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# Defining Issues®

KPMG LLP

The IFRS Movement Worldwide 1
The IFRS Movement in the U.S. 2
Challenges to Achieving the Goal 2
Challenges to Adopting IFRS in the U.S. 3
The SEC's Role in a Transition to IFRS 4
Adoption Timeline 5
Transition Disclosures 5
Convergence 6
Industry Guidance 6
Nonpublic Entities 6



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## How the IFRS Movement Will Affect Financial Reporting in the U.S.

The SEC's concept release on the potential use of IFRS by domestic public companies and the movement in favor of a single set of global standards raise the prospect that U.S. public companies will one day be required to file IFRS financial statements.[1] With capital markets becoming less and less bound by political borders, a single set of high-quality, globally-accepted accounting standards has the potential to improve financial-statement comparability among companies regardless of their domicile. This edition of *Defining Issues* analyzes the major forces that make an IFRS filing requirement in the U.S. more likely and what a transition to an IFRS-only regime would look like and mean for U.S. companies.

### The IFRS Movement Worldwide

IFRS are already transnational to a degree no set of accounting standards has ever been, and the movement toward IFRS abroad affects the way regulators, standard setters, and other members of the U.S. financial-reporting community evaluate the potential use of IFRS here. Over 100 countries either require or allow the use of IFRS or a variant for financial reporting by listed companies, and some of those countries allow the use of IFRS for local regulatory or statutory financial reporting by non-listed companies. The European Union, Australia, and South Africa have adopted requirements to use IFRS, and still other countries, including Brazil, Canada, India, and Israel, plan to require or permit the use of IFRS in the next few years. Japan and China are working to have their standards converged with IFRS within five years.

The current and growing breadth of IFRS adoption across the world suggests that IFRS has become the most practical approach to achieving the objective of having a single set of high-quality, globally-accepted standards for financial reporting. Those who share this belief are influenced by the fact that the IASB's structure and due-process procedures are open, accessible, responsive, and marked by extensive consultation.

[1] SEC Release No. 33-8831, Concept Release On Allowing U.S. Issuers To Prepare Financial Statements In Accordance With International Financial Reporting Standards, August 7, 2007, available at www.sec.gov.

The rationale for a single set of high-quality accounting standards adds momentum to the global IFRS movement. It is based on the promise of greater financial-statement comparability, reduced complexity for preparers and users, and reduced capital-raising costs, all of which enhance capital flows for economic growth. The greater the number of accounting languages used to describe financial results, the more complex the task for investors evaluating cross-border investment alternatives. The fewer barriers to cross-border investing, the more likely that investors will find the most productive and efficient use for their capital.

## The IFRS Movement in the U.S.

Regulators and standard setters have been relatively consistent in supporting the development of a single set of globally-accepted accounting standards. The SEC's proposal to end the reconciliation between IFRS and U.S. GAAP for foreign private issuers and its concept release requesting comments on potentially permitting IFRS filings by domestic public companies suggest it has concluded that IFRS is the set of standards that has the potential to fulfill that goal.[2]

The FASB and the IASB have for several years been engaged in an effort to reduce differences between U.S. GAAP and IFRS, the well-known attempt to achieve "convergence" on high-quality standards. The cooperation is obvious evidence of mutual respect and can be viewed as work that facilitates the U.S. adoption of IFRS over the long term. FASB Chairman Robert Herz recently said that it may be time to "accelerate the convergence effort and the movement in the U.S. toward IFRS." He called for a "blueprint" to transition U.S. public companies to an improved version of IFRS, with standards improved through the convergence process issued as part of both U.S. GAAP and IFRS.[3]

Herz's position, by combining a plan to promote IFRS with action to improve them, reminds interested parties that standards are not static, but subject to change. A move to IFRS would have to look ahead to their ongoing maintenance and improvement and to the regulatory and other infrastructure that promotes their consistent application.

There is, however, a clear difference between supporting the goal of a single set of high-quality globally-accepted accounting standards and supporting an implementation program for adopting IFRS. One can support the former but not the latter. One can believe the goal is desirable but not feasible at the moment, or one can believe the goal is desirable and feasible enough to demand action now.

