the error correction in the earliest period for which restatement is practicable.

Discontinued Operations

Discontinued operations are accounted for under IFRS 5. IFRS 5 replaced IAS 35 in 2005. The replaced standard referred to these events as “discontinuing operations” in part because the required disclosures were required during the time the operating unit was being disposed of, not once the task was complete. The definition of discontinued operations has changed very little between the two standards.

IFRS defines a discontinued operation as a component of an entity that either has been disposed of or is classified as held for sale (as defined within IFRS 5), and

1. Represents a separate major line of business or geographical area of operations,
2. Is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations, or
3. Is a subsidiary acquired exclusively with a view to resell.

A segment (as defined in IAS 14) meets the definition of a component. Although the above criteria are similar to U.S. GAAP, they are viewed as being more restrictive in that FASB ASC 205 broadened the scope of a discontinued operation from a "segment of a business" to a "component of an entity," which may be a segment, a reporting unit, a subsidiary, or an asset group.

Under IFRS 5, the timing of when a discontinued operation is classified as such is the date the entity has actually disposed of the operation or when the operation meets the criteria (as defined within IFRS 5) to be classified as held for sale. IFRS 5 achieves substantial convergence with the requirements of FASB ASC 205, with respect to the timing of the classification of operations as discontinued operations and the presentation of such operations.

IFRS 5 requires certain disclosures pertaining to the discontinuing operation. Among other things, the entity must disclose balance sheet, income statement, and cash flow statement items pertaining to the discontinued operations. The after-tax profit or loss on discontinued operations must be disclosed on the face of the income statement. Cash flow effects can be disclosed either on the face of the statements or in the notes. Assets and liabilities of a segment (disposal group) held for sale must each be separately stated (not netted) on the balance sheet or in the notes.

The financial statements of Nestlé (Appendix B) and Bayer (Appendix C) contain examples of the presentation of disclosures associated with discontinuing operations.

The Nestlé income statement contains separate columns for continuing operations and for discontinued operations. A significant proportion of net income is from the discontinued operations. The balance sheet shows CHF 11.2 billion of assets held for sale and corresponding liabilities of CHF 2.9 billion. Note 25 provides extensive additional information including cash flow information.

On the face of Bayer's income statement, discontinued operations are reported in a manner similar to under U.S. GAAP—a net basis listed after income from continuing operations. Note 6.3 provides the detail of this net item for each income statement component.

On Bayer's balance sheet, the amount of assets and liabilities for discontinued operations are listed on the face of the statement (along with assets and liabilities related to assets held for sale). The effect on cash flow is disclosed in note 6.3.

In September 2008, the IASB issued an Exposure Draft and the FASB issued a Proposed FASB Staff Position. These proposals support a common definition of discontinued operations and require additional disclosures related to components of an entity that have been disposed of or are classified as held for sale.

Under the proposals, a discontinued operation would be defined as either (a) an operating segment (defined in SFAS 131 or IFRS 8) that has been disposed of or is held for sale, or (b) a business (defined in SFAS 141 or IFRS 3) that meets the criteria to be classified as held for sale on acquisition. The proposed definition, if adopted, would narrow the broader U.S. GAAP "component of an entity" definition under SFAS 144, as noted above.

Long-term Construction Contracts

IFRS does not allow the use of the completed contract method for long-term contracts (IAS 11). If total revenues, costs (past and future), and stage of completion can be reliably estimated, companies must use the percentage-of-completion method. If those items cannot be reliably measured, the company should expense costs in the period they are incurred and recognize revenues to the extent that it is probable the costs are recoverable (a cost-recovery method).

In June 2010, the IASB and FASB issued joint exposure drafts on Revenue Recognition. The boards plan to issue a final standard in 2011. This final standard is planned to replace both IAS 11 and IAS 18 for IFRS. The status of this joint project is updated on both boards' websites.

Derivatives

Derivatives and hedges (see next section) are primarily covered under IAS 32, IAS 39 and FASB ASC 815. Accounting for derivatives and hedges can be extremely complex. The IASB has formed an IAS 39 Implementation Guidance Committee that has published over 200 questions and answers pertaining to the Standard. The FASB has also formed a Derivatives Implementation Group that has provided guidance on over 175 issues. Primarily because of this complexity, the discussion herein is intended to be a broad overview of these standards.

IAS 39 defines a derivative as a financial instrument

- Whose value changes in response to a specified index, interest rate, security price, commodity price, foreign exchange rate, or similar variable;
- That requires little or no initial investment; and
- That is settled at a future date.

U.S. GAAP sets forth similar requirements but also requires that the terms of the contract must require or permit net settlement. Thus, certain financial instruments may fall within the scope of IFRS, but not U.S. GAAP. An example would be a forward contract for the purchase of 25,000 bushels of wheat in three months that can be settled only by delivery of the wheat. Here, it is likely that IFRS would account for the contract as a derivative, while U.S. GAAP would not.

Both IFRS and U.S. GAAP generally account for derivatives in a similar manner—initially measuring the derivative at cost and subsequently measuring all derivatives at fair value with changes being recognized on the income statement (unless the instrument meets the requirements for hedge accounting).

Financial instruments, including derivatives, are another major joint project for the IASB and FASB. The IASB plans to replace IAS 39 in three phases, and plans to complete the project in 2011. The project status is available on both boards' websites.

Hedge Accounting

Hedge accounting under IFRS and U.S. GAAP is similar. The discussion below will highlight a few of the more-significant differences.

Both IFRS and U.S. GAAP permit hedge accounting provided that the entity meets certain criteria pertaining to documentation (risk management objectives and other criteria) and hedge effectiveness.

As to effectiveness, the hedge must be "highly effective" in offsetting changes in the fair value of the hedged item. Under U.S. GAAP, a hedge instrument meets this criterion if expected and actual results are within a range of 80 percent to 125 percent. Thus, a hedging instrument would be highly effective if it increased (or, conversely, decreased) in value by 90 cents for every $1 decrease (or, conversely, increase) in fair value of the hedged item. Under IFRS, an instrument is a hedge if actual results are within that range and if, at the time the hedge is entered into, the hedging instrument changes can be expected to "almost fully offset" the changes in the value of the hedged item. Thus, U.S. GAAP can be perceived as slightly less restrictive than IFRS.

Both IFRS and U.S. GAAP define a fair value hedge and cash flow hedge in a similar manner—the former being a hedge of the change in fair value of a recognized asset or liability and the latter being a hedge of the amount or volatility of a future cash flow. Under IFRS, a hedge of a foreign currency risk of a firm commitment can be treated as either a cash flow hedge or a fair value hedge.

Disclosures by Example Companies

All of our example companies provide significant disclosures pertaining to derivatives and hedging. General information about derivatives and hedging transactions is provided in the companies' accounting-policies notes. Specific disclosure can also be found in note 37 for Jardine, 11 for Nestlé, 30 for Bayer, and 16 for Nokia.

Segment Reporting

Segment reporting was previously covered under IAS 14. In November 2006, the IASB issued IFRS 8 entitled "Operating Segments" which is effective for periods beginning on or after January 1, 2009 (earlier application permitted). IFRS 8 replaces IAS 14 and was written by the IASB for the purpose of convergence of accounting standards, in this case "converging" IAS 14 with SFAS 131. As a result, the current differences between IFRS and U.S. GAAP regarding segment reporting is now relatively minor, where previously there were many differences. Differences between IFRS 8 and SFAS 131 are listed in the Basis for Conclusion section of IFRS 8.

IFRS 8 defines an operating segment as a component of an entity that (a) engages in business activities from which it may earn revenues and incur expenses (including inter-company revenues and expenses); (b) whose operating results are regularly reviewed by the entity's chief operating decision maker; and (c) for which discrete financial information is available.

IFRS 8 provides guidance on which operating segments require separate financial reporting information; generally when certain 10 percent thresholds are met. If the total external revenue reported by operating segments is less than 75 percent of the entity's revenue, additional operating segments must be defined and reported even if they do not meet the "10 percent threshold" rules until at least 75 percent of the entity's revenue is included in reportable segments.

Some entity disclosures are required, even when an entity has only one reportable segment. This includes information about each product and service or groups of products or services. Certain geographical information is also required with expanded disclosure requirements regarding revenues/assets by individual foreign country (if material). Also required are disclosures regarding transactions with major external customers. A customer is considered "major" if the entity earns 10 percent or more of its revenues from the customer.

Within the "Basis for Conclusions" section of IFRS 8, the IASB lists remaining differences between IFRS 8 and SFAS 131. These remaining differences include:

(a) FASB indicates that "long-lived assets" implies hard assets that cannot be readily removed, which would appear to exclude intangibles. Non-current assets per IFRS include intangibles.

(b) IFRS requires the disclosure of a measure of segment liabilities if such measure is regularly provided to the chief operating decision maker. SFAS 131 does not require the disclosure of a measure of segment liabilities.

(c) SFAS 131 requires an entity with a matrix form of organization to determine operating segments based on products and services. IFRS requires such an entity to determine operating segments by reference to the core principle of the IFRS.

Segment Reporting by Example Companies

Our example companies offer extensive segment disclosures.

Jardine (Appendix A) provides extensive segment disclosure in note 4. Its primary reporting format is by business segments. Additional business unit, geographical, or segment information is provided in notes 5, 8, 11, 14, 18, 20, 25, 32, 34, and 36.

