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Key Differences between IFRS and U.S. GAAP:

Impact on Financial Reporting

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Impact on Financial Reporting

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1. Introduction

The global movement to adopt International Financial Reporting Standards (IFRS) is the paramount financial reporting issue of the 21st century. Over 100 countries now require IFRS as the basis of financial reporting by their publicly-traded companies. In the U.S., convergence of U.S. GAAP to IFRS has been ongoing for many years, formally since the Norwalk Agreement of 2002. Based on a proposed timetable developed by the U.S. Securities and Exchange Commission, acceptance of IFRS in the U.S. could be as early as 2015. Understanding IFRS is critically important to management accountants, auditors, financial analysts, corporate executives, and others involved with financial reporting.

This paper has two objectives. The first is to describe some of the key differences between U.S. GAAP and IFRS. The second is to compare actual financial statements in which results were reported under both IFRS and U.S. GAAP. Findings indicate that while there are some notable differences between IFRS and U.S. GAAP, differences between the two sets of accounting standards do not lead to significant overall differences.

2. Background

A universal or global system of accounting has been widely touted as a benefit to investors, as worldwide adoption of IFRS would facilitate comparability of financial statements prepared in different countries. If adopted by all countries, IFRS would provide uniformity regarding how and what financial information is disclosed. Assisting their companies implement IFRS, if and when adopted, will be an important role for management accountants of publicly-traded companies.

The globalization of business, along with advances in technology, has fostered interconnected worldwide capital markets. How IFRS will affect a company's accounting process is of great importance to management accountants, auditors, corporate executives, investors, lenders, financial analysts, regulators, and others connected to corporate financial reporting. Corporate management is responsible for the quality and reliability of financial statements. The proposed replacement of U.S. GAAP with IFRS makes understanding the impact of IFRS on corporate financial reporting more essential than ever.

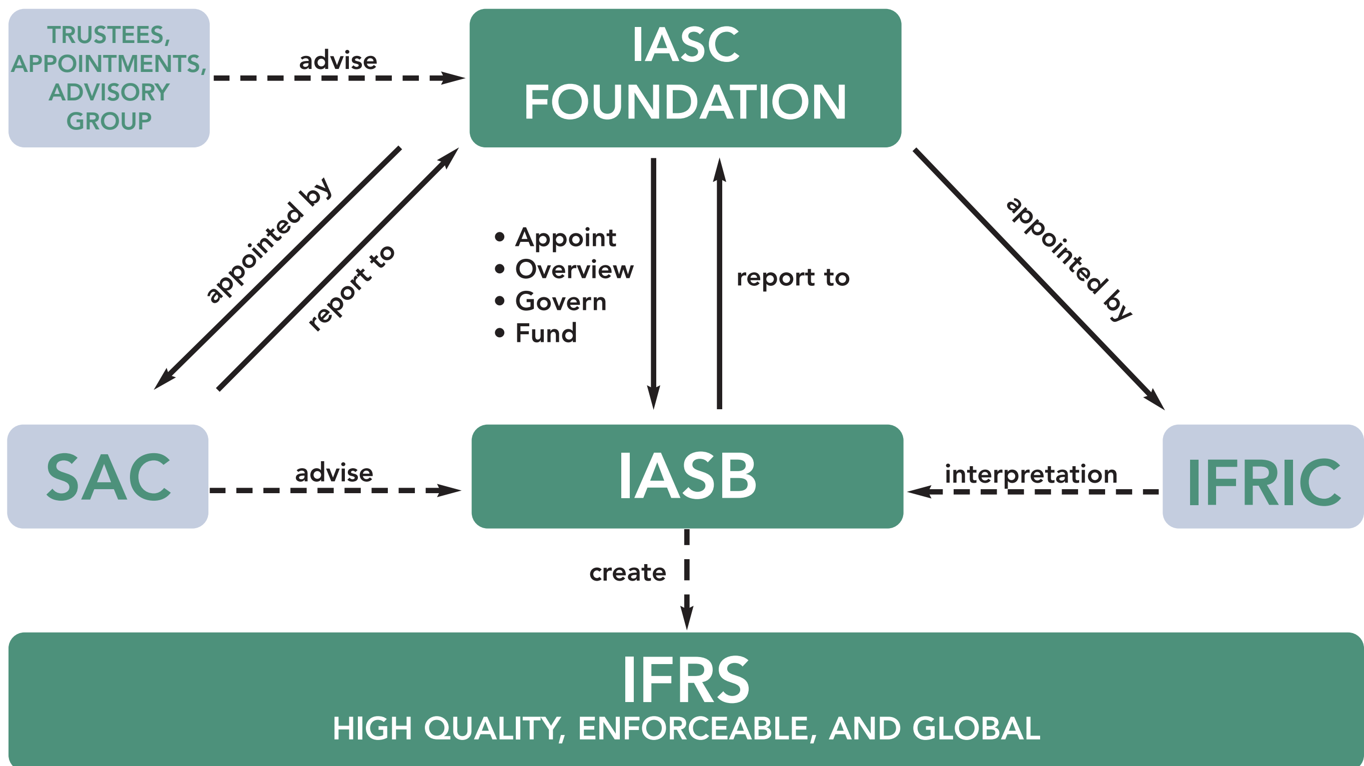
Formed in 2001, the International Accounting Standards Board (IASB) replaced its predecessor, the International Accounting Standards Committee (IASC), which itself was formed in 1973. The IASB promulgates standards in a series of pronouncements designated International Financial Reporting Standards. Standards previously issued by the board of the IASC were subsequently adopted by the IASB. These older standards, which had been issued between 1973 and 2000, continue to be designated International Accounting Standards (IASs). The non-superseded IASs are part of IFRS.