## Challenges to Achieving the Goal

In order for IFRS to serve as the standards for an IFRS-only regime in the U.S. and globally, the IASB's funding and staffing would have to be established on a more independent footing, the less-detailed guidance that characterizes IFRS must not lead competent, good faith judgments to be challenged, and national versions of IFRS must not undermine the advantages of cross-border comparability.

***A Self-Sufficient, Independent IASB.*** The financial resources of an IASB that serves as the global standard setter would have to be more assured, sufficient, and self-sustaining for it to function independently, and would have to be more equitably shared among the capital markets that benefit from the use of IFRS. The IASB currently relies on voluntary contributions from private companies, accounting firms, international organizations, and central banks. A more permanent and equitable funding mechanism would share the Board's cost in proportion to the size of the capital markets that use IFRS. This approach would be consistent with the IASC Foundation Trustees' funding plan, which would base a significant amount of funding on levies assessed in the capital markets where IFRS are used.[4]

In part due to its funding, the IASB has in the past relied on other standard setters for staffing assistance and initial standard-setting development. In its position as global standard setter, the Board and its staff must be able to maintain and improve IFRS, a capability that would call for increased staff and funding.

***The Specificity of IFRS Guidance.*** IFRS is less detailed in its application guidance than is U.S. GAAP. Much has been made of this difference by calling IFRS a more principles-based approach, but the key difference

[2] SEC Release No. 33-8818, Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP, July 2, 2007, available at www.sec.gov.

[3] Robert H. Herz, International Accounting Standards: Opportunities, Challenges, and Global Convergence Issues, Statement delivered to the Subcommittee on Securities, Insurance and Investment of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, October 24, 2007.

[4] IASC Foundation, Future Funding, available at www.iasb.org.

is the level of detail in the application guidance. It raises these questions: Would less detailed application guidance increase situations in which similar economic events are subject to different accounting outcomes, thereby reducing the comparability of financial statements? Would the types of professional judgments preparers and auditors have to make under an IFRS-only regime with relatively less application guidance be accepted by users and regulators, assuming the judgments are reasonable and supportable and accompanied by transparent disclosures? The effectiveness of an IFRS regime with less detailed application guidance would depend on the degree to which users and regulators accept reasonable accounting and reporting judgments, even if they result in different outcomes in what appear to be similar circumstances.

***Consistency of "IFRS."*** A threat to achieving an IFRS-only regime is the potential for "jurisdictional IFRS" ("as adopted" national versions), a form of IFRS that is different from what is promulgated by the IASB, but is mandated in a territorial jurisdiction. In a worst-case scenario these could develop into the equivalent of national GAAPs, reducing transnational comparability to an empty claim. Jurisdictional IFRS could thus make the goal of a single set of high-quality globally-accepted standards impossible to achieve in a meaningful way, leaving the U.S. with a new national GAAP named IFRS, less control over standard setting, and far less in the way of transnational comparability than promised by the IFRS movement. The potential problem would have to be contained by the active commitment and joint determination of interested parties and regulators. Their aim would have to be to make IFRS mean only those standards issued by the IASB and its interpretive body, the International Financial Reporting Interpretations Committee (IFRIC), and their predecessor bodies, the International Accounting Standards Committee and the Standing Interpretations Committee.

## Challenges to Adopting IFRS in the U.S.

Adopting IFRS would impose costs and require attention from all parties in the financial-reporting community, from preparers, users, and auditors to colleges and universities and the SEC, which would face a heavy agenda.

***Costs of Conversion.*** Companies converting to IFRS would incur costs to adapt systems, train personnel, and gain the experience needed to efficiently and effectively apply the knowledge gained from training. They would also incur costs within the same timeframe to develop a conversion plan that identifies and quantifies differences between U.S. GAAP and IFRS and to apply IFRS's first-time adoption requirements.[5] The process of conversion to IFRS will also likely increase audit costs related to the first-time adoption of IFRS. Some companies may incur costs to renegotiate debt or other agreements to permit periodic reporting in accordance with IFRS and to compute covenant provisions based on IFRS ratios.