Nestlé (Appendix B) has a primary reporting format of geographical area. It provides disclosure information in note 3.

The segment disclosures of Bayer (Appendix C) are based on business segments for the primary reporting format. Segment information is shown in note 1 and discussed in note 5.

Nokia (Appendix D) uses business segments as its primary reporting format. Segment information is provided in note 2.

Interim Financial Reporting

Rules for interim reporting have been in place under U.S. GAAP since 1973 with APB 28. However, under IFRS, rules were established only in 1998 with the promulgation of IAS 34.

Two different views exist as to how interim financial information should be reported. One is the "discrete approach," whereby each interim period is viewed as a separate reporting period. This view states that incomplete transactions must be treated in the same manner as at year-end. The other view, the "integral approach," holds that interim periods are viewed as an integral part of the annual period. In general, IFRS leans towards the discrete approach while U.S. GAAP favors the integral approach.

An example will illustrate the difference. A manufacturing company uses a standard cost accounting system. During the year, standard cost variances occur but those variances are expected to be made up by the end of the year. Under IFRS, the interim period is viewed as a separate reporting period and the variances must be reported in cost of goods sold and inventory. Under U.S. GAAP, the variances are not reported because it is expected that the variances will "zero out" by year-end.

Under IFRS, materiality is assessed in relation to the interim period. In general, U.S. GAAP approaches materiality on the basis of annual amounts.

Notwithstanding the application of the discrete approach under IFRS, income taxes are accounted for using an annual effective tax rate for both IFRS and U.S. GAAP.

At a minimum an interim financial report under IFRS should include current and comparative condensed balance sheets, income statements, equity statements, cash flow statements, and selected explanatory notes.

Summary and Conclusions

This chapter compares and contrasts the accounting for IFRS and U.S. GAAP for a several topics. The topics covered include accounting changes and error corrections, discontinued operations, long-term construction contracts, derivatives and hedge accounting, segment reporting, and interim financial statements. Companies are noted with examples of different accounting and presentation formats.

Quick Reference Guide to IFRS/U.S. GAAP Differences		
Chapter 7—Accounting Changes, Discontinued Operations, Derivatives and Hedging, Segment Reporting, and Interim Financial Statements		
Topic	**IFRS**	**U.S. GAAP**
Accounting Changes		
Change in estimate	Prospectively. However, a change in depreciation method is called a change in estimate.	Prospectively. A change in depreciation method is no longer accounted for as a change in accounting principle.
Correction of error (in previously issued statements)	Treated as prior period adjustments. Alternatively,	Prior period adjustment.

	can report in current I/S.	
Long-term Contracts		
Completed contract method	Prohibited.	Permitted.
Discontinued Operations		
Definition	Separate major component.	Identifiable component representing a major class of business.
Starting date (Measurement Date)	Date that the entity has actually disposed of the operation, or when the operation meets the criteria to be classified as held for sale.	Date on which management has committed to a formal plan of disposal.
Measurement	Lump sum measured using standards for impairment and/or provisions.	Measure (1) income/loss on operations from beginning of year to starting date and (2) G/L on disposal as estimated income/loss from operations to disposal date plus G/L on disposal.
Presentation	Continue to show in financial statements until discontinuance completed with additional disclosures on face of B/S and I/S or in notes.	From starting date report items (1) and (2) above on I/S. Separation of assets and liabilities not required, but shown often in practice.
Derivatives		
Definition	Instrument does not need to require or permit net settlement.	Net settlement must be required or permitted.
Hedging		
Effective hedge	Hedge instrument must be expected to "almost fully offset" movements in the hedged item and must actually offset 80 percent to 125 percent of the movements in the hedged item.	Hedge instrument must offset 80 percent to 125 percent of the expected and actual movements in the hedged item.
Foreign Currency Risk of Firm Commitment	Accounted for as cash flow hedge or fair value hedge.	Accounted for as fair value hedge.
Fair Value Hedge	IFRS and U.S. GAAP are similar.	IFRS and U.S. GAAP are similar.
Cash Flow Hedge	IFRS and U.S. GAAP are similar.	IFRS and U.S. GAAP are similar.
Interim Reports		
Approach	Discrete approach whereby each interim period is viewed as a separate reporting period.	Integral approach whereby the interim periods are viewed as an integral part of the annual

		period.
Segment Reporting		
Segment's disclosure of non-current assets	Includes intangible assets.	Excludes intangible assets.
Disclosure of segment liabilities	Required if such a measure is provided to the chief operating decision maker.	Not required.
Identification of segments for matrix form of organization	Operating segments are determined using the basis of the core principle of the standard.	Segments are based on products and services of the organization.

Self-Test

1. How should a change in estimate be treated under IFRS?

    a. Restatement of prior periods.
    b. Prospectively.
    c. As a change in accounting principle.

2. When a company that uses a national GAAP and changes to IFRS for the first time, the company must use the benchmark treatment for any changes in accounting principle.

    a. True.
    b. False.

3. Which international statement currently addresses discontinuing operations?

    a. IAS 8.
    b. IAS 35.
    c. IFRS 5.

4. Which method does IFRS allow for long-term contracts under IAS 11?

    a. Constructive gains and losses method.
    b. Completed contract method.
    c. Percentage-of-completion.

5. Which requirement may cause a financial instrument to fall within IFRS for derivatives but not within U.S. GAAP for derivatives?

    a. The terms of the contract must require or permit net settlement.
    b. Settlement at a future date.
    c. The terms of the contract must require or permit little or no initial investment.

6. Which segment reporting criteria is of concern under both IFRS and U.S. GAAP?

    a. Customers providing more than 10 percent or firm-wide revenue.
    b. Internal reporting.
    c. Risk and return profiles.

7. Which approach to interim financial reporting does IFRS favor?

    a. Discrete approach.
    b. Integral approach.
    c. Materiality approach.

Knowledge Application

1. What are the benchmark and alternative treatments for IFRS for the following items:

    a. Changes in Accounting Principle

b. Correction of an Error

2. Examine the note disclosures for Jardine, Nestlé, Bayer, and Nokia and determine the primary and secondary segment reporting formats.

Chapter 8

Business Combinations, Consolidated Financial Statements, and Foreign Operations

~~Business Combinations, Consolidated Financial Statements, and Foreign Operations~~

Chapter Objectives

- Differentiate between U.S. GAAP and IFRS for the following business combination issues:
  - Accounting methods used for business combinations
  - Defining the acquisition cost
  - Revaluation of Assets and Liabilities upon acquisition
  - Recognition of intangible assets
  - Valuation and amortization of goodwill and negative goodwill
  - Required disclosures
- Understand the differences in methods of consolidation for subsidiaries, joint ventures, and associates.
- Understand transaction and translation issues for foreign subsidiaries and how they differ between U.S. GAAP and IFRS.

Introduction

This chapter addresses the differences between IFRS and U.S. GAAP for business combinations, consolidated financial statements, and foreign subsidiaries.

Business Combinations

Business combinations are covered in IFRS 3 and SFAS 141. While IFRS 3 and SFAS 141 are similar, there remain some significant differences. Some of the larger differences are discussed within this chapter.

As part of the FASB's commitment to the convergence project, they issued SFAS 141(R) in December 2007 (codified at FASB ASC 805). The Statement is effective for reporting periods beginning on or after December 15, 2008. The IASB also revised IFRS 3, which was issued in

January 2008, and is effective for annual reporting periods beginning on or after July 1, 2009. The two revised statements reduce some of the differences between the two accounting policies.

Accounting Methods

IFRS 3, *Business Combinations*, superseded IAS 22, *Business Combinations*, and was originally issued in March 2004. In January 2008, the IASB issued a new version of IFRS 3, which is effective for business combinations in periods beginning on or after July 1, 2009 (with earlier application permitted). To differentiate between the two versions of IFRS 3, we will refer to the older version as "IFRS 3 (2004)" and the newer as "IFRS 3 (2008)". Both versions of IFRS 3 require the acquisition method of accounting for business combinations. IAS 22 allowed a uniting of interest method of accounting for business combinations (similar to the pooling of interests method under previous U.S. GAAP), but this method was eliminated by IFRS 3. The acquisition method requires the fair value of acquired assets and assumed liabilities and contingent liabilities to be measured at the date of acquisition.

The definition of a business under IFRS 3 (2004 and 2008) is somewhat broader than it is under U.S. GAAP. The IASB determined that additional sets of activities and assets should be considered a business. The following requirements cause a business to be identified as a business under IFRS 3, but would not be identified as a business under U.S. GAAP:

- The presumption in IFRS that transactions on which goodwill arises must involve the transfer of a business.
- The absence of a requirement in IFRS 3 (2004) that a business be self-sustaining. IFRS 3 (2008) continues to exclude "self-sustaining," but adds that the set of activities must be *capable* of being conducted and managed for the purpose of providing a return.
- The absence of a requirement in IFRS 3 (2004 and 2008) that a developed set of activities that has not commenced principal planned operations is not presumed to be a business.

In general, in an acquisition, the assets (tangible and intangible) and liabilities of the acquired firm are revalued to fair value, and goodwill, if any, is recorded. This general treatment holds for IFRS and U.S. GAAP.

