A Guide to IFRS

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Course Description

International Financial Reporting Standards (IFRS) is the framework used by many publicly traded companies around the world today to report their financial results. With support from important constituencies, the SEC and the FASB have taken several steps toward what will be a major transition from accounting and reporting framework currently in place in the United States to IFRS. In an effort to better understand how convergence will affect financial reporting in the United States, depending on the IFRS implementation action taken by the SEC, this course examines some of the material differences that currently exist between U.S. GAAP and IFRS.

Field of Study	Accounting
Level of Knowledge	Basic to Intermediate
Prerequisite	Basic Accounting
Advanced Preparation	None

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A Guide to IFRS

Learning Objectives:

After completing this section, you should be able to:

1. Recognize key differences between IFRS and GAAP affecting the financial statements.
2. Recognize the objectives of the IASB's conceptual framework project.

For several years, major accounting and reporting differences have existed between U.S. generally accepted accounting principles (GAAP) and international Financial Reporting Standards (IFRS). However, in a 2002 Memorandum of Understanding (MOU) between the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), commonly known as the "Norwalk Agreement" (http://72.3.243.42/news/memorandum.pdf), the two accounting standard-setting bodies made a firm commitment to develop high quality accounting standards that converge. In effect, this effort has been a movement toward a globalization of accounting standards.

In this MOU, the two boards agreed to several joint projects in an effort to converge accounting standards. Since the Norwalk Agreement, the FASB and IASB have issued new standards that closely converged and revised many existing ones in order to attain a near-uniform set of accounting standards. While the challenge for practitioners is to learn and eventually implement this new set of global accounting standards, the benefits of a single set of worldwide standards is expected to produce financial reporting that is more comparable, transparent, and achieves greater understandability. The American Institute of Certified Public Accountants (AICPA) amended Rules 202 and 203 of the AICPA Code of Professional Conduct by inserting the IASB into the allowable rules.

What is IFRS?

International Financial Reporting Standards (IFRS) is the framework used by many publicly traded companies around the world today to report their financial results. With support from important constituencies, the US Securities and Exchange Commission (SEC) and the FASB have taken several steps toward what will be a major transition from accounting and reporting framework currently in place in the United States to IFRS.

As of this writing, the SEC has temporarily halted early implementation of IFRS. In the United States, registered companies were scheduled to issue financial statements using IFRS in 2014 as part of a proposed "road map." The original timeline for IFRS convergence with U.S. GAAP is as follows: U.S. companies registered with the SEC are currently required to file financial statements in accordance with U.S. GAAP. In 2008, foreign private issuers were allowed to issue financial statements in accordance with IFRS without footnote reconciliation to U.S. GAAP. On August 27, 2008, the SEC then voted unanimously to adopt a road map for conversion of accounting standards, thus implementing IFRS in the United States by as early as 2010 and requiring all companies to file financial statements under IFRS by 2014. However, on February 24, 2010, the SEC withdrew proposed rules that would have allowed early implementation of IFRS and announced it would table the decision until later.

Note: In late-2012, the SEC Staff postponed decisions relating to their Work Plan on whether, when and how to incorporate IFRS into the US financial reporting system. Efforts were scaled back dramatically after the financial crisis as rule-making required by the Dodd-Frank Act of 2010 shifted the agency's priorities. The Wall Street Journal reported on Feb 4, 2014, that SEC's appeared to back away from the possibility that U.S. companies would one day file financial reports under International Financial Reporting Standards. In its new plan, the SEC writes: "Due to the increasingly global nature of the capital markets, the agency will work to promote higher quality financial reporting worldwide and will consider, among other things, whether a single set of high-quality global accounting standards is achievable." However, IFRS continues to be updated, and as the marketplace becomes increasing global, more US companies have non-US stakeholders. These stakeholders may require IFRS financial information, audited IFRS financial statements, and budgets and management information prepared under IFRS. The objectives of having a single set of high-quality, globally accepted accounting standards remain.

Why IFRS?

According to a recent report released by PricewaterhouseCoopers, the demand for IFRS is driven by several factors, including the magnitude of multinational corporations, global capital markets, economic interdependence, foreign direct investment, and multinational political organizations, like the European Union.

1. Globalization rules.

The globalization of business and finance has inevitably led to calls for a common set of high-quality, global accounting standards. More than 12,000 companies in almost a hundred countries have successfully adopted IFRS. The U. S. is by far the largest of the few remaining hold-outs. Failure to make the transition could put the United States at a disadvantage with respect to future non-domestic investment here. Most large global companies are also multinational and conduct more than half of their business outside of their own country. McDonald's is just one example.

2. Complexity of current US standards has taken a toll on domestic companies.

Decades of detailed financial reporting guidance from multiple US standard-setting bodies make navigating and applying US standards extremely difficult, complex, and cumbersome. For example, there are now hundreds of FASB Statements, Interpretations, and Staff Positions, not to mention all of APB Opinions and Accounting Research. Bulletins still in effect today. More specifically, US GAAP covers over 25,000 pages; guidance for IFRS takes just 2,500. The complexity of US GAAP is not only difficult to unravel, it has resulted in a higher cost of compliance and increasing incidence of mistakes. IFRS offers a sophisticated and simplified platform for a fresh start.

In addition, the past ten years have been volatile ones for the US economy with many infamous business frauds and accounting scandals, the Sarbanes-Oxley Act (SOX) of 2002, and the related Public Company Accounting Oversight Board (PCAOB). The combined effect of these events has prompted the FASB, the SEC, and the AICPA to reassess the current rules-based US standards system in favor of one that is much more principles-based.

3. Convergence of the two dominant accounting frameworks is a timely proposition.

To date, the path to a common set of global standards has been an attempted convergence between IFRS and US GAAP. For example, for the past few years, and with most of the last 15 to 20 FASB Statements issued, the Board has been very clear that the reason for changes has been to try to reduce the differences between, or to better converge, US GAAP and IFRS. Much good has been accomplished. Both the US FASB and the IASB remain strongly committed to the idea of converging their standards. But complete convergence may elude the standard setters because of differing cultural, legal, regulatory, and economic environments. Nonetheless, the difficulty and cost of maintaining two sets of standards is not sustainable.

4. IFRS will create cost efficiencies for companies.

A number of forward-looking US companies are already preparing for the conversion to IFRS with a goal of substantial savings and efficiencies. Much of US GAAP is becoming more like IFRS already. For example, US companies used to treat changes in accounting principle as an item that affected the income statement. Now, in accordance with SFAS 154, they actually show accounting principle changes as an effect on the retained earnings statement. The reason for this change is directly related to IFRS.

In an effort to better understand how convergence will affect financial reporting in the U.S., depending on the IFRS implementation action taken by the SEC, this course examines some of the material differences that currently exist between U.S. GAAP and IFRS.

Required Financial Statements and Structural Differences in Primary Financial Reporting

Financial statements required under U.S. GAAP and IFRS are somewhat similar. IFRS require a Statement of Financial Position similar to U.S. GAAP, but its format is not based on order of liquidity of assets, an income statement, a Statement of Changes in Equity or a Statement of Recognized Income and Expense (reported as a separate financial statement), Statement of Cash Flows, and disclosure notes including a Summary of Significant Accounting Policies. Under U.S. GAAP, comprehensive income and changes in equity are reported as a separate financial statement (allowable under IFRS—and is reported as a Statement of Changes in Equity) or reported in the notes to the financial statements (not allowed under IFRS). However, U.S. GAAP allows for a combined statement of income and comprehensive income, which is not allowed under IFRS.

Unlike U.S. GAAP, IFRS require comparative information on each financial statement for the preceding period only, with the option of providing additional years of comparable reporting. SEC registrants are required to present current and prior years information on the balance sheet, while other financial statements are required to report three years of comparable results.