However, the costs of many of the conversion activities would be nonrecurring, and they may not be incurred or incurred to the same degree by companies with foreign operations that prepare IFRS financial statements for statutory purposes and have therefore established some IFRS reporting capabilities. Some companies with IFRS reporting capabilities may experience a net decline in preparation costs over time because they would no longer need to maintain two sets of reporting capabilities for foreign subsidiaries whose statutory reporting requires or permits IFRS.

***Training.*** The costs and efforts to develop more in-depth knowledge of IFRS would fall on all groups within the financial-reporting community, including preparers, users, auditors, regulators, and colleges and universities. In-depth knowledge of IFRS in the U.S. is likely limited to institutional investors, the senior-analyst and credit-rating communities, large accounting firms, and domestic companies that report using IFRS in foreign jurisdictions or to foreign parents. In terms of the critical mass of expertise needed for an IFRS-only regime, these sources of in-depth knowledge are unlikely by themselves to be sufficient.

The cost and duration of IFRS training by preparers, auditors, and users would depend, in part, on the degree to which colleges and universities integrate IFRS into their curricula. Accounting departments would have to attract or internally develop faculty capable of teaching IFRS-based accounting, develop instructional materials, and gain acceptance for their IFRS-based accounting programs by accreditation bodies and licensing boards. These tasks could be made more difficult by the current shortage of PhD-qualified accounting faculty.

[5] IFRS 1, First-time Adoption of International Financial Reporting Standards.

## The SEC's Role in a Transition to IFRS

The SEC should develop a plan for the complex series of linked actions needed for IFRS to become the sole set of standards for use in financial statements filed with the SEC. In our view the plan should include preparing a timeline for adoption by public companies, resolving the question of whether any legislative action would be needed to recognize the IASB as the standard setter, coordinating the development of XBRL reporting, addressing the applicability of SEC rules and regulations in an IFRS-only regime, and evaluating the contribution convergence can make to the transition to an IFRS-only regime.

All these actions would be predicated on successful initiatives to create an independent, self-sufficient IASB, a task that should be included in the SEC's plan. The SEC could work through IOSCO with other regulators in order to bring about the funding resources and staffing needed to create an independent, self-sufficient IASB fully ready to be the global standard setter.[6]

***Possible Legislation.*** During the period of transition to the mandated use of IFRS, the SEC should recognize the IASB in addition to the FASB as an accounting standard setter whose standards may be used by domestic companies in financial statements filed with the SEC. When the transition period is complete, the SEC should recognize the IASB as *the* standard setter for purposes of domestic companies' compliance with the filing requirements for financial statements under the federal securities laws. In both cases, the recognition would be similar to the SEC's current acknowledgement of the FASB.[7] However, the SEC would need to consider for either purpose whether legislative action would be necessary for it to be able to designate the IASB as an independent standard setter for purposes of the federal securities laws.

The SEC should recognize the IASB as the standard setter with standard-setting authority equivalent to that currently enjoyed by the FASB. We do not believe that IASB standards and the guidance produced by IFRIC should be subject to any other formal ratification or other endorsement process. The IASB's due process procedures would suffice and should be respected. A formal endorsement process would subject the application of new standards to time lags, and it would risk calls for modifications applicable only in the U.S. that could undermine cross-border comparability and create a U.S. variant of IFRS.

***SEC Rules, Regulations, and Interpretations.*** Before domestic companies are permitted or required to adopt IFRS, the SEC and its staff would have to determine which of its rules, regulations, and other formal and informal requirements would apply when companies prepare their financial statements in accordance with IFRS. Many of the SEC's rules and regulations refer to U.S. GAAP or are based on concepts and terminology used in U.S. GAAP.[8] In some cases, there is no comparable IFRS guidance, and in others there is IFRS guidance, but the meanings of key terms are different from their meanings in U.S. GAAP—for example, the different meanings of the terms "probable" and "related parties."

The risk in this important exercise would be prescribing additional information in financial statements beyond that required by IFRS. To do so would undermine the comparability intended to be achieved by using the same accounting standards that are used in other countries. Additional information outside the financial statements (e.g., MD&A) would not create this problem.