Cost of the Acquisition

The cost of the acquisition represents the fair value of the consideration given by the acquirer. Contingent consideration is deemed to be part of total consideration; it is measured at fair value at the date of acquisition and any subsequent changes are recognized on the income statement (rather than adjusting goodwill). Transaction costs (professional fees and the like) are expensed and not included in the cost of acquisition. With the changes promulgated in SFAS 141(R), acquisition cost is determined similarly by U.S. GAAP and IFRS.

Assets and Liabilities to Be Revalued

The required treatment under IFRS 3 (2008) and under FASB ASC 805 is to revalue all assets and liabilities to fair value—majority interest and minority interest. Thus, the minority interest would be, in effect, stated at fair value of the net identifiable assets.

Under IFRS, no goodwill is attributed to the minority interest.

Recognition of Intangible Assets

Under IFRS, intangible assets must be separately identified and recorded only if they meet the definition and recognition criteria for an intangible asset (controlled by the entity and held for use in the production or supply of goods or services, for rental to others, or for administrative purposes and that will provide future economic benefit).

Intangibles are defined a bit broader under U.S. GAAP. Here an intangible must be recognized if it represents a contractual or legal right or is capable of being separated or divided from the business and sold, licensed, rented, or exchanged. This definition can sometimes lead to the recognition of more intangibles under U.S. GAAP, for example, franchises, customer lists, and supplier lists.

U.S. GAAP also requires acquirers to include any acquired in-process research and development (R&D). FASB ASC 805 requires that R&D be recognized as a separate intangible asset. This asset is subject to impairment testing under FASB ASC 350.

Goodwill

Goodwill represents the difference between consideration paid and the fair value of the net assets (tangible and intangible) of the acquired enterprise.

Goodwill must be evaluated for impairment under IAS 36. In general, this standard requires goodwill to be reviewed for impairment at least annually and if events or circumstances indicate that the carrying amount may not be recoverable, then it is to be written down accordingly.

Under U.S. GAAP, goodwill is also not amortized but is tested for impairment at least annually at the reporting unit level under the provisions of FASB ASC 350. Chapter 5 discusses asset impairment.

Negative Goodwill

Negative goodwill, which is referred to as discount on acquisition in IFRS 3, occurs when the consideration paid is less than the fair value of the net assets acquired.

Under IFRS 3 (2004) if negative goodwill exists, the acquirer should reassess the fair values determined and the measurement of the cost of the acquisition. After reassessing this information, any excess remaining is recognized immediately in profit or loss for the period. The IFRS 3 (2004) requirements for negative goodwill represent a significant change from the previous accounting practice, which varied from allocation across non-monetary assets, amortization over a period, and various other methods.

Under U.S. GAAP, negative goodwill is allocated on a *pro rata* basis to all assets other than current assets; financial assets (other than equity method investments); assets to be sold; prepaid pension assets; and deferred tax assets. Any remaining negative goodwill is recognized as an extraordinary gain.

The revised IFRS 3 (2008) and SFAS 141(R) remove the term "negative goodwill" and instead refer to a bargain purchase. In both revised statements, a bargain purchase is to be recognized as a gain attributable to the acquirer and is to be recognized immediately as income. However, both the IASB and FASB believe that with the revised standards, negative goodwill should be a remote possibility in most situations.

Disclosures

Most disclosures concerning business combinations are required under both IFRS and U.S. GAAP. There are a few disclosure items that are required only by one or the other.

Disclosures required by IFRS, but not by U.S. GAAP include a description of any operations to be disposed of; a percentage of voting shares acquired; and a reconciliation of beginning and ending goodwill.

Disclosures required by U.S. GAAP, but not by IFRS include reasons for the business combination; basis for determining the value of any shares issued; total amount of goodwill, the amount expected to be tax deductible, and the amount by reportable segment; amount of purchased R&D acquired and written off during the period; amounts allocated to intangible assets and amortization periods; and *pro forma* income statement including comparatives showing the effect of the acquisition.

> **Note:** Most of the disclosure differences above have been eliminated with the revised IFRS 3 (2008), issued in January 2008, and SFAS 141(R). A few remaining disclosure differences between the two revised statements include

- SFAS 141(R)'s disclosure requirements apply only to public business enterprises. The revised IFRS 3 disclosure requirements apply to all acquirers.
- SFAS 141(R) includes a disclosure requirement for the reconciliation of goodwill which is very close to IFRS's requirement. However, the revised IFRS 3 provides a detailed list of items that should be shown separately.
- The revised IFRS 3 requires the acquirer to disclose the amount and an explanation of any gain or loss recognized in the current period that (a) relates to assets or liabilities acquired in a business combination that was effected in the current or previous reporting period, and (b) is of such a size or nature that disclosure is relevant to understanding the combined entities financial statements. SFAS 141(R) does not require this disclosure.

Sample Companies

Each of the sample companies discloses information concerning movements in their goodwill accounts: Jardine in note 14, Nestlé in note 14, Bayer in note 17, and Nokia in note 12. It appears as though all sample companies use the purchase method for their acquisitions.

Bayer provides significant narrative concerning acquisitions and dispositions in "Scope of Consolidation" in note 6.

Consolidated Financial Statements

Consolidated financial statements, investments in subsidiaries, and investments in joint ventures are covered primarily in IAS 27 and IAS 31. U.S. GAAP is promulgated generally in ARB 51 and SFAS 94 (both included within FASB ASC 810).

If a parent/subsidiary relationship exists, consolidated financial statements must be prepared. Under IFRS, the determination of a subsidiary relationship depends on the concept of control, specifically the "power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities." Thus, under IFRS, if the parent has the ability to govern and obtain the benefits, the subsidiary entity must be consolidated, regardless of the ownership interest. U.S. GAAP focuses on a controlling financial interest through ownership of a majority ownership interest.

FASB ASC 810-10-25 and SIC 12 primarily govern consolidation of Variable Interest Entities (VIE) and Special Purpose Entities (SPE). Under U.S. GAAP, an entity is evaluated as to whether it is a VIE/SPE. If so, the primary beneficiary (the entity that receives the majority of the economic risks and rewards) consolidates the VIE/SPE. Under IFRS, the notion of "control" (previous paragraph) is applied. If control exists, the SPE/VIE is consolidated. The concepts related to primary beneficiary do not exist under IFRS.

In December 2008, the IASB issued Exposure Draft 10—Consolidated Financial Statements. The ED proposes a single definition of control for IAS 27 and SIC 12, intended to result in consolidation of off-balance-sheet entities on a more consistent basis. The proposed definition of control is when "the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity." The current IASB project plan anticipates issuance of a revised standard in the first quarter of 2011.

In general, the consolidating process (combining of accounts, elimination entries, and so on) and the consolidated financial statement appearance are very similar under IFRS and U.S. GAAP. However, there are a few differences:

- If there are reporting date differences (different FYEs between the parent and subsidiary) and there are significant intervening events, adjustments are required to be made to the consolidated financial statements under IFRS. Under U.S. GAAP, the events must be disclosed and adjustment is permitted, but not required.
- Noncontrolling interests (formerly "minority interests") are presented outside of the equity section on the balance sheet under U.S. GAAP, but as a separate component of equity under IFRS. NOTE: FASB ASC 810-10-65, effective for fiscal years beginning after December 15, 2008, conforms U.S. practice to IFRS.
- Noncontrolling interests are accounted for at fair value under U.S. GAAP (FASB ASC 805). Under IFRS, these interests are accounted for using the equity method. However, revised IFRS 3 (for annual reporting periods beginning on or after July 1, 2009) allows companies to use either the equity or the fair value method.

IFRS permits companies to prepare standalone parent-company-only financial statements. Those statements need not be issued in conjunction with or be appended to the consolidated financial statements. Such an approach is not permitted under U.S. GAAP. All of our sample companies prepare and distribute parent-company-only financial statements (these statements are not provided herein, but are available on the websites of the respective companies).

Joint Ventures

IAS 31 defines a joint venture as “a contractual arrangement whereby two or more parties undertake an economic activity which is subject to joint control.” Here, the entity does not meet the “control” standard set by IAS 27 so normal consolidation procedures do not apply.

IAS 31 permits the use of proportionate consolidation for joint ventures. The parent reports on the consolidated statements its *proportionate* share of each asset, liability, equity, revenue, and expense account of the joint venture. The equity method may also be used. See Example 8-1.

The IASB issued Exposure Draft 9—Joint Arrangements, which, if adopted, would eliminate the proportionate consolidation method. This proposed change received significant opposition during the comment period and the IASB is gathering additional input prior to making a final determination. A final standard was anticipated in the third quarter of 2009, but has been delayed until at least the first quarter of 2011.

Associates

Entities for which there is a significant interest, but not control, are referred to in IFRS as “associates.” Under U.S. GAAP, these entities are similar to those where an entity owns more than 20 percent but less than 50 percent of the voting stock. Under IFRS (IAS 28), these entities are accounted for under the equity method. Under U.S. GAAP (FASB ASC 825-10), these investments can be accounted for at fair value. If the fair value option is not elected, the equity method is required.

Under IFRS, the accounting policies of the associate company and the investor company must be the same for like transactions and events in similar circumstances. If the accounting policies do not conform, the associate’s financial statements must be adjusted to conform. There is no similar provision under U.S. GAAP. The different accounting treatment for differing FYEs and significant intervening events noted above for consolidated financial statements also applies to accounting for associates.