In addition, in regard to consolidated financial reporting, under U.S. GAAP, the parent firm must present consolidated financial statements. However, IFRS allows for exemptions if the parent is a wholly owned or partially owned subsidiary, the parent does not trade bond or equity instruments in the public market, or it did not file (or will not file) financial statements with a regulatory agency.

Lastly, U.S. GAAP currently allows both multi-step and single-step income statement formats, whereas under IFRS, the single-step format is not used. In addition, U.S. GAAP defines the four elements on an income statement as revenues, expenses, gains and losses, while IFRS provides only two elements, income and expenses. In addition, under IFRS, revenues and gains are reported as income, which increase economic benefits; and expenses include both expenses and losses, which decrease economic benefits. With the IFRS approach, all items are reported as income from operations, therefore, ignoring unusual or irregular activity. Extraordinary item reporting is prohibited under IFRS, whereas discontinued operations reporting is allowed, with some differences to U.S. GAAP. In addition, U.S. GAAP presents expenses using a functional classification, which is required by the SEC, while on IFRS-produced income statements, expenses are presented using a nature of expense classification, which prohibit allocations and requires more specificity.

Financial Statement Presentation—Joint Project of the FASB and IASB

In addition to the current structure of financial reporting under U.S. GAAP and IFRS, one of the goals contained in a 2007 Memorandum of Understanding was to develop a common standard for financial statement presentation that focuses on relationships across financial statements, disaggregating information on each financial statement to allow for better efforts of predicting an operation's future cash flows, and to improve a user's ability to assess an entity's liquidity and financial strength. While two of the three phases have been completed, the proposed changes will affect financial reporting in the United States and worldwide when convergence of standards begins to take shape.

Phase A of the project proposes four financial statements and requires no less than two years of comparative data to be presented in such statements. The proposed financial statements include: a Statement of Comprehensive Income, a Statement of Financial Position, a Statement of Cash Flows, and a Statement of Changes in Equity. While many of the features of financial reporting will continue, the proposal recommends including a new parallel classification structure across three of the four proposed financial statements (excluding the Changes in Equity Statement). *Phase B* of the project led the two boards to issue three proposed objectives of information that should be presented in financial statements “in a manner that”:

- Portrays a cohesive financial picture of an entity's activities, which means “that the relationship between items across financial statements is clear and that an entity's financial statements complement each other as much as possible.”
- Assists users in assessing future cash flows by “assessing the amount, timing, and uncertainty of future cash flows” by requiring that financial information be “disaggregated reasonably homogeneous groups of items”; however, should items differ economically, users may report “differently in predicting future cash flows.”
- Helps users assess an entity's liquidity and financial flexibility by providing information concerning liquidity, which will assist users in assessing the entity's ability to “meet its financial commitments as they become due ... [and allows users to assess] the entity's ability to invest in business opportunities and respond to unexpected needs.”

The Statements of Comprehensive Income, Financial Position, and Cash Flows will each contain a Business section, which will report operating activities and investing activities of the specific statement. For example, the Statement of Comprehensive Income's Business section will contain operating income and expenses as well as investing income and expenses; the Statement of Financial Position's Business section will report operating assets and liabilities, and investing assets and liabilities.

In addition to the Business section, in three of the four statements (excluding the Changes in Equity Statement), a Financing section is provided as well as a section on taxes and discontinued operations (net of taxes). There are many other provisions in the proposed structure of the financial statements, which is in its preliminary stage and no final outcome has been determined; the joint project (IASB and FASB) staff are currently reviewing public responses to the proposed financial statements as this book goes to press. Current information on the status of the proposed financial statements and other issues regarding the joint project may be accessed at: www.fasb.org/project/ and www.ifrs.com/convergence_landing.html.

Different Approaches to Income Measurement and Fair Value Use under IFRS and U.S. GAAP

The IASB's approach to standard-setting is **principle-based**, in contrast to the FASB's (and its predecessor bodies') **rule-based** approach. IFRS thus tends to be less detailed than U.S. GAAP, with few exceptions and little interpretive and implementation guidance. They therefore require a greater exercise of professional judgment regarding the application of the principles to the economic substance of transactions. In contrast, U.S. GAAP is sometimes criticized as stressing adherence to the letter of accounting rules rather than their substance.

Both U.S. GAAP and IFRS recognize **accrual** accounting as the key concept underlying income measurement. However, IFRS and U.S. GAAP differ in their income measurement in that IFRS emphasize measurement of assets and liabilities on the balance sheet at **fair value** and U.S. GAAP emphasize the matching rule and measurement of items on the income statement. Whereas U.S. GAAP have various notions of value, including fair value, IFRS permit the use of a single concept of fair value as an exit value, that is, the amount an asset may be exchanged for, or a liability settled, between knowledgeable parties in an arm's-length transaction.

IFRS Differences Affecting the Statement of Financial Position

Cash and Cash Equivalents

Cash and cash equivalents are defined similarly under IFRS and U.S. GAAP. However, U.S. GAAP does not allow bank overdraft offsets to the cash account and reports them as a liability. The only exception where offsetting is allowable is in the case of two accounts held by the same bank; an overdrawn account may be offset against another account in the same institution. IFRS allows offsetting of overdrafts to cash as long as it is integral to the entity's cash management.

Receivables

Under U.S. GAAP, receivables are not reported at fair value. However, under IFRS they are initially reported at fair value, with subsequent adjustments accounted for using amortized cost (effective interest method). In addition, under U.S. GAAP, an estimate of bad debts impacts earnings on the income statement. When a receivable is deemed uncollectible using the allowance method for accounting for bad debts, the write-off of the specific account does not impact earnings; any recovery of a previously written-off account also does not impact earnings. Under IFRS, impairment losses previously recognized on the income statement may be reversed in subsequent years, adjusting earnings. U.S. GAAP prohibits reversals of impairment losses on bad debts.

In the case of derecognition of receivables, two transaction scenarios can occur. Under the first, a concern can sell (factor) a receivable to another company, transferring all of the risks and rewards of ownership, warranting derecognition of the receivable by the transferor. Under the second scenario, if a receivable no longer possesses any contractual rights to future cash flows, derecognition is warranted and the receivable is removed from the balance sheet. Under U.S. GAAP, a receivable is derecognized when there exists a loss of control of the receivable, whereas under IFRS, if substantially all of the risks and rewards are not transferred, the receivable is treated as a secured borrowing. U.S. GAAP disallows partial derecognition of receivables.

Inventories

U.S. GAAP generally measures inventory at lower of cost or market; under IFRS, inventory is measured at lower of cost or net realizable value (estimated selling price less estimated costs of completion and sale). IFRS includes distribution and marketing costs in its cost of sales, whereas U.S. GAAP excludes marketing costs in determining cost of sale.

Inventory write-downs under GAAP are normally determined either on an item-by-item, group, or categorical basis. IFRS writes inventory down to net realizable value (floor) on an item-by-item basis, but allows write-downs to occur by groups of similar products in special circumstances. In addition, any inventory write-downs under U.S. GAAP cannot subsequently be reversed, whereas IFRS allows previous inventory write-down reversals to be recognized in the same period as the write-down.

U.S. GAAP allows for the cost of inventory to be calculated using FIFO, LIFO, or a weighted-average calculation. IFRS allows FIFO and weighted-average, but prohibits use of LIFO. Special identification is allowed under both standards.

Note: FIFO numbers (for inventory and cost of goods sold) must be converted to LIFO numbers using the *LIFO reserve*, as follows

1. FIFO inventory = LIFO inventory + LIFO reserve

2. FIFO cost of goods sold = LIFO cost of goods sold – Change in LIFO reserve

This means many ratios including inventory ratios, current ratio, profitability ratios, and financial leverage ratios will be affected.