A key question would be the applicability of the SEC's guidance on materiality.[9] However, because the assessment of materiality does not depend on the accounting framework that is used for recognition, measurement, presentation, and disclosure, the SEC's guidance is likely to apply to U.S. companies preparing IFRS financial statements for SEC filings.

We expect that these SEC requirements would be applicable to domestic companies that apply IFRS:

- Requirements to present financial statements of other entities—for example, guarantors of registered securities, significant acquirees, and investees (Regulation S-X Rules 3-05, 3-09, 3-10, and 3-16),

[6] IOSCO is the International Organization of Securities Commissions.
[7] SEC Release No 33-8221, Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, April 25, 2003, available at www.sec.gov.
[8] See the table of examples in the comment letter submitted by the Center for Audit Quality on File Number S7-13-07, Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP available at www.sec.gov.
[9] Staff Accounting Bulletins No. 99, Materiality, and No. 108, Considering the Effects of Prior Year Misstatements in Current Year Financial Statements, available at www.sec.gov.

- Requirements regarding the periods for which primary financial statements would be presented (Rules 3-01 through 3-04),
- Requirements for preparing pro forma financial information, including items for which pro forma adjustments are appropriate (Article 11 of Regulation S-X), and
- Requirements to disclose information outside the financial statements about reserve estimates in accordance with Statement 69.[10]

***XBRL.*** The U.S. GAAP XBRL taxonomy for all financial-statement elements has been substantially completed, and the SEC staff is scheduled to make recommendations to the Commission by mid-2008 on the use of XBRL in filings.[11] Assuming a transition to mandatory IFRS filings and the ongoing movement toward required filings using XBRL, the staff would have to evaluate the comprehensiveness of the IFRS XBRL taxonomy, related plans for its maintenance and updating, whether domestic companies filing using IFRS would be able to use the existing IFRS XBRL taxonomy, and what steps would be necessary if they could not.

## Adoption Timeline

Because of the need for education and many other preparatory activities, a transition to an IFRS-only regime in the U.S. would benefit from a short period of voluntary reporting under IFRS. Assuming the SEC takes this step, it would help to make unmistakably clear that the mixed IFRS-U.S. GAAP regime is only a stepping stone to an IFRS-only regime. The IFRS-only regime would increase financial-statement comparability, but a permanent mixed regime would reduce it and both add costs and complicate the work and responsibilities of preparers, auditors, investors, creditors, regulators, and educators, who would have to develop and maintain knowledge of both IFRS and U.S. GAAP.

The elective period could be followed by a staged mandatory-adoption period intended to include all domestic public companies. IFRS reporting during the first stage could be required by the largest domestic companies (e.g., large accelerated filers). It could subsequently be required by smaller companies on a phased-in basis until all domestic issuers are required to use IFRS. This sequence would allow smaller companies with more limited resources additional time to adopt IFRS and enable them to gain from the experience of the larger companies in the first transition group.

The transition to IFRS under this or any other sequence of adoption would be eased if the SEC extended to those transitioning to IFRS the first-time IFRS adoption relief now provided to foreign private issuers, under which only two years of information, rather than the customary three, is acceptable in the year of IFRS adoption.[12]

## Transition Disclosures

Companies that adopted IFRS would encounter one-time elections within IFRS 1's adoption requirements that could make it difficult to compare transitioning companies. Preparers would need to plan their transition activities carefully, including the retrospective adjustment of prior-period financial statements. Detailed disclosures would be needed to inform users of the effects of the transition on the financial statements.

A company that adopted IFRS would be required under IFRS 1 to explain how the transition from U.S. GAAP to IFRS affected its reported financial position, financial performance, and cash flows and to reconcile equity and net income under U.S. GAAP and IFRS at the date of transition to IFRS and for the latest period presented under U.S. GAAP.

An SEC rule requiring domestic companies to apply IFRS could trigger SAB 74-like disclosure requirements.[13] The SEC would need to establish the disclosure requirements and timing for making those disclosures. The disclosures would likely include a description of the company's transition plan and transition management process, identification of key differences between U.S. GAAP and IFRS, and policies to be elected under IFRS. Quantitative disclosures would enable users to understand the significant effects of adopting IFRS on the basic financial state-

[10] FASB Statement No. 69, Disclosures about Oil and Gas Producing Activities, November 1982, available at www.fasb.org.