Example 8-1

P Company owns 50 percent of X Company. X Company has $100 of cash and $100 of equity. For simplicity, we will ignore the income statement. In case 1, P Company is deemed to have control of X Company. The consolidation worksheet would appear as follows:

Case 1—Standard Consolidation

Account	P Company	X Company	Consolidated
Cash	$800	$100	$900
Accounts Receivable	300	0	300
Total Assets	$1,100	$100	$1,200
Liabilities	$500	$0	$500

Equity	600	100	700
Total Liability & Equity	$1,100	$100	$1,200

In case 2, P Company owns its 50 percent interest in X Company in a 50/50 joint venture with an unrelated party. P Company does not have control of X Company, so consolidation rules under IAS 27 do not apply. Instead, the proportional consolidation rules (benchmark treatment) under IAS 31 are appropriate. In this case, the consolidated worksheet of P Company would be as follows:

Case 2—Proportional Consolidation of a Joint Venture

Account	**P Company**	**X Company**	**Consolidated**
Cash	$800	$50	$850
Accounts Receivable	300	0	300
Total Assets	$1,100	$50	$1,150
Liabilities	$500	$0	$500
Equity	600	50	650
Total Liability & Equity	$1,100	$50	$1,150

Alternatively, under IAS 31, joint ventures can be accounted for using the equity method.

Under U.S. GAAP, a joint venture is not defined, although FASB ASC 323 defines a corporate joint venture. Further, and more important, proportionate consolidation is not permitted.

Foreign Subsidiaries

Prior to preparing consolidated financial statements, the financial statements of foreign subsidiaries are translated into the presentation currency using the current rate method. That is, assets and liabilities are translated using the exchange rate at the balance sheet date, and income and expenses are translated using the exchange rates at the dates of the transactions.

Although the application of the current rate method is the same under U.S. GAAP, any translation gains and losses are incorporated into other comprehensive income.

Under U.S. GAAP, equity is translated at historical rates. Under IFRS, equity can be translated at either the historical rate or the closing rate. The policy should be applied consistently. If the closing rate is used, any exchange rate differences are recognized in equity (so total equity will not be different between the two methods).

If the subsidiary is in hyperinflationary economy, IFRS requires that the financial statements be restated to current purchasing power before translating to the reporting currency. In the case of U.S. GAAP, the dollar is the functional currency for these types of entities, so purchasing power adjustments are not made.

If a foreign subsidiary revalues long-lived assets under IFRS, the applicable exchange rate to use for the long-lived assets when translating the financial statements of the foreign subsidiary is the rate in effect when the assets were revalued. Thus, the applicable exchange rate will change if assets are revalued multiple times. Assets cannot be revalued under U.S. GAAP so this situation does not occur.

Summary and Conclusions

This chapter compares and contrasts the accounting for business combinations, consolidated financial statements, and foreign operations for IFRS and U.S. GAAP. There are material differences between the two such as accounting methods allowed for business combinations, asset/liability revaluation under the purchase option, goodwill amortization, disclosure requirements, consolidation of different types of ventures, and the translation of foreign subsidiaries.

Quick Reference Guide to IFRS/U.S. GAAP Differences		
Chapter 8—Business Combinations, Consolidated Financial Statements, and Foreign Operations		
Topic	**IFRS**	**U.S. GAAP**
Business Combination Issues		
Purchase/pooling	Purchase is required. Pooling (uniting of interests) is not allowed.	Pooling not allowed.
Asset/liability revaluation under purchase	Revalue entire asset/liability (to extent both of majority and minority interest). Substantively the same as U.S. GAAP per revised IFRS 3 and SFAS 141(R).	Revalue majority interest only. Substantively the same as IFRS per revised IFRS 3 and SFAS 141(R).
Purchase price (stock portion)	Use FMV of shares at date of acquisition.	Same.
Goodwill amortization	Not amortized but evaluated each year for impairment.	Not amortized but evaluated each year for impairment.
Other (greater IFRS requirements)	Must disclose: percent of voting shares acquired; any operations to be disposed of; reconciliation of beginning/ending goodwill. Substantively the same as U.S. GAAP per revised IFRS 3 and SFAS 141(R).	No similar disclosure requirements. Substantively the same as IFRS per revised IFRS 3 and SFAS 141(R).
Other (greater USG requirements)	No similar requirements. Substantively the same as U.S. GAAP per revised IFRS 3 and SFAS 141(R).	Disclose: purchased R&D acquired and written off; pro-forma I/S showing effect of acquisition. Substantively the same as IFRS per revised IFRS 3 and SFAS 141(R).

Consolidation Issues		
When does parent/sub relationship exist?	Focus on concept of power. Parent's ability to govern sub to obtain benefits.	Focus on majority ownership interest, coupled with control
Different year-end between parent and subsidiary or associate	If significant intervening events, must adjust.	If significant intervening events, must disclose. Permitted to adjust.
Investments in Associates (significant interest but not control)	Report on equity method with share of profits to I/S. May need to adjust for differing accounting methods.	Report at fair value or equity method. Adjustment for differing accounting methods is not required.
Joint Ventures	Defined as contractually agreed sharing of control of an economic activity.	No definition.
Consolidation/Equity method for JV's	Proportionate consolidation is permitted (bring into consolidated statements the parent's *proportion* of each item of asset, liability, equity, revenues, and expenses). Alternatively, can use the equity method.	Proportionate consolidation is not permitted. Use equity method.
Foreign Subsidiary Issues		
Transactions	IFRS/USG are similar except that assets that are revalued are reported using the rate that existed when the new FV was determined (so applicable rate will change).	Same except no revaluation.
Translation	IFRS/USG are similar except that, (a) translation gains and losses are taken directly to equity and (b) for goodwill, can use either the historical rate or yearend rates, but must be consistent.	(a) Translation G/L is recognized in other comprehensive income and (b) goodwill is translated at closing rates only.
Sub in hyperinflationary economy	Restate to current purchasing power before translating to reporting currency.	Dollar is the functional currency so purchasing power adjustments are not made.

Self-Test

1. Which business combination method should be used under IFRS when the shareholders of the two parties achieve a continuing mutual sharing in the risks and benefits attaching to the combined entity such that neither party can be identified as the acquirer?

    a. Purchase method.
    b. Uniting of interests method.
    c. Pooling method.

2. Which type of consideration in a business combination will more likely create a different cost of the acquisition under IFRS and U.S. GAAP?

    a. Cash.
    b. Common stock.
    c. Neither cash nor stock would create a different cost.

3. Under IFRS, goodwill should also be attributed to the minority interest.

    a. True.
    b. False.

4. Under IFRS, how often must goodwill be evaluated for impairment?

    a. Goodwill should not be evaluated for impairment.
    b. Only when events or circumstances indicate that the carrying amount may not be recoverable.
    c. Every year.

5. Under IFRS, how is negative goodwill treated?

    a. Negative goodwill is ignored.
    b. Recognized in income immediately.
    c. Recognized as income after the fair values and cost of acquisition are reassessed.

6. In determining the subsidiary relationship for consolidation, what does IFRS focus on?

    a. The ability of the parent to govern and obtain the benefits from the subsidiary regardless of the ownership interest.
    b. The existence of a controlling financial interest (a majority ownership interest).
    c. All ownership interests must be consolidated, regardless of how small.

7. Under IFRS, what is the term for entities for which there is a significant interest, but not control?

    a. Associates.
    b. Joint ventures.

c. Subsidiary.

Knowledge Application

1. On July 1, Parent Company agrees to issue one million shares of stock in exchange for all the outstanding stock of Subsidiary Company. On July 1, the stock of Parent Company is selling for $80 per share. The transaction is completed and Parent Company issues the stock and obtains control over the net assets and operations of Subsidiary Company on November 1 when its stock is selling for $70 per share.

   Calculate the cost of the acquisition under both IFRS and U.S. GAAP both prior and subsequent to the effective dates for IFRS 3 and SFAS 141(R). Would the amounts differ?

2. Given the following basic information for the companies listed, show an example of standard consolidation and proportionate consolidation for P Company and S Company.

   P Company owns 50 percent of S Company. S Company has $50 of cash and $50 of equity. In case A, P Company is deemed to have control of S Company. Complete the following for standard and proportional consolidations:

Case A—Standard Consolidation

Account	**P Company**	**X Company**	**Consolidated**
Cash	$400	$50	$
Accounts Receivable	150	0	
Total Assets	$550	$50	$
Liabilities	$250	$0	$
Equity	300	50	
Total Liability & Equity	$550	$50	$

Case B—Proportional Consolidation

Account	**P Company**	**X Company**	**Consolidated**
Cash	$400	$	$
Accounts Receivable	150	0	
Total Assets	$550	$	$
Liabilities	$250	$0	$
Equity	300		
Total Liability & Equity	$550	$	$

Solutions to Self-Tests and Knowledge Applications

Chapter 1

Self-Test

1.

a. Correct. Accounting rules differ across countries and may be cosmetic or substantive. An example of a cosmetic difference is the presentation of the balance sheet in many countries that are, or were, members of the British Commonwealth. The balance sheet of a UK company is presented (1) in reverse order of liquidity and (2) in the form A – L = OE rather than A = L + OE.

b. Incorrect. Accounting rules differ across countries and may be cosmetic or substantive. An example of a substantive difference is a business combination that is accounted for, in effect, as a pooling of interest under UK GAAP while the combination would be accounted for as a purchase under U.S. GAAP.

c. Incorrect. The difference is only cosmetic. Accounting rules differ across countries and may be cosmetic or substantive.