The organizational structure of the IASB was derived from a strategy review undertaken by its predecessor body, the board of the International Accounting Standards Committee. The IASB structure includes a monitoring board of capital market authorities, which appoints members of the IASC Foundation, which is the parent body of the IASB. The IASC Foundation is overseen by a geographically diverse group of trustees. The foundation provides oversight of the IASB (IASB 2010). The IASB organizational design is shown in Figure 1.

At the time of this writing, IFRS acceptance includes more than 12,000 companies located in 113 nations. The number is likely to exceed 150 countries within the next few years, including Canada in 2011 and Mexico in 2012. Accountants, auditors, corporate executives, investors, and other corporate stakeholders will need to become knowledgeable regarding IFRS. Correspondingly, professional associations and industry groups will need to incorporate IFRS into their educational materials, publications, testing, and certification programs. For example, the Institute of Management Accountants has provided webinars on IFRS for its members. Colleges and universities will need to include IFRS in their curricula, to prepare future accountants.

Differences in accounting standards among

Figure 1: Structure of the International Accounting Standards Board



Source: IASB (International Accounting Standards Board). 2010. IASB Structure. International Accounting Standards Board, Website: iasb.org (June 1).

nations are traced to a number of factors, including political systems, sources of capital, inflation, taxation, culture, accidents of history, and business complexity. For example, political systems define who is in charge of accounting standards in a nation. Whether capital is raised in equity markets or through debt financing affects the need for transparency and disclosure. Nations with high inflation generally need inflation-adjusted numbers in corporate financial reports; this is not necessary in countries such as the U.S., which historically has experienced relatively low levels of inflation.

The accounting standards developed in the U.S. are different from IFRS, as U.S. standards are tailored to the unique environment of the U.S., while IFRS is tailored to meet worldwide financial reporting requirements, including those of the U.S. but other countries, too. Consequently, IFRS is not the "ideal" solution for any individual nation, but the standards strive to be the ideal solution for the overall global financial markets. If there were no global financial markets and corporate stocks were traded only within one nation, then the need for IFRS in specific countries would be less obvious. IFRS is a global solution to a global need. To the extent possible, of course, the IASB attempts to develop IFRS with consideration to needs of individual countries such as the U.S.

Resistance to adopting IFRS includes the following: (1) agreeing on who will create the rules, (2) how different the IFRS rules will be from a nation's domestic GAAP, (3) costs of changing GAAPs, and (4) national sovereignty. In the U.S., many accountants are generally satisfied with the work of the Financial Accounting Standards Board and are not at all sure about turning over the standard-setting

process to the IASB. There is concern about how different the new accounting standards might be and the cost of changing over to those new standards. Turning over the standard-setting process to a foreign organization is a major source of concern.