Investments

Accounting for trading, available-for-sale, and held-to-maturity instruments is similar between U.S. GAAP and IFRS. One clarifying difference is that under IFRS, securities are called “assets,” which is a much broader category. As with securities (asset) classification, under IFRS, any non-trading financial asset is classified as available-for-sale; under U.S. GAAP, only debt securities and marketable equity securities are classified as available-for-sale investments. Another major difference exists with unrealized gains and losses of available-for-sale securities, which are reported in comprehensive income under U.S. GAAP, whereas under IFRS, such gains and losses are reported in the equity section of the balance sheet. In addition, IFRS allows for impairment reversals for only available-for-sale debt (not equity) securities and held-to-maturity securities, while U.S. GAAP does not permit impairment reversals of any investments.

Another key difference is with debt security impairment. Under U.S. GAAP, a debt security is classified as other than temporarily impaired (OTTI) if the entity has the positive intent to sell an impaired debt security, or if the entity does not expect to recover the full amortized cost basis of the security and more likely than not the concern will be required to sell the security prior to its recovery, or if the debt security has a credit loss. Under IFRS, a debt security is deemed to be impaired if there is objective evidence of impairment and the estimated future cash flows if the security is adversely affected. IFRS requires that impairment losses on debt securities are recognized in current earnings, whereas U.S. GAAP records other-than-temporarily impaired debt securities in other comprehensive income. Lastly, under U.S. GAAP, an equity security is other-than-temporarily impaired if the decline is considered significant and prolonged, whereas under IFRS, impairment is recorded if the decline is significant or prolonged. Note that as of this writing, the FASB-IFRS joint project dealing with financial instruments is expected to be issued and may converge many of these differences as well as introduce new treatments.

Equity-Method Investments

Both U.S. GAAP and IFRS account for investments where the investor possesses significant influence over the investee, holding at least 20% and up to 50% of an investee's outstanding stock, lacking control over the entity. IFRS refers to an equity investment as an *investment in associates*. Additionally, IFRS requires that the investee and investor firms follow the same accounting policies, where U.S. GAAP does not require such a practice.

Property, Plant and Equipment

In general, U.S. GAAP and IFRS treat the accounting for property, plant and equipment similarly, including the initial accounting for all costs necessary to bring the asset to its intended use. Under IFRS, IAS 16.16(b) describes costs of property, plant and equipment as “any costs directly attributable to bring an asset to the location and condition necessary for it to be capable of operating in a manner intended by management.” Additionally, there are no differences in depreciation methods used. Differences exist primarily in the treatment of capitalized interest, the components approach for depreciation, and the subsequent revaluation of the asset's fair value.

Interest incurred is capitalized under U.S. GAAP only during construction of a qualifying asset. Under IFRS, interest costs of borrowing may either be capitalized for the acquisition, construction, or production of a qualifying asset or expensed in the period incurred. Whichever method selected must be consistently applied.

IAS 16 requires that upon initial recognition of a depreciable asset, costs are allocated to significant components of the assets (including non-physical components). Each component is then separately depreciated. For example, a roof would be one component and the remainder of the structure would be a separate component—each having different useful lives and depreciated separately. In addition, subsequent expenditures must be capitalized to the asset as long as probable future economic benefits will flow to the entity and the costs can be reliably measured. U.S. GAAP does not follow the components approach to depreciation.

Another difference between U.S. GAAP and IFRS is in the revaluation of property, plant and equipment. U.S. GAAP requires property, plant and equipment be accounted for using the cost method. Under IFRS, property, plant and equipment is reported on a company's books at fair value less accumulated depreciation and impairment losses (if any). The accumulated depreciation account is used to revalue plant and equipment with the permission of two treatments, which use a revaluation surplus account. When a depreciable asset is revalued, depreciation is also revalued over the remaining useful life of the asset.

IAS 16 allows for two revaluation alternatives: Revaluation of specific assets regularly or revaluation of assets of the same class. When revaluation occurs under IFRS, and the revaluation requires a write-up (increase) to the asset (assuming no previous downward revaluation), the asset is debited and the incremental increase is credited to a surplus account (revaluation surplus account), which is an equity account. If there is a write-down (decrease) to the asset (assuming no previous upward revaluation), such downward revaluation is debited to an expense and the asset's book value is credited. If there had been a previous upward revaluation (causing surplus recognition) and a current downward revaluation occurs, the write-down cannot exceed the amount in the revaluation surplus account. Examples of a land revaluation are provided below.

EXAMPLE

Assume in Year 1, QRS Corp. owns land costing $500,000 with a current fair value of $550,000. The journal entry to adjust the book value of the land to reflect its fair value is:

Land	50,000	
Revaluation surplus—Land		50,000

Any subsequent decreases in the fair value of the land would be offset against the revaluation surplus account, with any excess charged to an expense.

EXAMPLE

Assume in the following year (Year 2), the fair value of QRS Corp.'s land has decreased to $480,000. The journal entry to adjust the book value of the land to reflect its fair value (with previous upward revaluation) is:

Revaluation surplus—Land	50,000	
Loss on Revaluation—Land*	20,000	

Land		70,000

[*] The loss on revaluation is treated as an expense of the period.

For previous revaluation that had resulted in the recognition of an expense, any subsequent revaluations resulting in an increase to the fair value of the asset, such incremental increases should be recognized as income to the extent of the previously recognized expense; any excess revaluation increase would be credited to the revaluation surplus account.

EXAMPLE

Assume in Year 3, the fair value of QRS Corp.'s land is $510,000. Given that there was a recent downward revaluation in Year 2, the journal entry to adjust the book value of the land to reflect its fair value is:

Land	30,000	
Revaluation surplus—Land		10,000
Gain on revaluation—Land[*]		20,000

[*] The gain on revaluation is recognized as income in Year 3 to the extent of expense recognition in the previous year(s).

Revaluations Involving Depreciable Assets

When depreciable assets are revalued annually, IAS 16 allows for two permissible treatments. The first is offsetting accumulated depreciation against the gross book value of the depreciable asset, with the difference restated to reflect the revalued amount of the asset.

EXAMPLE

Assume KRF Corp. owns a building that cost $2,000,000 and has accumulated depreciation of $400,000, with a book value of $1,600,000. Assume KRF Corp. revalues the building to reflect its fair value of $1,800,000. Under this treatment, KRF Corp. would first remove its accumulated depreciation of $400,000, reducing the building by that amount of expired cost. Then, in the second entry, the building would be debited for $200,000 and the revaluation surplus credited, reflecting the net amount that is being restated. The entries are:

Accumulated depreciation—Building	400,000	
Building		400,000
Building	200,000	
Revaluation surplus—Building		200,000

The second permissible treatment is accumulated depreciation is proportionately restated with the change in the revalued asset; the result is the book value of the asset, after revaluation, equaling the revalued amount of the asset:

EXAMPLE

Assume KRF Corp. owns a building that cost $2,000,000 and has accumulated depreciation of $400,000, with a book value of $1,600,000. Assume KRF Corp. revalues the building to reflect its fair value of $1,800,000. KRF Corp. would restate the building account and accumulated depreciation based on the ratio of net book value to the revalued assets, which is 80% ($1,600,000/$2,000,000), and the entry is:

Building	250,000*	
Accumulated depreciation—Building		50,000
Revaluation surplus—Building		200,000

* $200,000 ÷ 80% = $250,000

The result of the above entry will provide a book value that equals the revalued amount of the building.

Intangible Assets and Goodwill

U.S. GAAP and IFRS are similar in their definition of an intangible asset, which lacks physical substance and is not viewed as a financial asset. In addition, U.S. GAAP and IFRS consider intangibles as identifiable assets if they are separable or as a result of contractual or legal rights. Goodwill, in particular, is viewed similarly by both as a residual that arises from a business combination and is not amortized but is tested annually for impairment. Some significant differences exist. While U.S. GAAP bases amortization of intangibles based on historical cost less any impairment, IFRS allows revaluation of the value of the intangible by crediting any upward revision to the asset to a revaluation surplus account and adjusted against equity; downward revisions to fair value reduce the revaluation surplus account (until the account declines to zero). In addition, impairment for intangibles is treated differently under U.S. GAAP and IFRS (see the Impairment section below).