2.

a. Incorrect. Business complexity is not the primary factor in following the French model.

b. Incorrect. The legal system factor is based on a code or common law foundation rather than considered an accident of history.

c. Correct. War, conquest, and colonialism can create or change accounting rules in a country as a result of a change in allegiance. Countries that were formerly French colonies often follow the French model.

3.

a. Correct. One of the possible impediments to the creation and adoption of worldwide accounting rules is the determination of who will create the rules

b. Incorrect. Creating a comprehensive body of accounting standards is difficult, time consuming, and costly. In the 1970s and 1980s, only a handful of countries in the world had created, or were even in a position to create, such a body of rules.

4.

a. Incorrect. While the IASC was formed in 1973 the first IAS was published in 1974.
b. Correct. The IASC published its first International Accounting Standard in 1974.
c. Incorrect. The IASC approved a conceptual framework in 1989.

5.

a. Correct. Beginning January 1, 2005, IFRS is required for EU publicly traded companies.
b. Incorrect. In June 2002, the Council of Ministers of the EU adopted a regulation that required the use of IFRS for financial reporting for publicly traded companies in the EU no later than January 1, 2005.

6.

a. Correct. Reducing costs by having a single set of financial statements for users in multiple international settings creates most of the demand for international standards.
b. Incorrect. In the end, most of the demand for international standards can be traced back to the concept of reducing costs—for owners, creditors, preparers, analysts, and the general public.

7. *Cosmetic differences*—Use of different terminology or a different language. Differences in organization of the statements.

Substantive differences—Differences in principles (purchase versus pooling or revaluation of fixed assets).

8. *Legal system*—In most countries, the legal system is based on a code or common law foundation. Code countries, such as France and Germany, have accounting regulations that tend to be detailed and comprehensive. In common law countries, such as the UK and the U.S., accounting rules are less detailed and require companies and accountants to exercise higher levels of professional judgment.

Sources of capital—In the U.S., shareholders provide the majority of capital to businesses. These shareholders often own relatively small ownership stakes and are not involved with company operations. As a result, U.S. GAAP is oriented towards full-disclosure and relative transparency. In some countries, Germany for example, the predominant providers of capital are banks. Often the banks also own large blocks of stock and hold seats on the board of directors. Transparency and disclosure are not as extensive in such countries because the capital providers are more likely to be privy to operational details.

Inflation—When inflation is very high, financial statements begin to lose their comparability from period-to-period. Countries that have experienced very high levels of inflation, such as Mexico or Brazil, often promulgate rules designed to increase comparability by use of inflation indices or similar mechanisms to adjust prior year amounts to a level equal to current year amounts.

Taxation—In countries such as France or Germany, accounting reports are the basis for determining tax liabilities. Accounting rules in these countries are much more detailed and are often driven by tax policy. In countries such as the U.S., tax rules and accounting rules can be, and often are, different.

Culture—Culture is what makes us "us." It is the mental programming that determines who we are, what we believe, how we view right and wrong, and what behavior is acceptable and unacceptable. It is unconscious and not noticed, but it shapes how we act and interact on a daily basis. Since culture gets to the core of beliefs, it will affect the nature and content of accounting rules.

Accidents of History—War, conquest, and colonialism can create or change accounting rules in a country as a result of a change in allegiance. For example, countries that are or were part of the British Commonwealth often have accounting rules that are very similar to the UK. Similarly, former French colonies follow the French model.

Business complexity—Countries with complex business entities are more likely to have complex accounting rules. In addition, complex entities are more likely to participate in cross-border trade and capital seeking.

9. The rise of the multinational corporation and the growth of global capital markets.

10. Deciding who will create the rules, determining what the rules will be like, higher costs, and infringing on national pride.

11. The IASB differs from the IASC in structure; it is now more similar to the FASB. The Board is now smaller and is made-up of predominantly full-time board members. The SIC was also replaced by the IFIRIC. The new IASB will issue IFRS rather than IAS. There is also a new objective of the IASB that is the convergence project. The objective is to "bring about convergence of national accounting and international accounting standards."

Knowledge Application

Based on the measurement differences between the three sets of standards, there is no way that one set of financial statements can be in compliance with French, IFRS, and U.S. GAAP. In France, an individual company's accounts must follow statutory reporting requirements, while consolidated groups can follow IFRS or U.S. GAAP. Reconciliation is possible, but does not give a complete picture; therefore it does not comply completely with GAAP. The only way that this statement can be accurate is if Peugeot SA prepared three complete sets of financial statements, each in compliance with the appropriate set of standards.

Chapter 2

Self-Test

1.

   a. Incorrect. Common stock's international term is Share Capital while minority interests' international term is "Outside Interests."
   b. Correct. Outside interests is the international term for minority interests.
   c. Incorrect. External Board Members is not a term to represent either "outside interests" or "minority interests."

2.

   a. Incorrect. IFRS provide for what some refer to as a "fairness exception" to compliance with IFRS to allow for choosing a different application if application of a provision of any standard would cause the financial statements to be misleading.
   b. Incorrect. The term "exclusion allowance" does not relate to the fairness exception to achieve a fair presentation of financial statements.
   c. Correct. IFRS does provide for a "fairness exception" to compliance with IFRS; however, if such action is taken, significant footnote disclosure is required.

3.

   a. Correct. IAS 1 is the standard that sets forth the requirements for presentation of a complete set of financial statements.
   b. Incorrect. IAS 7 provides the requirements for the cash flow statement.
   c. Incorrect. IFRS 3 provides guidance on business combinations.

4.

   a. Incorrect. IAS 1 generally does not prescribe a particular format for the presentation of the financial statements, while in the U.S. a common format has evolved.
   b. Correct. Statements prepared in accordance with IFRS may be presented using multiple formats.

5.

   a. Incorrect. A statement of comprehensive income is not required under IFRS.
   b. Correct. IFRS does not require comprehensive income to be presented.

6.

   a. Correct. IFRS does not require disclosure in the cash flow statement or elsewhere in the financial statements of any non-cash transactions that affect financing or investing activities.

b. Incorrect. U.S. GAAP requires these activities to be presented at the bottom of the cash flow statement but IFRS does not have any requirements for these activities.
c. Incorrect. IFRS does not require disclosure in the cash flow statement of non-cash transactions.

7. IAS 1 sets forth the requirements for presentation of a complete set of financial statements comprising of a balance sheet, income statement, cash flow statement, equity statement (showing either all changes in equity accounts or changes in equity accounts other than transactions with owners), and footnotes.

8. Yes

9. No

10. This is required and common practice.

11. The IAS measurement criteria used to determine revenues and expenses is similar to that used under U.S. GAAP. However, IFRS definitions are broadly stated, so there is no distinction between revenues and gains or between expenses and losses in the IASC Framework. This differs from U.S. SFAS treatment that states gains and losses are increases or decreases in equity from peripheral or incidental transactions. In practice, gains and losses under IFRS are accounted for in a similar manner as under U.S. GAAP.

12. Statement of Recognized Gains and Losses

13. In the U.S., interest paid, interest received, and dividends received are all accounted for in the operating section and dividends paid are accounted for in the financing section. Under IFRS, interest or dividends paid can be reported in either the operating or financing section and interest or dividends received can be placed in either the operating or investing sections.

    Another difference is that IFRS does not require disclosure in the cash flow statement non-cash transactions that affect financing or investing activities (that is, issuing bonds in exchange for a long-term asset). Under IFRS, such transactions are to be disclosed elsewhere in the financial statements. Conversely, these activities are reported at the bottom of the cash flow statement under U.S. GAAP.

Knowledge Application

1. The balance sheet is prepared using IFRS.

2. Some cosmetic differences include the presentation of non-current assets presented before current assets, the presentation of stockholders' equity before liabilities, and long-term liabilities as provisions.

3. Some substantive differences include liquid assets lumped together, deferred taxes presented as both an asset and a liability, and net income presented on the balance sheet.

Chapter 3

Self-Test

1.
    a. Correct. In practice, accounts receivable are recorded and reported similarly under IFRS and U.S. GAAP.
    b. Incorrect. There is virtually no explicit IFRS guidance concerning accounts receivable but in practice, companies under IFRS and U.S. GAAP record and report accounts receivable similarly.

2.
    a. Incorrect. Derecognition refers to the sale of a receivable or other financial asset.
    b. Incorrect. Impairments of assets are referred to as impairments in international standards while the sale of receivables and financial assets is called "derecognition of a financial asset."
    c. Correct. In IFRS parlance, the sale of a receivable or other financial asset is called "derecognition of a financial asset."

3.
    a. Correct. The only treatments allowed under IFRS are FIFO and weighted average. LIFO is not permitted.
    b. Incorrect. Weighted average is one of the two benchmark treatments, along with FIFO. LIFO is not permitted.
    c. Incorrect. FIFO is one of the two benchmark treatments, along with weighted average. LIFO is not permitted.

4.
    a. Incorrect. Under U.S. GAAP, inventories are valued at the lower of cost or market while under IFRS it is the lower of cost or Net Realizable Value.
    b. Correct. Under IFRS, inventories are valued at cost, not to exceed Net Realizable Value.
    c. Incorrect. Selling price would normally be higher than Net Realizable Value.