IFRS is often referred to as being principles-based, while U.S. GAAP is said to be more rules-based. Estimates are that, if printed, U.S. GAAP would amount to about 25,000 pages, and IFRS would take up only about 2,000 pages. With fewer pages and less specifics, IFRS often lacks the very detailed guidance included in U.S. GAAP. Regardless of differences in size, both U.S. GAAP and IFRS have the same goal of transparent and full disclosure financial reports. IFRS includes a "fairness exception" that is much like a "Rule 203 exception" under U.S. auditing standards. Under IFRS, if management determines that applying a standard would result in misleading financial representation, then management must follow a different application to attain a fair presentation.

3. Past Research

International Financial Reporting Standards have been the focus of numerous academic research studies.[1] Key events of the past decade include stated support of IFRS in 2000 by the International Organization of Securities Commissions and the Norwalk Agreement in 2002 between the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), which was followed by a second agreement in 2006. In these agreements, the FASB and IASB formally stated their goal to converge IFRS and U.S. GAAP.

In 2005 the European Union mandated use of IFRS for financial reporting by EU publicly-traded companies. In 2007, the U.S. Securities and Exchange Commission announced that it would accept IFRS for financial reporting by non-U.S. firms trading in U.S. markets. In 2008, a timeline was proposed by the SEC that, if followed, would eventually require use of IFRS by all U.S. publicly-traded companies, foreign and domestic; the timeline was revised in 2010. Based on this timeline, complete acceptance of IFRS in the U.S. could be as early as 2015.[2] The timeline is shown in Figure 2.

Figure 2: SEC's Proposed Timeline for Moving Companies to IFRS (August 27, 2008)

End of 2009: Limited group of large companies given the option to use IRFS. SEC estimates 110 U.S. companies will be able to take advantage of the offer.

2011: SEC evaluates the progress of achieving proposed milestones, and makes a decision about whether to mandate adoption of IRFRS. If IFRS is mandated, the commission will develop a staged rollout, starting with the largest public companies first.

2014: Year the first wave of companies will be mandated to report financial results using international accounting standards, if IFRS reqirements are adopted in 2011.

2016: Year that all public companies, big and small, will be mandated to report financial results using international accounting standards, if IFRS requirements are adopted in 2011.

*Revised February 24, 2010; No early adoption option; earliest possible first year of IFRS reporting changed to 2015.

The question is whether acceptance of IFRS for corporate financial reporting in the U.S. is inevitable. Adoption of IFRS has been called an "unstoppable juggernaut."[3] In only a few years, mostly starting in 2005, IFRS went from being little used to become the world's dominant set of accounting standards. In the U.S., arguably the most profound event was the SEC's decision in 2007 to revise its rules to allow non-U.S. companies to include in their SEC filings financial statements without reconciliation to U.S.

GAAP if the financial statements are prepared in accordance with IFRS as issued by the International Accounting Standards Board. Thus, IFRS became accepted in the U.S., if only for these select companies. This was a historic event in U.S. financial reporting, as acceptance of IFRS eliminates a substantial barrier for foreign private issuers to enter and to remain in the U.S. markets.

Corporate leaders in the U.S. who recommend acceptance of IFRS include John Thain, CEO of the New York Stock Exchange, and Paul Volcker, former Federal Reserve chairman.[4] In 2009, newly appointed SEC Chairperson Mary Schapiro expressed reservations regarding adoption of IFRS and refused to be constrained by the timetable put forward by her predecessor.[5] Nevertheless, FASB Chairman Robert Herz indicated that the U.S. should consider adopting IFRS in the next three to five years regardless of whether all differences between U.S. GAAP and IFRS were resolved.[6]

A number of studies have evaluated the feasibility of convergence to IFRS, including the potential benefits of producing more accurate, timely, and complete financial information, eliminating international differences in accounting standards, and removing barriers to the global capital markets.[7] Obstacles to IFRS convergence include persistence of international differences under IFRS, the existence of market, legal, and political differences, and IFRS enforcement issues.