Regarding research and development costs, such costs are segregated into two types: research phase costs and developmental phase costs. Under both U.S. GAAP and IFRS, research phase costs are expensed in the period incurred. Developmental phase costs are expensed in the period incurred under U.S. GAAP. Under IFRS, such costs are similarly expensed unless technological feasibility is achieved. If technical feasibility results, such development costs are capitalized only if there is an intention to complete the developed asset, if there exists an ability to either use or sell the asset, if future economic benefits are reasonably expected to result, and if the entity provides adequate resources to finish development of the asset. With regard to in-process research and development costs that are acquired as part of a business combination, U.S. GAAP and IFRS standards have converged, where acquired in-process research and development costs are capitalized and amortized, with annual testing for impairment.

Contingent Liabilities

U.S. GAAP and IFRS measure contingent liabilities similarly in that such a liability can only be recognized if the outcome is probable and can be reasonably estimated. However, IFRS contains a slight difference in estimating the contingent liability. While U.S. GAAP uses a more conservative (low-end) estimate in recording the liability, IFRS recognizes a contingent liability at the mid-point of the estimate range.

Defined Benefit Plans

Under U.S. GAAP, prior service costs are retroactive benefits from a plan amendment based on the expected future service life of such participants. These prior service costs are often amortized proportionately (or using straight-line) over the expected future period of service. IFRS uses the terminology *past service costs* and recognizes such costs using a straight-line basis over the average remaining service period until the amended benefits are vested. Therefore, under IFRS, entities are amortizing past service costs over a shorter period of time. Under IAS 19.96, should any past service costs be vested at the time the plan is amended, the entity must recognize them in the period of the amendment. U.S. GAAP makes no distinction whether the employees are vested or not vested.

Another area yet to be converged in regard to defined benefit plans is the issue of actuarial valuations and the measurement date. Under U.S. GAAP, actuarial valuations are required to be performed annually and are mandated by ERISA regulations. In addition, the measurement date for valuation of the plan assets and the projected benefit obligation is the balance sheet date, unless a specific event causes for re-measurement. Under IFRS, there is no mandate as to the frequency of actuarial valuations; however, IAS 19.77 requires valuation results to be updated as of the balance sheet date for any significant changes since the previous valuation.

In addition to prior (past) service cost treatment, there are differences in procedures on handling actuarial gains and losses. Actuarial gains and losses are the differences between the actual and expected result in the valuation of the projected benefit obligation and plan assets. U.S. GAAP and IFRS allow a choice for recognition of actuarial gains and losses. Under U.S. GAAP, any actuarial gains and losses measured can be reflected as part of Other Comprehensive Income (OCI) to the extent they are not recognized in earnings on the income statement. Alternatively, such gains and losses are permitted to be recognized in earnings in a systematic and rational method resulting in more rapid recognition than if the corridor method is used. Actuarial gains and losses that are recognized in Accumulated Other Comprehensive Income (AOCI) are reclassified to current earnings using a corridor approach (or using an alternative approach if it results in faster recognition). IFRS allows actuarial gains and losses to be either recognized completely in either OCI, in earnings of the period, or recognized in earnings using a corridor method (or using an alternative approach if it results in faster recognition).

U.S. GAAP also requires recognition of the funded status of the pension, either as a net pension asset or net pension liability. IFRS does not require funded status recognition on the balance sheet. As for asset ceilings, U.S. GAAP does not limit the amount of net pension assets, whereas under IFRS, the prepaid pension amount is limited by an asset ceiling.

Income Tax Deferrals

In accounting for deferred income tax differences, U.S. GAAP and IFRS use the asset and liability approach in recognizing future tax differences arising from present transactions. There are a few differences in approaches. First, U.S. GAAP's recognition of a deferred tax asset (or liability) is based on the assumption that the underlying asset or liability will eventually be reversed (recovered or settled) in a manner consistent with its use in the business. IFRS recognizes deferred taxes based on the expected manner of settlement or recovery. Second, U.S. GAAP employs an Asset Valuation account to the extent that it is *more likely than not* that the deferred tax asset will eventually be realized (reversed) at a future date. Under IFRS, a deferred tax asset is recognized for most deductible temporary differences and for the carryforward of unused tax losses and credits, but only to the extent it is probable that taxable profit will be available to permit the use of those amounts. Probable means more likely than not. Thus, no valuation allowance is recognized. Therefore, IFRS has a higher recognition threshold.

Third, U.S. GAAP allows for a deferred tax asset or liability classification to be either current or noncurrent, based on the classification of the related asset or liability. IFRS instead classifies all deferred tax differences as noncurrent. Lastly, IFRS measures the deferred tax based on tax rates that are enacted or substantively enacted at the reporting date, whereas U.S. GAAP uses only the enacted tax rates at the reporting date (and ignores estimated future tax rate adjustments).

Fourth, one of the more relatively pervasive concerns is the temporary differences with regard to revaluations of property, plant, and equipment. IFRS requires that such temporary differences be recognized directly into equity; U.S. GAAP currently does not allow for such revaluations, so no deferred tax differences would exist.

Fifth, under U.S. GAAP, intercompany profits are derived using the seller's tax rate, whereas under IFRS, such intercompany profits are calculated using the buyer's tax rate. In addition, under U.S. GAAP, deferred tax liabilities are recognized on domestic subsidiaries if greater than 80%-owned; IFRS does not recognize deferred taxes for joint ventures or investments in subsidiaries if the parent controls the timing of the deferred tax reversal and it is probable that the temporary difference is not expected to immediately reverse. Finally, the last substantive difference exists with foreign nonmonetary assets. Under IFRS, deferred taxes are recognized for any differences related to foreign nonmonetary assets remeasured from the local to functional currency, whereas under U.S. GAAP, deferred taxes are not recognized for such functional currency remeasurements.

Lease Accounting

U.S. GAAP and IFRS recognize the economic substance of recording leases of both the lessor and lessee. However, there are some relatively significant differences in the accounting treatments. While U.S. GAAP refers to *capital lease* treatment, IFRS terminology refers to such leases as *finance leases*. Under U.S. GAAP, leased assets consist of only property, plant, and equipment, whereas under IFRS, the leased asset can consist of other types of assets including leases to explore mineral or natural resources and other licensing agreements (e.g., motion pictures, plays, and manuscripts). U.S. GAAP is more rules-based; for example, four criteria are used by the lessee and lessor (plus two required additional criteria for lessor) in determining if a lease should be capitalized. Many of these criteria are quantitative thresholds. IFRS similarly focuses on recording a lease where it transfers substantially all of the risks and rewards of ownership from the lessor to the lessee. A lease is classified as a finance lease if it transfers substantially all the risks and rewards of ownership to the lessee. Unlike the specific quantitative criteria under U.S. GAAP, IFRS provides a series of indicators that are used to determine if a lease is classified as a finance lease. This criteria determination is much more general than U.S. GAAP and is not rules-based.

Another difference involves the accounting for executory costs. U.S. GAAP expenses and excludes specific costs from the calculation of minimum lease payments, including insurance, maintenance and taxes, whereas IFRS excludes costs for services and taxes from minimum lease payments. Lastly, the present value of the minimum lease payment by the lessee are computed under U.S. GAAP as the *lower of* the lessor's implicit rate (if known by the lessee) or the lessee's incremental borrowing rate. IFRS uses the interest rate implicit in the lease if known by lessee. If the lessee lacks knowledge of such rate, then the lessee uses its incremental borrowing rate.