[11] SEC Press Release 2007-200, SEC Chairman Cox Announces Landmark Progress in Providing Instant, User-Friendly Access to Financial Reporting Information for Investors, September 25, 2007, available at www.sec.gov.

[12] SEC Release No. 33-8567, First-Time Application of International Financial Reporting Standards, April 12, 2005, available at www.sec.gov.

[13] Staff Accounting Bulletin, No. 74, Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period, available at www.sec.gov.

ments—for example, by reconciling IFRS and U.S. GAAP information.

## Convergence

Ongoing convergence efforts could improve the quality of IFRS and ease the burden of transition for preparers and other interested parties. For these reasons, we believe that convergence efforts should be given a high priority by the IASB and FASB. The Boards should make their projects on financial-statement presentation, revenue recognition, classification of instruments as debt or equity, the conceptual framework, and fair value for all financial instruments their highest priorities.

## Industry Guidance

IFRS does not contain industry-specific guidance, the type of guidance that in this country explains how to apply U.S. GAAP to airlines and casinos, for example, nor does it contain fundamentally different accounting and reporting models for specific industries, such as those for investment companies and broker-dealers. The SEC would have to decide whether to develop a separate approach to transitioning investment companies and broker-dealers to IFRS.

The absence of industry-specific guidance and pronouncements on other topics that are covered in U.S. GAAP is partly a matter of the IASB's progress on its agenda, as in the case of its project on accounting for insurance contracts. However, in planning a transition to mandatory IFRS in the U.S., the SEC would have to evaluate the absence in IFRS of other coverage by FASB and SEC guidance, for example, accounting for specific industry issues, such as extractive activities, and other areas where IFRS lacks guidance, such as common-control transactions and the prescriptiveness of the minimum-line-item requirements for the balance sheet and income statement. However, we do not believe that the SEC should impose any additional reporting requirements within the audited financial statements that are not required by IFRS.

## Nonpublic Entities

The transition to an IFRS-only regime for public companies raises the question of the use of IFRS by U.S. private entities, a question obviously beyond the SEC's control. However, the full benefits of a single set of high-quality accounting standards can arguably be made available only when it is applied by all business entities, whether public or private. Maintaining two sets of accounting standards in the U.S. would impose unnecessary costs on companies that are subject to statutory filings or other reporting requirements based on U.S. GAAP and on the users and auditors of those companies' financial statements. The use of U.S. GAAP by private companies would significantly increase the cost of capital for those who must convert to IFRS as part of the process of "going public," and it would be inconsistent to favor a single set of accounting standards for all but private-company reporting. The adoption of IFRS by U.S. private entities would enable colleges and universities to bring more order to their curricula and free students from course decisions that should not weigh so highly in determining their career choices. For these reasons, as the IFRS movement unfolds for SEC registrants, it is likely to lead to the promotion of IFRS for private entities.

The forces now at work in favor of IFRS mean that U.S. companies are likely to face a demanding learning curve for adopting and applying IFRS, a transition from being constituents of the FASB to being constituents of the IASB, and a closer integration with the emerging global financial-reporting community. The SEC's cooperation with other national and regional regulators and its actions as a member of IOSCO would grow in importance and directly affect the way it fulfills its responsibilities under the securities laws for the protection of users of financial statements. U.S. preparers, investors, creditors, auditors, colleges and universities, and the SEC would depend on one another, each group's actions affecting the progress and outcome of the U.S. financial-reporting community's transition to IFRS. The experience might bring a greater sense of our national interest in high-quality financial information. It is sure to give all members of the financial-reporting community good reason to follow the evolving IFRS movement in the U.S. and how it will affect them.

**KPMG's Position**

KPMG's position on the use of IFRS in the United States is set out in its comment letter on the SEC's Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards. We believe that permitting domestic public companies to file IFRS financial statements should be part of a plan to establish the mandatory use of IFRS in the U.S. as part of a wider effort to bring about a single set of high-quality, globally-accepted accounting standards issued by a single global standard setter. The letter is available at www.us.kpmg.com/Rutus_Prod/Documents/9/KPMG_Comment_Letter.pdf.



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