In a study by Wang and Smith, an examination is made of how different GAAPs, including IFRS, affect performance of valuation models.[8] Financial data from Asia-based companies, including those in China, were analyzed. In a study by Daske et al., early evidence is examined of the economic consequences of mandatory IFRS reporting worldwide.[9] Bolt-Lee and Smith provide a review of several IFRS-related recent studies.[10]

4. Differences Between IFRS and U.S. GAAP

While there are areas of difference between U.S. GAAP and IFRS, similarities exceed differences. Differences can be regarded as cosmetic or substantive. Cosmetic differences are primarily associated with appearance or location of information in financial reports. Substantive differences cause differences in the value of an item or whether an item is reported at all.

Regarding cosmetic differences, International Accounting Standard 1 (IAS 1) does not prescribe a particular format for presentation of financial statements. As a result, multiple formats have evolved in practice. The presentation of the balance sheet in many countries that are, or were, members of the British Commonwealth use the format: Assets – Liabilities = Stockholders' Equity, rather than the U.S. format of Assets = Liabilities + Stockholders' equity. In addition, balance sheet items are shown from least liquid to most liquid, the reverse of the U.S. format.

Another example of a cosmetic difference is use of different words to refer to the same financial statement item. A few examples are as follows, with the international term followed by the U.S. counterpart:

- Turnover – Sales
- Stocks – Inventory
- Share Capital – Common Stock or Paid-in Capital
- Share Issue Premium – Additional Paid-in Capital
- Debtors – Accounts Receivable
- Creditors – Accounts Payable
- Revenue Reserves – Retained Earnings

With regard to substantive differences, under IFRS, there is no distinction between revenues/gains or expenses/losses on the income statement. Regarding the statement of changes in stockholders' equity, two different approaches can be used. The IFRS benchmark treatment is similar to U.S. GAAP; the alternative treatment allows for items such as capital transactions to be included in notes.

Regarding the statement of cash flows, under IAS 7, the statement of cash flows is a required statement. Requirements of IAS 7 are much the same as SFAS 95 in the U.S., with a few differences. In the U.S., interest paid, interest received, and dividends received are shown in the operating section, while dividends paid are shown in the financing section. Under IFRS, interest paid, interest received,

and dividends received are normally accounted for as operating cash flows as well. Interest paid may be accounted for as a financing cash flow, however, while interest received and dividends received may be accounted for as investing cash flows, because they are costs of obtaining financial resources or returns on investments. Non-cash transactions (such as issuance of bonds for long-term assets) do not need to be disclosed on the face of the cash flow statement.

Regarding notes to the financial statements, IFRS requires disclosure of currency used in the financial statements. The currency used on the IFRS financial statements need not be the primary currency of the company. For example, a company based in Australia, with operations primarily in Southeast Asia, could choose to use the euro as its reporting currency.

Regarding inventory accounting, under IFRS, FIFO and weighted average methods are permitted, but LIFO is not an acceptable treatment. Both IFRS and U.S. GAAP require lower-of-cost-or-market (LCM). Still, "market" is defined differently. Consequently, different valuation amounts may result. Unlike U.S. GAAP, IFRS permits subsequent write-up after write-down.

Under IFRS, inventory is valued at cost, not to exceed net realizable value (NRV). NRV is sales proceeds less additional costs to complete and to make the sale. IAS 41 provides special guidance for biological assets and agricultural produce. Under U.S. GAAP, inventory is valued at lower-of-cost-or-market (LCM) with market being defined as replacement cost (RC), but with an upper limit (ceiling) of NRV and a lower limit (floor) of NRV minus a normal profit margin. Consequently, if replacement cost is below NRV, IFRS and U.S. GAAP will have different valuations.

Regarding property, plant, and equipment (PP&E), under IFRS, the benchmark treatment under IAS 16 is to report PP&E at cost net of depreciation and potential impairments. IAS 16 provides for an alternative treatment, to revalue PP&E to fair value. Companies may use "highest and best use" to determine fair value. After a company begins to revalue PP&E, it must continue to doing 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." Consider the following scenario: Land that cost 200,000 is revalued to its fair value of 240,000 on December 31 with the following journal entry:

December 31	Land	40,000
	Revaluation Surplus	40,000

Regarding investment property, under IAS 40, investment property is defined as property held for rental or capital appreciation or both. Investment property may be accounted for under the "fair value model" or the "cost model." Under the fair value model, changes to fair value are recognized on the income statement. Under the cost model (cost less accumulated depreciation), fair value must be disclosed in notes.