Equity

There are several differences in the classification of items in the equity section of the Statement of Financial Position under U.S. GAAP and IFRS. First, “common stock” is referred to as “share capital” under IFRS, “additional paid-in capital” is reported as “share premium” under IFRS, and “retained earnings” are often referred to as “accumulated profit and loss” or “retained profits.” Similar to U.S. GAAP, treasury stock under IFRS is reported as a reduction to shareholders' equity; however, IFRS allows treasury stock amounts to be offset against specific equity accounts. Further, IFRS does not recognize gains or losses on the disposition of treasury shares and, instead, makes an adjustment to equity. Under U.S. GAAP, using the cost method, proceeds in excess of the purchase price are generally credited to a specific paid-in capital account from treasury stock, while subsequent losses are reduced from the paid-in capital account (to the extent of its balance) and then any residual is deducted from retained earnings.

In addition to the standard items classified in the Equity section of the Statement of Financial Position, two other common classification issues exist: the treatment of convertible bonds and the reporting of noncontrolling (minority) interest in a subsidiary. For corporate bonds that are convertible into common shares, U.S. GAAP reports such financial instruments as debt. However, under IFRS, proceeds of a debt instrument that are convertible into common shares are allocated between debt (reported at fair value) and equity (reported at residual value). As for reporting on noncontrolling (minority) interest in a subsidiary, , U.S. GAAP and IFRS methods now report noncontrolling interest in a subsidiary in the Equity section.

IFRS Differences Affecting The Income Statement

Revenue Recognition

One of the more complex differences between U.S. GAAP and IFRS is in the area of revenue recognition. IAS 18 deals with revenue recognition issues, specifically when to recognize revenues from the sale of goods or services, interest, dividend income, and royalties. Other revenue recognition issues are reflected in other IFRS pronouncements. For the most part, under IFRS, income is the framework, with revenue being a subset of income. Conversely, under U.S. GAAP, revenue is considered an element of the income statement, whereas income is not considered an element, but a calculated result. Under U.S. GAAP, revenue is generally recognized when a product has been delivered or a service performed, the sales price is fixed and determinable, and collectability is reasonably assured. Following are some specific U.S. GAAP-IFRS differences involving revenue recognition. Note that as of this writing, the FASB-IFRS joint project dealing with revenue recognition is yet to be issued and may converge many of these differences as well as introduce new treatments.

Sale of Goods

Revenue recognition principles appear in several areas of authority within the literature, particularly with the application of the concepts of *realized*, *recognized*, and *earned* revenue. In addition, the SEC offers specific guidance on revenue recognition for listed companies. The IASB does not receive guidance from a regulatory body such as the SEC. Further, U.S. GAAP has several areas of specific industry guidance with regard to revenue recognition; IFRS has no industry guidance.

IFRS uses a risks and reward model when applying revenue recognition under IAS 18. In applying IFRS, revenue is generally recognized when probable economic benefits exist, the item(s) of revenue and costs can be reliably measured, the significant risks and rewards of ownership are conveyed from the seller to the buyer, and the seller does not retain managerial involvement to the degree of ownership or retain effective control over the buyer. According to ASC 605-10-S99, if there is to be revenue recognition from the sale of goods, there needs to be persuasive evidence of an arrangement, collectability of the revenue is reasonably assured, the sales price is fixed and determinable, and the delivery occurred or services were rendered. Under IFRS, collectability is not mentioned in IAS 18, but is considered inherent in the standard by the mention of the receipt of probable future economic benefits.

Bill-and-Hold Transactions

Under U.S. GAAP, revenue is recognized under bill-and-hold transactions after:

- The risks of ownership have passed to the buyer,
- The customer has a fixed commitment to purchase the goods,
- The buyer requests that the transaction be processed on a bill-and-hold basis,
- The buyer has a substantial business purpose for placing the order on a buy and hold basis,

- The seller cannot retain any performance obligations that would taint the completion of the earnings process,
- The acquired goods have to be held separate from the seller's inventory and not be used to fill orders,
- The product is ready for delivery, and
- There is a fixed schedule for delivery to the buyer that includes the date of delivery consistent with the buyer's business purpose.

Under IFRS, revenue recognition for bill-and-hold arrangements occurs when the buyer takes title, provided it is probable that delivery will occur; goods are on hand, identified, and ready for delivery to the buyer; the buyer acknowledges deferred delivery arrangements; and usual payment terms exist. However, one noteworthy aspect to both U.S. GAAP and IFRS, any time a buyer requests a delay in the delivery of goods, but takes title and acknowledges receipt of the invoice, revenue is not yet recognized. The seller still has to pay for storage, delivery, and insurance costs on the goods, so the significant risks and rewards have not yet passed to the buyer. Under IFRS, written orders are not required; however, U.S. GAAP requires that if written orders are customary business practices, then that format would be needed as evidence of the transaction.

Multiple Element Arrangements

A multiple element contract involves goods sold with subsequent maintenance or support offered for no additional cost (such as a warranty). Under IFRS, revenue is recognized under IAS 18 based on separability of identifiable components of a transaction and revenue is allocated to each component usually based on relative fair market value. IAS 18, par. 19, requires full revenue recognition and an accrual of costs. This approach ignores the matching principle.

U.S. GAAP (ASC 605-25-25) provides criteria for separating the contract components in such arrangements. In general, the total consideration received should be allocated to each element of the contract based on relative fair values.

Long-Term Construction Contracts

U.S. GAAP (ASC 605-35-25) permits, with specific guidance, the use of either the percentage-of-completion method, completed-contract method (on a limited basis), or zero-profit method for recognition of gross profits for long-term construction contracts. Corresponding revenues and expenses related to the construction project are recognized on the income statement either by computing a ratio of stages of completion (using a cost-to-cost approach or other reasonable method) or basing recognition on the actual costs incurred of the project and deferring revenue recognition until project completion.

Under IFRS, IAS 11 permits use of either the percentage-of-completion method or zero-profit method to account for long-term construction contracts. IAS 11 does not permit the completed-contract method; therefore, revenues are recognized only by computing a ratio of stages of completion and costs are expensed in the period incurred. In addition, IAS 11 includes the fair value of receivables in recognizing revenues. U.S. GAAP uses fair value only if the receivable is at fair value; otherwise, the amount of revenue is based on the negotiated amount (undiscounted). In addition, SOP 81-1 does not permit construction accounting standard application to service contracts and must instead be accounted for based on the type of service provided. To contrast, IFRS allows either the percentage-of-completion method or zero-profit method for service contracts.

In the discussion above, in the case of real estate sales, according to IFRIC 15, if the agreement is a construction contract, IAS 11 applies and revenue is accounted for using the rules described. However, if the real estate agreement is not a construction contract, then IAS 18 would apply and revenue recognition would occur based on sale of goods or services criteria. The criteria in IFRIC 15 as to whether an agreement is a real estate contract centers on one criterion: if the agreement specifies major structural elements of design before or during construction, it is accounted for using IAS 11. If it does not specify major structural elements of design, but the contract specifies control and risks and rewards being transferred as the contract work progresses, then IAS 18 is used, but revenue is recognized in stages; otherwise, the contract is accounted for as a sale of goods under IAS 18.

Customer Loyalty Programs

There are variations on how companies account for rewards programs granted to their customers. U.S. GAAP has mixed practices. ASC 605-25-25 may apply to such arrangements, where entities account for these programs similar to a product warranty approach, accruing the incremental estimated cost of providing the goods or services that are to be redeemed. IFRIC 13 requires companies to estimate the value of points to the customer and defer the revenue as a liability until the concern has fulfilled its obligation to supply awards. IFRIC 13 requires awards to be recognized as a separate component of the sale if any consideration received is allocated to the loyalty program based on relative fair value or using a residual method.

In addition, IFRS includes gains in the definition of revenue, which are not reported separately on the income statement, whereas U.S. GAAP records gains separate from revenue and defines it as a specific element on the income statement.