5.
    a. Correct. IAS 2 states that inventories are usually written down to net realizable value on an item-by-item basis. It is also permitted to group similar items when those items relate in limited circumstances.
    b. Incorrect. While it is permitted to group similar items when those items relate, it is not appropriate to write inventories down based on a classification of inventory (for example, finished goods), or all the inventories in a particular industry or geographical segment.
    c. Incorrect. IAS 2 states that inventories are usually written down to net realizable value on an item-by-item basis. It is only permitted to group similar

items when those items relate in limited circumstances. Answer a. is a better answer.

6.

a. Incorrect. Derivatives are included in the trading securities category unless they are hedges.

b. Correct. Trading securities are debt and equity securities held for sale in the short term and also include derivatives, unless they are hedges.

c. Incorrect. Derivatives are included in trading securities, unless they are hedges.

7. Under U.S. GAAP, SFAS 140 provides guidance concerning recording and reporting sales of accounts receivable and other financial assets. The standard focuses on the concept of control and whether that control of the asset has been surrendered. Under FASB ASC 860, control is surrendered if all the following conditions are met:

- The assets are transferred beyond the reach of the transferor.
- The transferee can pledge or exchange the transferred assets freely.
- The transferor has not kept effective control through mechanisms such as a required repurchase provision.

Under U.S. rules, a sale of trade receivables without recourse will normally be deemed to be a sale where control is surrendered with no continuing involvement; thus, a sale would be recorded. A sale of trade receivables with recourse will be considered a sale even though there is continuing involvement if the three conditions noted above are met (that is, control is surrendered).

Under international standards, IAS 39 governs sales of trade accounts receivable. In IFRS parlance, the sale of a receivable or other financial asset is called "derecognition of a financial asset." In order to report a sale under IAS 39, the entity must lose or give up control of the contractual rights associated with the asset. Under IFRS, factoring receivables without recourse will qualify as a sale. Factoring with recourse has been previously held to qualify as a sale, but current guidance states that such an approach is no longer permissible if there is no substantive risk assumed by the "buyer" of the receivables. Obviously, the facts and circumstances associated with a recourse sale will govern. However, it is possible that a recourse sale may be accounted for differently under IFRS and U.S. GAAP.

8. Inventory valuation can differ when market is below cost. It can also differ when the value of inventory that has been previously written down later increases.

9. Under U.S. GAAP, if inventory has been written down to market under the lower-of-cost-or-market rules, it cannot be written up if market value increases in a subsequent period. However, IAS 2 states "…when the circumstances that previously caused inventories to be written down below cost no longer exist or when there is clear evidence of an increase in net realizable value because of changed economic

circumstances, the amount of the write-down is reversed (that is the reversal is limited to the amount of the original write-down…" The recovery is reported in income.

10. 10. IAS 39 states that an asset is impaired if its carrying amount exceeds its estimated recoverable amount. Under IFRS, changes in the FMV of AFS are recognized directly in equity, through the statement of changes in equity, except for impairment losses and foreign exchange gains and losses, until the financial asset is derecognized. Once (and if) the financial asset is derecognized, the cumulative gain or loss previously recognized in equity is to be recognized in profit or loss.

    Companies must evaluate their HTM securities for impairment. Indicators of impairment are similar between IFRS and U.S. GAAP. If a security is deemed to be impaired, it must be written down to its estimated recoverable amount (present value of future cash flows discounted at the original effective interest rate).

    Under IFRS, if a HTM security has been written down and subsequently some or all of the impairment loss is reversed, the reversal is reflected in the income statement. The asset cannot be written back up to more than the amortized cost at the time of the original impairment calculation. Reversals of prior impairment charges are not permitted under U.S. GAAP.

Knowledge Application

Sub-case A—The value of the inventory under U.S. GAAP and IAS:

U.S. Replacement cost = 11.10 × 2,000,000 = 22,200,000
IAS NRV = 11.25 × 2,000,000 = 22,500,000

In changing from IFRS to U.S. GAAP a write-down of $300,000 would be required.

A subsequent recovery could be recognized under IFRS, but not under U.S. GAAP.

Sub-case B—The treatment would be similar. Under IFRS, Bob has not relinquished control since he has restricted the buyer from further transferring the receivables. Under U.S. GAAP, since the three conditions are not met, you must treat the sale as with recourse.

Sub-case C—The treatment would be different under IFRS and U.S. GAAP. To be classified as a held-to-maturity (HTM) asset, the asset must have fixed or determinable payments and a fixed maturity. The entity must also have the "positive intent and ability" to hold the asset to maturity. It is not simply a present intention. HTM securities are recorded at amortized cost at the balance sheet date.

Under IFRS, If an entity sells "more than an insignificant amount" of HTM assets before maturity it is prohibited from using the HTM classification for two full annual reporting periods (known as tainting) and must reclassify all HTM assets as available-for-sale. "An insignificant amount" is determined with reference to total HTM assets, not total marketable securities or total assets. Any HTM assets reclassified are remeasured to fair value on the date of reclassification. U.S. GAAP does not contain as specific tainting provisions.

Chapter 4

Self-Test

1.

   a. Incorrect. IFRS 3 provides guidance for business combinations.

   b. Correct. IAS 16 provides the guidance for property, plant, and equipment.

   c. Incorrect. IAS 14 provides guidance for segment reporting.

2.

   a. Incorrect. The exchange of dissimilar assets is recorded at fair market value.

   b. Correct. Dissimilar asset exchanges are recorded at fair value and a gain or loss is recorded.

   c. Dissimilar assets are exchanged at FMV with a gain or loss recorded.

3.

   a. Correct. The offsetting side of the revaluation journal entry will be to "revaluation surplus" in the equity section.

   b. Incorrect. The credit can be referred to by various names such as revaluation surplus, revaluation reserve, property revaluation equity, or something similar but would not be a realized gain.

   c. Incorrect. The credit can be referred to by various names such as revaluation surplus, revaluation reserve, property revaluation equity, or something similar but would not be put in accumulated depreciation.

4.

   a. Incorrect. Generally, deferred taxes are not calculated on the unrealized increase in asset value for depreciable assets used in business operations on the premise that these assets are expected to be used and are not held out for sale.

   b. Correct. SIC 21 states that deferred taxes must be calculated on non-depreciable assets, such as land, since the recovery of the carrying amount of such assets will be realized through eventual sale, not depreciation charges.

   c. Incorrect. Generally, deferred taxes are not calculated on the unrealized increase in asset value for depreciable assets used in business operations.

5.

   a. Correct. Once companies begin to revalue their assets, they must continue doing so.

b. Incorrect. Even though a company begins to experience a downward revaluation adjustment when companies begin to revalue their assets, they must continue the revaluation process.

6.

a. Incorrect. The disclosure of depreciation method is required by both IFRS and U.S. GAAP.

b. Correct. IFRS require, as a disclosure beyond what U.S. GAAP requires, companies to provide a reconciliation of beginning and ending balances of long-term assets only for the current period.

c. Incorrect. IFRS requires several additional disclosures beyond what U.S. GAAP requires on varying topics.

7. Proportional Method:

Building (600,000 × .5)	300,000	
Accumulated Depreciation (100,000 × .5)		50,000
Revaluation Equity		250,000

Gross Method:

Building	150,000	
Accumulated Depreciation	100,000	
Revaluation Entry		250,000

Knowledge Application

1.

a. December 31, 2008

Land	75,000	
Revaluation Equity		75,000

December 31, 2009

Land	5,000	
Revaluation Equity		5,000

December 31, 2010

Land	22,000	
Revaluation Equity		22,000

b. December 31, 2008

Balance Sheet: Increase in Land $75,000; Increase in Equity $75,000
Income Statement: No effect

December 31, 2009

Balance Sheet: Increase in Land $5,000; Increase in Equity $5,000
Income Statement: No effect

December 31, 2010

Balance Sheet: Increase in Land $22,000; Increase in Equity $22,000
Income Statement: No effect

Chapter 5

Self-Test

1.

a. Incorrect. U.S. GAAP uses the term capital lease as a classification while IFRS uses the term finance lease for the same type of classification.
b. Correct. Both IFRS and U.S. GAAP use the operating lease classification.
c. Incorrect. U.S. GAAP uses the term capital lease as a classification while IFRS uses the term finance lease for the same type of classification.

2.

a. Correct. The disclosures that lessors and lessees must provide are generally the same.
b. Incorrect. In general, the disclosures that the lessor makes mirror (that is, income vs. payments) the disclosures that the lessee must provide.

3.

a. Incorrect. SFAS 13 contains this as one of two additional points for a lessor to classify a lease as a capital lease, but IAS 17 does not contain these two additional criteria.
b. Correct. IAS 17 does not contain this as an additional point for a lease to qualify as a finance lease. SFAS 13 does include this as one of two additional points for a lease to be classified as a capital lease.

4.

a. Incorrect. Goodwill is not included in this definition because it is not identifiable and because it cannot be transferred from one owner to another without also transferring other assets or a business or portion thereof.
b. Correct. This is the definition of an intangible asset under IAS 38. Intangible assets include patents, copyrights, brand names, customer lists, trade names, and other rights that can be conveyed.
c. Incorrect. Land is a tangible asset with physical substance.

5.

a. Incorrect. Under IFRS, costs in a research phase are to be expensed. Under IAS 38, costs during the development phase can be capitalized if the company can demonstrate compliance with each of six requirements.
b. Incorrect. Under IFRS, costs in a research phase are to be expensed.
c. Correct. Under IAS 38, costs during the development phase can be capitalized if the company can demonstrate compliance with each of six requirements.