Regarding leases, under U.S. GAAP, leases are classified as capital if one or more of four criteria are met: title transfer, bargain purchase option, lease term equals or exceeds 75% of economic life, or present value (PV) of minimum lease payments (MLP) greater than or equal to 90% of the asset's fair market value (FMV). Under IFRS, the criteria are less rigid. Under IAS 17, a lease is classified as either an operating lease or a finance lease (U.S. GAAP refers to finance leases as capital leases). Per IAS 17 a finance lease "…transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred." Four of the eight IFRS criteria are as follows:

- The lease transfers ownership to the lessee.
- The lessee has a bargain purchase option.
- The lease term is for the "major part" of the economic life of the asset.
- The present value of the minimum lease payments "amounts to at least substantially all of the fair value of the leased asset."

Depending on one's interpretation of "major part" and "substantially all" in the third and fourth criteria, U.S. GAAP and IFRS would yield different classifications of a lease.

Regarding deferred taxes, according to U.S.

GAAP, if a company has a deferred tax asset (DTA), the company must determine whether a valuation allowance is needed. A valuation is required if "more likely than not" a part or all the DTA will not be realized. DTA would be recorded at gross and a corresponding allowance would also be recorded. Under IFRS, DTA is recorded only if the DTA is expected to be realized; the DTA is reported at net, not the gross and allowance. Under IFRS, deferred tax assets and deferred tax liabilities are reported only as long-term, while U.S. GAAP would distinguish short- and long-term.

Some other comparisons between U.S. GAAP and IFRS are as follows:

- Discontinued operations – similar.
- Long-term construction contracts – IFRS does not permit completed contract method.
- Derivatives – similar.
- Hedge accounting – similar.
- Segment reporting – IFRS is more comprehensive.

Under U.S. GAAP, if a parent/subsidiary relationship exists, then consolidated statements must be prepared. Determining the relationship under IFRS, the emphasis is on the parent's ability to govern and obtain benefits from the subsidiary, while U.S. GAAP puts the emphasis on existence of a controlling financial interest. Unlike U.S. GAAP, IFRS permits stand-alone parent-company-only financial statements.

5. Empirical Analysis of Accounting Values Under IFRS and U.S. GAAP

Researchers have examined financial reports that include both U.S. GAAP and IFRS results. In a study by Smith and Files, an examination is made of accounting values on financial statements of corporations headquartered in the European Union (EU) that list stock on the New York Stock Exchange (NYSE), for years 2005 and 2006.[11] The sample was limited to these firms and years because these years fall between two important rulings, the first made

Figure 3: IFRS- versus U.S. GAAP-Reported Financial Statement Information of EU Firms Cross-listed on the NYSE

		Reported using IFRS ($MM)[a]					Reported using U.S. GAAP ($MM)[b]				
	N	MEAN	MEDIAN	STD. DEV.	MIN	MAX	MEAN	MEDIAN	STD. DEV.	MIN	MAX
Revenue	126	46,109	28,132	60,079	116	306,731	50,548	28,253	72,597	116	384,653
Net Income	126	4,420	3,092	7,359	-26,031	28,864	5,394	2,858	7,821	-780	31,864
Total Assets	126	200,707	48,591	385,299	511	1,860,758	188,187	49,124	320,453	342	1,406,955
Total Liabilities	126	154,351	20,793	354,151	-11,149	1,745,830	155,296	23,996	310,838	18	1,442,989
Shareholder Equity	126	43,912	15,437	124,210	44	972,466	33,926	15,438	51,039	50	287,989
EPS (basic)	122	14.68	1.93	39.70	-21.51	186.30	7.39	1.67	19.98	-36.87	92.96
EPS (diluted)	126	13.97	2.02	38.23	-21.51	184.90	7.64	1.76	20.01	-36.87	91.91

This table compares the financial statement numbers reported under International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles (GAAP) for the same European Union (EU) firms. Each firm, which is headquartered in the EU but lists stock on the New York Stock Exchange (NYSE), is mandated by the EU to report using IFRS and mandated by the Securities and Exchange Commission (SEC) to provide reconciliation of differences between IFRS and U.S. GAAP in a Form 20-F. All values (except earnings per share values) are reported in millions ($MM) and have been winsorized at the 1st and 99th percentiles.