Discontinued Operations

Currently, the definition of “discontinued operations” in ASC 360 does not converge with IFRS 5. Under U.S. GAAP, discontinued operations apply to asset groups, whereas under IFRS, discontinued operations apply to major lines of business or geographical areas of operation. In addition, U.S. GAAP provides specific guidance on continuing involvement, where there is minimal guidance under IFRS. In presentation of discontinued operations under U.S. GAAP, disclosure of revenues, pre-tax profit (or loss), gain (or loss) on disposal of the unit, and the tax effect of discontinued operations is presented below income from continuing operations. Under IFRS, the same items are presented as under U.S. GAAP with the exception of also disclosing the expenses associated with the revenue segregated as part of the discontinued operation. Further, IFRS 5 requires that cash flows related to discontinued operations be separately presented by categories (i.e., operating, investing, and financing activities). U.S. GAAP has no cash flows disclosure requirement.

Share-Based Payment

U.S. GAAP and IFRS standards have closely converged in the accounting of share-based payment, where the fair value of shares and options that are awarded to employees are recognized over their period of service (period of benefit). One significant difference that remains regarding share-based payment is that under U.S. GAAP, ASC 718 applies to employee and non-employee share-based payments, whereas IFRS 2 generally only applies to employees of the concern. Share-based payments are classified as a liability under ASC 718 if the grantor can be compelled to deliver cash or other assets and no equity holder relationship is established. IFRS 2 classifies share-based payment awards as separated into components: cash-settled (the extent the liability will be settled in cash or other assets) and equity-settled (which is the award's fair value over the liability incurred).

In addition, there are differences in the treatment of the grant date under U.S. GAAP and IFRS. Under ASC 718, the grant date is the date the employer and employee have a mutual understanding of the terms and conditions of the stock-based award and the employee begins to benefit from or be negatively impacted by the changes in the employer's share price. Under IFRS 2, the grant date is the date the entity and the employee agree to a share-based payment arrangement and possess a mutual understanding of the terms and conditions of the arrangement.

Impairment

Intangible Impairment

U.S. GAAP measures impairment as the excess of the intangible's carrying value over its fair value (expected future cash flows, undiscounted); IFRS recognizes impairment if the intangible's carrying value exceeds its recoverable amount (which is the higher of the intangible's fair value less costs to dispose of the asset and its value in use). Under U.S. GAAP, recorded impairment losses are not reversed in subsequent periods, as the intangible's revised basis for amortization reflects the written-down asset after impairment loss recognition. Under IFRS, IAS 36 allows for recovery of impairment losses (other than goodwill) in subsequent periods if there has been a change in economic conditions or a change in the expected use of the asset. Such allowable impairment recoveries (or asset write-ups) are limited to the intangible's pre-impairment carrying value.

For goodwill, U.S. GAAP tests for impairment annually (or more often if evidence of impairment exists) and is based on a two-step, recoverability test and impairment assessment. IFRS uses a one-step process in testing for goodwill impairment, where an impairment loss is recognized if the asset's carrying value is greater than its discounted fair value, less cost to sell and its discounted value in use.

Property, Plant and Equipment Impairment

According to U.S. GAAP and IFRS, a company must record an asset impairment when the book value of an asset is not recoverable. U.S. GAAP relies on a recoverability test to determine whether impairment has occurred. If the sum of expected future cash flows (undiscounted) is less than the carrying amount of the asset, the asset is considered impaired. Such an impairment loss is measured as the difference between the carrying amount of the asset and its fair value. U.S. GAAP prohibits subsequent impairment reversals.

Under IAS 36, an asset is impaired when its recoverable amount is less than its carrying amount. The recoverable amount is the greater of net selling price and its value in use. The net selling price is the market value of the asset less any disposal costs. “Value in use” is the present value of expected future net cash flows over the remaining useful life of the asset. The impairment loss is the difference between the asset's book value and its recoverable amount, which is recognized in income. IFRS permits asset write-ups for subsequent recoveries of impairments.

Earnings per Share

The calculations of basic and diluted earnings per share (EPS) are similar under U.S. GAAP and IFRS, with some minor differences. First, both require EPS to be reported on the face of the income statement if the shares are traded publicly. U.S. GAAP and IFRS each report EPS for income from continuing operations and for net income or loss; however, U.S. GAAP requires EPS for discontinued operations and extraordinary items. In addition, under U.S. GAAP, if the treasury stock method of calculating incremental shares is used, a quarterly calculation of the average stock price is used. IFRS calculates the incremental shares based on a weighted-average at the end of the accounting period, not at the end of each quarter. This topic is one that the two boards are jointly working on in order to converge accounting treatments.

Subsequent Events

Under U.S. GAAP, ASC 855 deals with accounting and disclosure requirements for subsequent events. Specifically, subsequent events are considered through the date the financial statements are issued or are available to be issued. In addition, SEC registrants are not required to disclose the date through which the subsequent events have been evaluated. Under IFRS, IAS 10 defines subsequent events through the date of financial statement authorization; the date of authorization of financial statement issue is disclosed.

Comprehensive Income

The FASB recently issued Accounting Standards Update (ASU) No. 2011-05 (*ASC 220, Comprehensive Income), Presentation of Comprehensive Income*. The ASU is intended to increase the prominence of other comprehensive income in financial statements and will supersede some of the guidance in ASC 220.

The central changes contained in the ASU provide that an entity that reports items in other comprehensive income have the option to present comprehensive income in either one or two consecutive financial statements as follows:

1. As a single statement approach by presenting the components of net income and total net income, the components of other comprehensive income and total other comprehensive income, and a total for comprehensive income.

2. In a two-statement approach, where an entity must present the components of net income and total net income in the first statement. That statement must be immediately followed by a financial statement that presents the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income.

This ASU disallows the presentation of other comprehensive income in the statement of changes in equity. It also conforms very closely to IFRS.

IFRS Differences Affecting the Statement of Cash Flows

Both IFRS and U.S. GAAP require that the statement of cash flows should have three major sections—operating, investing, and financing—along with changes in cash and cash equivalents. One area where there can be substantive differences between IFRS and U.S. GAAP relates to the classification of interest, dividends, and taxes. The following table indicates the differences between the two approaches.

Item	IFRS	U.S. GAAP
Interest paid	Operating or financing	Operating
Dividends paid	Operating or financing	Financing
Interest and dividends received	Operating or investing	Operating
Taxes paid	Operating—unless specific identification with financing or investing	Operating

Conceptual Framework Project

One of the unique features of the FASB was its issuance of a conceptual framework to assist in solving and narrowing accounting treatment differences. Since 1978 when the first concept statement was issued, the board has used the conceptual framework to develop and modify existing accounting guidance. Since the FASB and IASB jointly decided to converge accounting standards, in October 2004, the boards added to their agendas a joint project to develop an improved, common conceptual framework that builds on their existing frameworks (i.e., the IASB's *Framework for the Preparation and Presentation of Financial Statements* and the FASB's *Statements of Financial Accounting Concepts*). The project will do the following:

1. Focus on changes in the environment since the original frameworks were issued, as well as omissions in the original frameworks, in order to efficiently and effectively improve, complete, and converge the existing frameworks.

2. Give priority to addressing and deliberating those issues within each phase that are likely to yield benefits to the boards in the short term; that is, cross-cutting issues that affect a number of their projects for new or revised standards. Thus, work on several phases of the project will be conducted simultaneously and the boards expect to benefit from work being conducted on other projects.

3. Initially consider concepts applicable to private sector business entities. Later, the boards will jointly consider the applicability of those concepts to private sector not-for-profit organizations. Representatives of public sector (governmental) standard-setting boards are monitoring the project and, in some cases, considering the potential consequences of private sector deliberations for public sector entities.