6.

a. Correct. Net selling value is the fair value less costs to dispose.
b. Incorrect. Value in use is the net present value of the future cash flows from the asset.
c. Incorrect. Gross value would imply costs to dispose have not been subtracted.

7.

a. Leases:

- While U.S. GAAP has "bright lines" that differentiate between operating and capital leases, IFRS does not.
- IFRS is more substance driven while U.S. GAAP is more form driven.
- Leases may be treated differently under IFRS and U.S. GAAP.
- Disclosures are more extensive under IFRS than U.S. GAAP.
- The interest rate used to calculate the PV or the minimum lease payments may differ.
- IFRS does not contain the two additional lessor criteria (lease payment collectability is reasonably assured and there are not uncertainties concerning unreimbursable costs).
- There are some lease transactions covered under U.S. GAAP that are not covered under IFRS.

b. Long-lived asset impairment

- The indicators of possible long-term impairment are not as well defined under U.S. GAAP as IFRS.
- Note that under IFRS, impairment is suggested if one of the factors occurs. Then the asset carrying amount is compared to its recoverable amount, determined using the present value of net cash flows or selling price. Under U.S. GAAP, a company will determine if one of the factors indicates that an asset might be impaired. If there is such an indication, a company performs a recovery test whereby the asset's net carrying value is compared to the undiscounted future net cash flows from the asset. If

the undiscounted cash flows are greater than the carrying value, no impairment is recorded. However, if the undiscounted cash flows are less than the carrying value, a loss must be recognized. The loss to be reported is the difference between the carrying value and the asset's fair value.

c. Reversal of asset impairment

- Under IFRS, an enterprise is permitted to reverse a previously recorded impairment loss in certain circumstances.
- U.S. GAAP does not allow reversal of impairment.

d. Intangible assets

- Goodwill is not included as an intangible asset under IFRS.
- Under IFRS, under certain circumstances development costs can be capitalized.
- Subsequent to initial recognition, intangible assets can be measured at a revalued amount.

8. Most internally-generated intangible assets are expensed as incurred. Many internally-generated intangibles would be eligible for capitalization treatment if they were purchased. A primary roadblock to capitalization is that the cost of an internally-generated intangible is often difficult or impossible to measure.

In the case of internally-generated Research & Development (R&D), IFRS and U.S. GAAP differ somewhat. IAS 38 states that costs are to be split into a research phase and a development phase. Research and development carry definitions similar to that found under U.S. GAAP.

Costs in a research phase are to be expensed. Costs during the development phase can be capitalized if the company can demonstrate all of the following:

- The technical feasibility of completing the asset so it will be available for sale or use.
- The intention to complete the asset and either use or sell it.
- The ability to use or sell the asset.
- How the asset will generate future economic benefit (that is, the existence of a sales market or the usefulness of the asset for internal use).
- The availability of adequate resources to complete and use or sell the asset.
- The ability to reliably measure the expenditures during development.

Note that internally generated brands or customer lists should not be recognized as capitalizable intangibles. The Standard takes the view that such assets cannot be distinguished from the cost of developing or maintaining the business as a whole.

Under U.S. GAAP, all costs of research and development are expensed.

Subsequent to initial recognition, IAS 38 permits intangible assets to be measured under one of two methods.

The benchmark treatment is to report intangibles at cost less any accumulated amortization and accumulated impairment losses (if any).

The alternative treatment is to report intangibles at the revalued amount less any subsequent accumulated amortization and accumulated impairment losses (if any). This treatment is only permitted if fair value can be determined with reference to an active market for the intangible asset. This restriction suggests that it will be unusual for the vast majority of intangible assets. The Standard states that an active market might exist for taxi licenses, fishing licenses, or production quotas. The Standard also suggests that patents, trademarks, brands, and similar assets do not have an active market since each asset is unique.

Any revaluation amount should be shown in revaluation surplus using the procedures noted in Chapter 4 concerning PP&E. If the revaluation method is chosen, revaluations must be made regularly.

U.S. GAAP does not permit revaluations.

9. Signs of possible impairment include, but are not limited to,

- Asset market value has declined significantly more than would normally be expected as a result of passage of time or normal use.
- Adverse changes in the technological, market, economic, or legal environments of the enterprise have occurred, or are expected to occur, in the near future.
- Market interest rates have increased during the period and those increases are likely to affect discount rates used in asset valuation.
- For public enterprises, the carrying amount of the net assets of the company is more than its market valuation.
- Evidence exists concerning obsolescence or physical damage to an asset.
- An adverse effect has occurred in the extent to which or manner in which an asset is used or is expected to be used. Examples include plans to discontinue an operation or dispose of an asset.
- Evidence indicates that the economic performance of an asset is, or will be, worse than expected.

U.S. GAAP provides for a similar list of conditions.

Knowledge Application

1. Under U.S. GAAP, the lease would be classified as an operating lease since none of the four criteria are met. Under IFRS, it is likely that the lease would be classified as a financing lease because the lease term is for the "majority of" the economic life and the PV of the payments can be considered to be equal to "substantially all" of the fair value of the leased asset.
2. $70,000.

Chapter 6

Self-Test

1.
   - a. Correct. The definition of a liability under IFRS, as well as U.S. GAAP, includes that the obligation cannot be avoided.
   - b. Incorrect. The definition of a liability is similar under IFRS and U.S. GAAP and includes the following factors: a present obligation that will require a future transfer of an asset, the obligation cannot be avoided, and the obligating event has occurred.

2.
   - a. Incorrect. IAS 37 states that a contingent liability should not be recognized, but should be disclosed unless the likelihood of payment is remote.
   - b. Incorrect. IAS 37 states that unless the likelihood of payment is remote, a contingent liability disclosed.
   - c. Correct. A contingent liability under IFRS is similar to a reasonably possible contingent liability under U.S. GAAP. Both standards require disclosure of the contingent liability but no provision should be recorded.

3.
   - a. Correct. Under IFRS, the past service cost component of pension expense is recognized over the remaining vesting period of the benefit. If benefits have already vested, past service cost is recognized immediately.
   - b. Incorrect. This is the approach under U.S. GAAP where the past service cost component is known as prior service cost. Under IFRS this component is recognized over the remaining vesting period of the benefit and would be recognized immediately if the benefits have already vested.
   - c. Incorrect. Under IFRS, the past service cost component of pension expense is recognized over the remaining vesting period of the benefit. If benefits have already vested, past service cost is recognized immediately.

4.
   - a. Incorrect. IAS 16 covers property, plant, and equipment and convertible debt is not included in this standard. IAS 32 includes coverage of convertible debt.

b. Correct. IAS 32 is Financial Instruments: Disclosures and Presentation and includes coverage of convertible debt.

c. Incorrect. IFRS 4 provides guidance on insurance contracts.

5.

a. Correct. Normally, the debt component can be reasonably measured by determining its fair value using a market discount rate for non-convertible debt.

b. Incorrect. The equity component is generally more difficult to measure as a separate component and is allocated based on the residual allocation method.

c. Incorrect. Normally, the debt component can be reasonably measured by determining its fair value using a market discount rate for non-convertible debt. The equity component is generally more difficult to measure as a separate component and is allocated based on the residual allocation method.

6.

a. Incorrect. For the issuer, mandatorily-redeemable preferred stock is generally reported as a liability under IFRS.

b. Incorrect. Under IFRS mandatorily-redeemable preferred stock is generally reported as a liability while non-redeemable preferred stock would be reported as equity.

c. Correct. Mandatorily-redeemable preferred stock is generally reported as a liability under IFRS.

7.

a. Incorrect. This is a true statement because identifiability is a characteristic element of an intangible asset under IFRS.

b. Incorrect. An asset has to be nonmonetary to be classified as an intangible asset under IFRS. Therefore, this statement is true.

c. Correct. This is a false statement because under IFRS, an intangible asset can arise from contractual and legal rights.

8.

a. Incorrect. Under IFRS, an asset is impaired if the carrying value is greater than the recoverable amount which is the greater of value in use or fair value less costs to sell. This statement is not precise.

b. Correct. For an asset to be impaired, the carrying value must exceed recoverable amount. Recoverable amount is defined as greater of value in use or fair value less costs to sell.

c. Incorrect. This is not a complete description of the impairment test under IFRS. For impairment to be incurred, the carrying value has to exceed recoverable amount, which is defined as the greater of fair value less costs to sell or value in use.

9.

a. Incorrect. Under U.S. GAAP, a contingent liability is recorded at discounted present value if the timing of the payments is fixed or reasonably determinable; this is not a requirement under IFRS.
b. Incorrect. This is not a requirement under IFRS; it is a requirement only under U.S. GAAP.
c. Correct. Under IFRS, the provision is discounted only if the effects of discounting are material.