[a] IFRS financial statement information is hand-collected from the Form 20-F filed with SEC. In some cases, the 20-F reports IFRS financial statements in Euros, Great Britain Pounds, etc. For the purposes of our study, all numbers have been converted to U.S. dollars using the average monthly currency conversion value for the month and year in which the 20-F was filed.

[b] GAAP financial statement information is hand-collected directly from the Form 20-F, when available. Otherwise, this information is collected from Compustat.

by the EU and the second by the United States. Beginning in 2005, all EU firms were required to use IFRS-based financial reports. In 2007, the U.S. Securities and Exchange Commission ruled that non-U.S. firms using IFRS would no longer be required to reconcile to U.S. GAAP when reporting earnings.[12] Consequently, 2005 and 2006 are unique years in which EU firms trading in U.S. markets would provide financial statements using two different standards: IFRS and GAAP. Financial statements by non-U.S. firms are reported annually to the SEC using a Form 20-F.

Figure 3 shows summary statistics for the financial information obtained for the EU firms, as reported under both IFRS and U.S. GAAP. The mean net income reported under IFRS and GAAP are $4,420 and $5,394 million, respectively. Thus, net income reported under GAAP appears to be higher. The median net income value is higher under IFRS, however ($3,092 million under IFRS versus $2,858 million under GAAP).

Figure 4 shows results of the analysis of differences between IFRS- and GAAP-reported financial numbers. The mean earnings per share is the only mean with a statistically significant difference between IFRS and GAAP, and no items have significantly different medians. Lack of significant differences between IFRS- and GAAP-reported financial statement items is a notable finding, as it suggests that IFRS adoption will not cause a major change in U.S. financial reporting results, at least in an overall context. Admittedly, individual firms may encounter significant differences for specific financial statement items between IFRS- and GAAP-based results.

6. Summary and Conclusions

The movement toward adoption of International Financial Reporting Standards has become a global juggernaut, with over 100 countries now accepting or requiring IFRS for financial reporting by publicly-traded companies. U.S. adoption of IFRS appears quite possible, but is still far from certain. Some leaders have recommended adoption of IFRS, but others have expressed reservations, notably SEC Chairperson Mary Schapiro.

Differences between U.S. GAAP and IFRS can be

Figure 4: Test of Differences between IFRS- and U.S. GAAP-reported Financial Statement Information of EU Firms Cross-listed on the NYSE

	Difference (mean) GAAP – IFRS	T-value	*Difference (median)* GAAP – IFRS	Chi-square value
Revenue	4,439	1.11	121	0.01
Net Income	974	1.57	-234	0.04
Total Assets	-12,520	-0.96	533	0.08
Total Liabilities	945	0.07	3203	0.44
Shareholder Equity	-9,986	-0.92	1	0.00
EPS (basic)	**-7.29**	**-2.72*** **	-0.26	1.43
EPS (diluted)	**-6.33**	**-2.57*** **	-0.26	0.61

Note: This table compares the financial statement numbers reported under International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles (GAAP) for the same European Union (EU) firms. Each firm, which is headquartered in the EU but lists stock on the New York Stock Exchange (NYSE), is mandated by the EU to report using IFRS and mandated by the Securities and Exchange Commission (SEC) to provide reconciliation of differences between IFRS and U.S. GAAP in a Form 20-F. All values (except earnings per share values) are reported in millions ($MM) and have been winsorized at the 1st and 99th percentiles.

Differences are computed as [GAAP – IFRS]. Chi-square values are computed using the Kruskal-Wallis test. *, **, and *** indicate that values are significantly different from zero at the p = 0.10, 0.05, and 0.01 levels, respectively.

cosmetic or substantive. For example, regarding financial statement presentation, cosmetic differences include use of the accounting equation (A=L+SE versus A- L=SE), terminology, and order of liquidity. Substantive differences involve matters such as inventory valuation, PP&E, leases, and deferred taxes. The FASB and IASB are working together in efforts to converge the two sets of accounting standards.

An examination of financial reports that include both U.S. GAAP and IFRS results shows that there is little difference between IFRS- and GAAP-reported financial statement overall average values. This is an important finding, as it suggests that U.S. adoption of IFRS will not cause major changes in U.S. financial reporting results, at least overall. Of course, individual companies may still be significantly affected on specific accounting items.

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