The objective of the joint FASB-IASB conceptual framework project is to develop an improved common conceptual framework that provides a sound foundation for developing future accounting standards. Such a framework is essential to fulfilling the boards' goal of developing standards that are principles-based, internally consistent, and internationally converged and that lead to financial reporting that provides the information capital providers need to make decisions in their capacity as capital providers. The new framework, once completely finalized, will deal with a wide range of issues and will build on the existing IASB and FASB frameworks and consider developments subsequent to the issuance of those frameworks.

In September 2010, the boards jointly completed a portion of the conceptual framework, *Chapter 1, Objective of General Purpose of Financial Reporting, and Chapter 3, Qualitative Characteristics of Useful Financial Information*. The two boards are still deliberating on Elements and Recognition, Measurement, and Reporting Entity in order to complete the project. Information on the joint conceptual framework project is at www.fasb.org/jsp/FASB/Page/SectionPage&cid=1218220137074 and www.ifrs.com/convergence_landing.html

Objective of General Purpose of Financial Reporting

According to Concept Statement No. 8, *the objective of financial reporting states that financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit.* This revised concept chapter replaces the former three-pronged objectives.

Qualitative Characteristics of Useful Financial Information

There were significant changes that the joint boards made to the hierarchy of accounting qualities. The first significant adjustment was changing the fundamental qualities from relevance and reliability to relevance and faithful representation. The ingredients of fundamental qualities under relevance are now predictive value and confirmatory value, which is information that is capable of making a difference in one of those decisions only if it will help users to make new predictions, confirm or correct prior predictions, or both. Materiality is mentioned as an aspect of relevance.

In addition to relevance, faithful representation (which replaces reliability) includes three ingredients: completeness, neutrality, and free from error. The joint boards concluded that there was a lack of a common understanding to the term reliability. According to the revised concept statement, faithful representation means that financial information represents the substance of an economic phenomenon rather than merely representing its legal form. Substance over form is, therefore, not considered a separate component of faithful representation because it would be redundant.

The enhancing qualities are comparability, verifiability (which used to be a secondary ingredient), timeliness (which used to be a secondary ingredient), and understandability. Some of these changes are significant and have altered the definitions of many of the contents of this part of the conceptual framework for both the FASB and IASB. The remainder of the conceptual framework project will deal with definitions of the elements and recognition in financial reporting, measurement, and reporting entity and are expected to be resolved by the joint boards in the near future.

Note: Under IFRS, the principal qualitative characteristics of information in financial statements are understandability, relevance, reliability, and comparability.

Where to Learn More about IFRS

The following links are some of your best tools for exploring IFRS and IFRS-GAAP conversion updates.

- **The International Accounting Standards Board.** Short summaries of all IFRS standards, news, and status of projects in progress. www.iasb.org.
- **IFRS website.** Developed by The American Institute of Certified Public Accountants in partnership with CPA2Biz, its marketing and technology subsidiary, www.ifrs.com.
- **Ernst & Young IFRS web page.** News and downloadable documents.

http://www.ey.com/US/en/Issues/IFRS

- **PricewaterhouseCoopers IFRS web page.** News and downloadable documents, http://www.pwc.com/usifrs. and www.pwc.com. (search IFRS)
- **Deloitte: An Overview of International Financial Reporting Standards.** Overview document. http://www.iasplus.com/en/standards/ifrs
- **KPMG IFRS group.** News and downloadable documents. www.kpmg.com/global/en
- **US Securities and Exchange Commission.** Proposal for First-Time Application of International Financial Reporting Standards. www.sec.gov/rules/proposed/33-8397.htm

Review Questions

1. Which of the following is principles-based?

   A. FASB.
   B. PCAOB.
   C. IFRS.
   D. U.S. GAAP.

2. Which of the following is defined in IFRS as the amount for which an asset may be exchanged for, or a liability settled, between knowledgeable parties in an arm's-length transaction?

   A. Purchase price.
   B. Fair value.
   C. Deemed cost.
   D. Present value.

3. ______________________ is prohibited for the cost of inventory under IFRS.

   A. Weighted average.
   B. LIFO.
   C. FIFO.
   D. Special identification.

4. ABC Company has the following information: LIFO cost of goods sold = $100 million; Beginning LIFO reserve = $10 million; Ending LIFO reserve = $11 million. The FIFO cost of goods sold is:

   A. $99 million.
   B. $101 million
   C. $90 million
   D. $111 million.

5. Under IFRS, a deferred tax asset is

   A. Reduced by a valuation allowance if necessary.
   B. Measured by applying the enacted tax rate to the deferred tax consequences.

C. Recognized to the extent that realization is probable.
D. Recognized to reflect the deferred tax consequences of a taxable temporary difference.

6. Regarding the qualitative characteristics of financial statements, the Framework states that which of the following is true?

A. Materiality is an aspect of understandability.
B. Substance over form is an aspect of comparability.
C. Relevance means predictive and confirmatory values.
D. Faithful representation has two ingredients: completeness and neutrality.

Glossary

Adjusted operating income (IFRS): Adjusted operating income does not take into account highlighted items.

Affiliated companies: Companies which are controlled by the parent. As a rule, the parent holds the majority of the voting rights and capital of the company.

Assets (IFRS): Resources that are at the disposal of the company as a result of events in the past and which should represent an economic benefit in the future.

Asset structure: The relationship between non-current assets (IFRS) respectively fixed assets (US GAAP) and current assets. It is determined by multiplying the ratio of noncurrent respectively fixed assets to current assets by 100.

Associated companies: Minority participations in companies on whose business or company policy a decisive, but not controlling influence is exercised. Associated companies are in principle valued at equity.

Borrowings: Total assets less equity.

Cash flow: Balance of funds inflow and outflow affecting payment.

Consolidated total income (IFRS): Consolidated total income attributable to the equity holders plus consolidated total income attributable to minority interests; also referred to as consolidated total income before minority interests.

Consolidated total income (US GAAP): Consolidated total income attributable to equity holders of the parent; also referred to as consolidated total income after minority interests.

Cost of sales: Total of all types of operating costs which can be directly allocated to clients' orders. These include in particular costs for external data procurement, costs for interviewees and interviewers.

Cost of sales accounting: Form of income statement which shows the income achieved in the market during the accounting period. Opposite: total cost accounting. Here the total operating income for the period is shown, whereby the sales and changes in inventories are shown against the total cost. Both forms of accounting produce the same income for the accounting period.

Current assets (IFRS): The total of all short-term receivables, deferrals, funds, securities and inventories reported on the assets side of the balance sheet.

Current assets (US GAAP): Assets intended for short-term use in business operations.

Current liabilities (IFRS): The total of all short-term provisions, liabilities and deferrals reported on the liabilities side of the balance sheet.

Deferred taxes: Tax assets or liabilities reported in the balance sheet to equalize the difference between the tax debt actually assessed and the commercial tax burden based on the financial reporting in accordance with -> IFRS for the commercial balance sheet. The basis for determining deferred taxes is the difference between the value of the assets and liabilities reported in the balance sheet in accordance with IFRS and the local tax balance sheet.

Dividend yield: Dividend per share in relation to the annual closing price.

EBIT (IFRS): Abbreviation for earnings before interest and taxes calculated as operating income plus income from associates plus -> other income from participations.

EBIT (US GAAP): Abbreviation for earnings before interest and taxes calculated as operating income plus other income less other expenses.

EBITDA: Earnings before interest, taxes, depreciation and amortization, calculated as EBIT plus depreciation and amortization charges.

Equity (IFRS): Equity comprises funds from the equity holders available to the company as capital contributions and/or deposits and retained profits as well as equity attributable to minority interests.

Equity (US GAAP): Equity comprises funds from the equity holders available to the company as capital contributions and/or deposits and retained profits.

Equity ratio: Balance sheet equity in relation to total assets. The higher the indicator, the lower the level of indebtedness.

Financial expenses (IFRS): Financial expenses that do not result directly from participating interests. These are calculated as interest expenses plus other financial expenses.