10. Contingencies:

Similarity—overall treatment
Difference—Terminology—provision vs. contingency; treatment of restructuring costs; amount reported when a range of possible amounts is possible

Deferred Taxes:

Similarity—general treatment
Difference—rates used must be enacted rates for U.S., while they can be substantively enacted for IFRS; financial statement presentation

Pensions:

Similarity—similar treatment
Difference—recording of minimum pension liability; calculation of past service cost component

Employee Stock Compensation:

Similarity—similar treatment
Difference—the criteria to determine whether an employee share purchase plan is compensatory or not is more stringent under IFRS

Convertible Debt:

Similarity—treatment if the convertibility feature can be separated
Difference—treatment if debt cannot be separately into component parts; treatment at conversion

Knowledge Application

ABC Company sold €10,000,000 face value of convertible bonds at a price of 102, realizing proceeds of €10,200,000. The 10-year bonds carry an interest rate of 7 percent. The market rate for equivalent non-convertible bonds is 8 percent. The fair value of the bond component is €9,320,370 determined as follows:

Present value of interest payments at 8 percent	€4,756,500
Present value of principal repayment	4,563,870
Fair value of bond at 8 percent	€9,320,370

The entry to record the bonds under IFRS would be:

Cash	10,200,000	
Discount on Bonds Payable	679,630	
Bonds Payable		10,000,000
Additional paid-in capital		879,630

Under U.S. GAAP, the entry would be:

Cash	10,200,000	
Bonds Payable		10,000,000
Premium on Bonds Payable		200,000

Chapter 7

Self-Test

1.

a. Incorrect. Under both IFRS and U.S. GAAP a change in estimate is treated prospectively with no restatement of prior periods presented.

b. Correct. Under IFRS, companies should account for a change in estimate prospectively.

c. Incorrect. Since SFAS No. 154, the FASB adopted the IASB approach so a change in accounting principle is no longer a method under U.S. GAAP for a change in estimate.

2.

a. Correct. When a company changes from a national GAAP to IFRS for the first time, the company is not permitted to use the alternative treatment and must use the benchmark (SIC 8).

b. Incorrect. Under SIC 8, a company is not permitted to use the alternative treatment to account for a change in accounting principle if the company is changing from a national GAAP to IFRS for the first time.

3.

a. Incorrect. IAS 8 addresses accounting changes and error corrections while IFRS 5 covers discontinuing operations.

b. Incorrect. IFRS 5 replaced IAS 35 in 2005.

c. Correct. IFRS 5 does address discontinuing operations.

4.

a. Incorrect. Constructive gains and losses are not considered under either U.S. GAAP or IFRS as an element to consider for long-term contracts.

b. Incorrect. IFRS does not allow the use of the completed contract method for long-term contracts.

c. Correct. Under IAS 11 if total revenues, costs (past and future), and stage of completion can be reliably estimated, companies must use the percentage-of-completion method.

5.

a. Correct. U.S. GAAP sets forth similar requirement to IFRS including that the financial instrument is settled at a future date; however, U.S. GAAP has an additional requirement that the terms of the contract must require or permit net settlement.
b. Incorrect. This is a common requirement under both IFRS and U.S. GAAP and would not cause a difference.
c. Incorrect. This is a common definition under both IFRS and U.S. GAAP for a derivative instrument.

6.

a. Incorrect. U.S. GAAP requires customer disclosures that are not required under IFRS.
b. Correct. IFRS and U.S. GAAP include internal reporting in the determination of segments.
c. Incorrect. IFRS defined a segment with reference to risk and return profiles but U.S. GAAP gives little concern to risk and return profiles. Under IFRS 8, both IFRS and U.S. GAAP use internal reporting.

7.

a. Correct. IFRS leans towards the discrete approach while U.S. GAAP favors the integral approach.
b. Incorrect. U.S. GAAP favors the integral approach in which interim periods are viewed as an integral part of the annual period, while IFRS leans toward the discrete approach where each interim period is viewed as a separate reporting period.
c. Incorrect. Materiality is important for both IFRS and U.S. GAAP, but is assessed in relation to the interim period for IFRS and for annual amounts for U.S. GAAP.

Knowledge Implementation

1.

a. Changes in Accounting Principle—The benchmark treatment under IAS 8 is to apply the change retrospectively. Thus, a firm will adjust beginning retained earnings by the cumulative effect of the change (net of tax) and will restate all prior years presented. Under IFRS, the cumulative effect of the change does not pass through the income statement as it did under previous U.S. GAAP.

The alternative treatment under IFRS is to account for a change in principle in a similar manner as under previous U.S. GAAP. However, companies that use a national GAAP and change to IFRS for the first time are not permitted to use the alternative treatment and must use the benchmark (SIC 8).

b. Correction of an Error—A correction of an error under U.S. GAAP is accounted for in beginning retained earnings by a prior period adjustment (net of tax) and a restatement of prior periods presented. The benchmark treatment under IFRS is the same as under U.S. GAAP.

The alternative treatment under IFRS (when in is impracticable to determine period-specific effects of an error on comparative information) is to treat the error correction in the current income statement (net of tax) and to provide pro forma disclosure of the effect of the change on prior periods presented, without restatement.

2. Jardine—Primary is business unit, secondary is geographical.

Nestlé—Primary is geographical, secondary is business unit.

Bayer—Primary is business unit, secondary is geographical.

Nokia—Primary is business unit, secondary is geographical.

Chapter 8

Self-Test

1.

a. Correct. IAS 22 stated that acquisition accounting should be used when one of the parties to a business combination obtains control over the net assets and operations of the other party and in this set of information neither party obtains this control. IAS 22 has been replaced by IFRS 3. IFRS 3 does not permit the uniting of interests method.
b. Incorrect. This was the type of business combination described in IAS 22 as a uniting of interest. However, SIC 9 states that it will be possible to identify an acquirer in virtually all cases and a uniting of interest is expected to occur in exceptional circumstances only. IFRS 3, which replaced IAS 22, eliminated the uniting of interest method and only the purchase method is allowed.
c. Incorrect. This was the term for the type of business combination described in IAS 22 as a uniting of interest. However, SIC 9 states that it will be possible to identify an acquirer in virtually all cases and a uniting of interest is expected to occur in exceptional circumstances only. IFRS 3, which replaced IAS 22, eliminated the uniting of interest method and only the purchase method is allowed.

2.

a. Incorrect. If the consideration is cash, there can be little argument as to the cost of the acquisition.

b. Correct. If common stock of the acquirer comprises some or all of the "currency" used in the transaction, the cost of the acquisition can be different under IFRS and U.S. GAAP.

c. Incorrect. If common stock of the acquirer comprises some or all of the "currency" used in the transaction, the cost of the acquisition can be different under IFRS and U.S. GAAP. However, if cash is used, there can be little argument as to the cost of the acquisition.

3.

a. Incorrect. Under IFRS, no goodwill is attributed to the minority interest regardless of whether the benchmark or alternative treatment is followed.

b. Correct. While the minority interest would be, in effect, stated at fair value of the net identifiable assets under the alternative treatment, and at book value under the benchmark treatment, no goodwill is attributed to the minority interest in either treatment.

4.

a. Incorrect. Under IAS 36 goodwill must be reviewed for impairment at least annually and when events or circumstances indicate that the carrying amount may not be recoverable.

b. Incorrect. Previously, IAS 36 only required goodwill to be reviewed for impairment if events or circumstances indicate that the carrying amount may not be recoverable. With, the revisions to IAS 36, goodwill now must be reviewed for impairment at least annually.

c. Correct. Under U.S. GAAP, goodwill must be tested for impairment at least annually and IAS 36 was revised to require that goodwill must be reviewed for impairment at least annually and when events or circumstances indicate that the carrying amount may not be recoverable.

5.

a. Incorrect. The assets and liabilities fair value and the cost of the acquisitions are reassessed. The remaining excess is recognized as income.

b. Incorrect. Only the remaining excess after the fair values and the acquisition cost are reassessed are recognized in income.

c. Correct. The assets and liabilities fair value and the cost of the acquisition are reassessed. Any remaining excess is recognized in income.

6.

a. Correct. Under IFRS, the determination of a subsidiary relationship depends on the concept of control, specifically the "power to govern the financial and operating policies of an enterprise so as to obtain the benefits from its activities."

b. Incorrect. U.S. GAAP focuses on a controlling financial interest through ownership of a majority ownership interest rather than the concept of control regardless of the ownership interest.

c. Incorrect. Under IFRS, the determination of a subsidiary relationship depends on the concept of control, specifically the "power to govern the financial and operating policies of an enterprise so as to obtain the benefits from its activities." Thus the parent must have the ability to govern.

7.

a. Correct. Entities for which there is a significant interest, but not control, are referred to in IFRS as "associates."
b. Incorrect. Joint ventures are defined by IFRS as a contractual arrangement whereby two or more parties undertake an economic activity which is subject to joint control.
c. Incorrect. A subsidiary would be controlled by a parent company.

Knowledge Implementation

1. Prior to the effective date of IFRS 3 and SFAS 141(R):

Under IFRS, the cost of the acquisition would be $70 million. Under U.S. GAAP, the cost of acquisition would be $80 million.

Subsequent to the effective date of IFRS 3 and SFAS 141(R), both IFRS and U.S. GAAP would be the same: $70 million.

2. Case A—Standard Consolidation

Account	**P Company**	**S Company**	**Consolidated**
Cash	$400	$50	$450
Accounts Receivable	150	0	150
Total Assets	$550	$50	$600
Liabilities	$250	$0	$250
Equity	300	50	350
Total Liability & Equity	$550	$50	$600

Case B—Proportional Consolidation

Account	**P Company**	**S Company**	**Consolidated**
Cash	$400	$25	$425
Accounts Receivable	150	0	150
Total Assets	$550	$25	$575
Liabilities	$250	$0	$250
Equity	300	25	325
Total Liability & Equity	$550	$25	$575