Financial income (IFRS): Financial income that does not result directly from participating interests. This is calculated as interest income plus other financial income.

Fixed assets (US GAAP): Assets intended for ongoing use in business operations. Fixed assets comprise intangible assets, tangible assets and financial assets.

Free cash flow: Cash flow from ongoing business activity less capital expenditures.

Goodwill: Intangible business asset that represents the value of the intangible assets of a company at the time of its acquisition that are not separately capitalizable, such as the expertise of staff. This is calculated as the purchase price of the company less re-valued equity on a pro rata basis.

Gross income from sales: Sales less cost of sales.

Highlighted items: The costs that are not taken into account in adjusted operating income: integration costs, amortization on disclosed hidden reserves as part of purchase price allocation, share-based payments and long-term incentives, other operating income and expenses including, in particular, currency effects from the valuation on the reporting date.

IAS: The International Accounting Standards (IAS) were developed and published by the IASC from 1973 to 2000. Unless specific standards have been revoked, they are still valid in full today. Since the reworking of IAS 1 in 2003, the "old" IAS have been collectively referred to as IFRS. Any existing standards are developed further as IAS and all new standards are known as IFRS.

IFRS: Accounting principles developed and published by the IASB. In addition to the actual IFRS, the IAS that are still valid and the interpretations of the IFRIC and SIC are grouped under the IFRS.

Impairment: Write-down of assets in addition to scheduled amortization /depreciation, or in place of scheduled amortization /depreciation in the case of intangible assets with an indefinite useful life. Impairment tests are used to establish whether the carrying value of assets is higher than recoverable amount for the asset. The asset is written down to the recoverable value as necessary.

Income (IFRS): Adjusted operating income.

Income from ongoing business activity (IFRS): EBIT plus financial income less financial expenses.

Income from participations (US GAAP): Contains the items income from participations, profits and losses on the disposal of participations and depreciation on participations.

Majority participations: Affiliated companies.

Margin: A margin represents the relationship of an indicator (income, EBIT, EBITDA etc.) to sales.

Minority participations: Generic term for associated companies and other participations. The participation quota is below 50%.

Net indebtedness (IFRS): Liquid funds and securities less pension liabilities and financial liabilities.

Net indebtedness (US GAAP): Financial resources and securities held as current assets less pension liabilities and financial liabilities.

Non-current liabilities (IFRS): Total of all long-term provisions, liabilities, deferred tax liabilities and other deferrals reported on the liabilities side of the balance sheet.

Non-current assets (IFRS): Assets that benefit business operations in the long term. In addition to intangible assets, tangible assets and investments, these include deferred tax assets and other non-current receivables and deferrals.

Operating income (IFRS): Gross income from sales less selling and general administrative expenses plus other operating income less other operating expenses.

Operating income (US GAAP): Gross income from sales less selling and general administrative expenses.

Operating profit (US GAAP): Sales of the divisions and regions less operating costs according to the Management Information System. The most important internal income indicator under US GAAP.

Other income from participations: Income from affiliated companies not included in the scope of consolidation and other participations as well as expenses and income from disposals or write-downs of book values of investments plus gains/losses from the disposal of participations.

Other operating expenses: Expenses in connection with ongoing business activity, excluding financial expenses, not attributable to cost of sales or selling and general administrative expenses. Examples are impairments, losses from the disposal of fixed assets and exchange losses.

Other operating income: Income from ongoing business activity, excluding financial income, which does not represent sales. Examples are profits on the disposal of fixed assets and exchange gains.

Other participations: Companies in which a participation is held but on whose business policy no decisive influence is exercised. The participation quota is below 20%.

Pay-out ratio: Total dividend in relation to consolidated total income.

Profit to sales ratio (IFRS): Consolidated total income in relation to sales.

Profit to sales ratio (US GAAP): Consolidated total income before minority interests in relation to sales.

Purchase price allocation: Allocation of the purchase price when companies are acquired to assets and liabilities not previously reported or not in such amounts.

Ratio of net indebtedness to cash flow: Net indebtedness in relation to free cash flow.

Return on capital employed (IFRS): EBIT in relation to average total assets.

Return on capital employed (US GAAP): EBIT after income from participations in relation to average total assets.

Return on equity: Consolidated total income in relation to average shareholders' equity.

Tax ratio (IFRS): Tax on income from ongoing business activity in relation to income from ongoing business activity.

Tax ratio (US GAAP): Taxes on income and earnings in relation to result from ongoing business activity.

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Review Question Answers

1. Which of the following is principles-based?

A. Incorrect. The FASB is rule-based.
B. Incorrect. The PCAOB was established by the Sarbanes-Oxley Act of 2002. It has rule-making authority regarding quality control, ethics and auditing standards. These rules, especially those governing quality control, will have great relevance to enforcement actions.
C. **Correct.** IFRS is principle-based and thus tends to be less detailed than U.S. GAAP, with few exceptions and little interpretive and implementation guidance.
D. Incorrect. U.S. GAAP stresses adherence to the letter of accounting rules.

2. Which of the following is defined in IFRS as the amount for which an asset may be exchanged for, or a liability settled, between knowledgeable parties in an arm's-length transaction?

A. Incorrect. Purchase price would be used if using historical cost to value an asset. However, this is not what is defined in IFRS.
B. **Correct.** This is IFRS's definition of fair value, which is very similar to the U.S. GAAP definition.
C. Incorrect. Deemed cost is an amount used as substitute for cost or depreciated cost at a given date.
D. Incorrect. This is the present worth of future cash flows generated by an asset.

3. ______________________ is prohibited for the cost of inventory under IFRS.

A. Incorrect. The weighted-average method is allowed under IFRS.
B. **Correct.** The LIFO is prohibited under IFRS while U.S. GAAP permits use of LIFO.
C. Incorrect. The FIFO method is allowed under IFRS.
D. Incorrect. Special identification is sometimes allowed under IFRS.

4. ABC Company has the following information: LIFO cost of goods sold = $100 million; Beginning LIFO reserve = $10 million; Ending LIFO reserve = $11 million. The FIFO cost of goods sold is:

A. **Correct.** By, definition, cost of goods sold = cost of purchase (or cost of goods manufactured for manufacturers) – change in inventory. It follows: FIFO cost of goods sold = LIFO cost of goods sold – Change in LIFO reserve = $100 – ($11 - $10) = $99 million.
B. Incorrect. $101 = $100 + ($11 - $10) = $101. Change in reserve was erroneously added.
C. Incorrect. This is the number $90, LIFO cost of goods sold – Beginning LIFO reserve.
D. Incorrect. This is the number $111, LIFO cost of goods sold + Ending LIFO reserve.

5. Under IFRS, a deferred tax asset is

A. Incorrect. Under GAAP, a deferred tax asset is reduced by a valuation allowance if necessary.
B. Incorrect. Under GAAP, the gross amount of the deferred tax asset is measured by applying the enacted tax rate to the deferred tax consequences.
C. **Correct.** Under IFRS, a deferred tax asset is recognized for most deductible temporary differences and for the carryforward of unused tax losses and credits, but only to the extent it is probable that taxable profit will be available to permit the use of those amounts. Probable means more likely than not. Thus, no valuation allowance is recognized.
D. Incorrect. A deferred tax liability is recognized to reflect the deferred tax consequences of a taxable temporary difference.

6. Regarding the qualitative characteristics of financial statements, the Framework states that which of the following is true?

A. Incorrect. Materiality is a feature of relevance.
B. Incorrect. Substance over form is a feature of faithful representation.
C. **Correct.** The ingredients of fundamental qualities under relevance are now predictive value and confirmatory value, which is information that is capable of making a difference in one of those decisions only if it will help users to make new predictions, confirm or correct prior predictions, or both.
D. Incorrect. It has three ingredients; free from error as the third ingredient.