

# **IFRS AND U.S. GAAP: DIFFERENCES AND CONVERGENCE**

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## **Abstract**

This paper describes selected major differences between International Financial Reporting Standards (IFRS) and U.S. generally accepted accounting principles (GAAP), and completed convergence projects of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) as of March, 2010. These selected differences pertain to the following accounting issues: fundamental framework, inventories, property, plant and equipment, intangibles with finite useful life, impairment of assets, leases, cash flows statement, contingent liabilities and assets, financial instruments, income taxes, derecognition of financial assets, consolidated financial statements, revenue recognition, and employee benefits. A short discussion question and an answer to enhance a class discussion are also provided for most of these issues. For the completed convergence projects, they are categorized into IFRS converged with U.S. GAAP (five projects), U.S. GAAP converged with IFRS (six projects), and convergence as a result of joint projects between FASB and IASB (two projects and a completed first phase of two major projects). Two convergence projects expected to become final standards later in 2010 are also discussed. Accounting educators should definitely try to incorporate these differences and the convergence outcomes into their classes.

## **INTRODUCTION**

The most sweeping change across U.S. accounting academia these days is an urgency to incorporate IFRS into an accounting curriculum. This important change started in August

2007 when the Securities Exchange Commission (SEC) issued *Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards* as promulgated by the International Accounting Standards Board (IASB). Then in August 2008, the SEC proposed a roadmap that could lead to the mandatory use of IFRS as early as 2014.<sup>1</sup> Recently on February 24, 2010, the SEC approved a new timeline for moving U.S. toward IFRS that envisions 2015 as the earliest possible date for the required use of IFRS by U.S. public companies. The SEC will decide by 2011, assuming completion of convergence projects and its staff's Work Plan, whether to incorporate IFRS into the U.S. financial reporting system, and if so, when and how. The staff's Work Plan will address many issues including whether IFRS is sufficiently developed, independence and funding of the IASB, investor understanding and education, effects on U.S. laws or regulations and impact on companies.<sup>2</sup>

This proposed roadmap is the result of worldwide financial reporting convergence toward IFRS. Over 110 jurisdictions now either require or permit the use of IFRS for the preparation of financial statements by their listed companies. Indeed, the U.S. has had a dual financial reporting system since November 15, 2007 when the SEC stopped requiring non-U.S. issuers that prepare financial statements in accordance with IFRS to reconcile net income and stockholders' equity to U.S. GAAP. The U.S. is also home to many organizations that are affiliates or investees of non-U.S. entities which require IFRS-based financial information (Langmead and Soroosh, 2009)

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<sup>1</sup> See the SEC proposed "Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers" at [www.sec.gov/rules/proposed/2008/33-8982.pdf](http://www.sec.gov/rules/proposed/2008/33-8982.pdf). This roadmap was initiated by the former Chairman Christopher Cox who aggressively promoted IFRS. The current Chairman Mary Shapiro seems to be more cautionary about IFRS (Barlas et al, 2009).

<sup>2</sup> See details of the SEC press release at [www.sec.gov/news/press/2010/2010-27.htm](http://www.sec.gov/news/press/2010/2010-27.htm).

Added to this urgency is the decision of the Board of Examiners of the American Institute of Public Accountants (AICPA) to test knowledge and understanding of IFRS as well as skills required to apply IFRS in the Financial Accounting and Reporting section of the uniform CPA examination starting January 1, 2011. In particular, the knowledge in which candidates are required to demonstrate proficiency are: (1) the differences between financial statements prepared on the basis of U.S. GAAP and IFRS, (2) process by which IFRS are set and roles of the IASB, and (3) first-time adoption of IFRS. The AICPA Council has, since 2009, designated the IASB as the body to establish professional standards with respect to international accounting and reporting principles, and U.S. auditors are now permitted to report on financial statements prepared in accordance with IFRS. This means that private unlisted U.S. companies are now allowed to use IFRS.

Therefore, accounting educators should definitely incorporate IFRS into as many courses as possible starting from introductory-level through advance-level courses. One approach is that, for each topic, an IFRS accounting treatment would be discussed along with that of U.S. GAAP. Many accounting practitioners are acquiring IFRS skills in this manner by starting with what they know, U.S. GAAP, and attempting to identify the IFRS differences (Deane and Heilman, 2009). Because education and training of those involved in the preparation and the use of financial statements is an important milestone to be achieved as a prelude to the SEC decision in 2011, accounting educators have an important role to increase awareness of the differences between US GAAP and IFRS among our students so that these future professionals will be better prepared to implement the proposed regulatory changes (Jamal, 2008). To help educators accomplish this role, this article describes *selected major* differences between IFRS and U.S. GAAP in an easy-to-understand table format. The table starts with fundamental framework followed by specific topics generally covered in financial accounting textbooks. A short question and an answer are also included in most topics to help

stimulate a class discussion. This study uses four sources to identify these differences: (1) eIFRS of the IASB at <http://eifrs.iasb.org/eifrs/Menu>, and (2) FASB literature including pronouncements and interpretations at [www.fasb.org](http://www.fasb.org), as well as FASB accounting standard codification at <http://asc.fasb.org/home>, (3) Douplik and Perera (2009), (4) Kieso et al. (2010),

The second half of the paper discusses IFRS and U.S. GAAP convergence efforts including a brief history of the convergence, an overview of completed convergence projects as of March, 2010, and a discussion of two convergence projects expected to be completed later in 2010. Information about the convergence came from searching the web site of the FASB ([www.fasb.org](http://www.fasb.org)) and the IASB ([www.iasb.org](http://www.iasb.org)). Accounting educators may want to incorporate these convergence efforts into relevant accounting topics to highlight the current evolution of U.S. financial reporting and to make students appreciate the commitment of the FASB and the IASB to aggressively converge and improve the two bodies of standards.

Equipping students with sufficient knowledge and skills about IFRS would definitely enhance their success of securing a job position especially with an accounting firm. PricewaterhouseCoopers clearly states in its IFRS Ready at [www.pwc.com/faculty](http://www.pwc.com/faculty) that it will include IFRS in the basis for making decisions about an applicant's level of technical and professional skills and knowledge starting in fall 2009. In particular, juniors and above interviewing for full time positions should have a full awareness of IFRS including the ability to identify an example of a difference between U.S. GAAP and IFRS. Preparers, auditors and other users of financial statements could also use this article as a starting point to understand major differences between IFRS and U.S. GAAP, and their convergence efforts.

### Fundamental Framework

| IFRS   | U.S. GAAP  |
|--|--|
| <ul style="list-style-type: none"><li data-bbox="378 537 781 793">- More principles-based: Provide a conceptual basis instead of a list of detailed rules, leading to more judgment with greater emphasis on economic substance over form.</li><li data-bbox="378 842 781 1098">- Conceptual framework has very high status, similar level as IFRSs. IAS 8 requires preparers to use the Framework in dealing with topics not yet addressed in any IFRSs or interpretations.</li><li data-bbox="378 1146 781 1507">- Has overriding principle of fair presentation. In an extremely rare circumstance when compliance with the requirement of a standard or interpretation would be so misleading, preparers are required to depart from that requirement with extensive note disclosures.</li></ul> | <ul style="list-style-type: none"><li data-bbox="820 537 1242 793">- More rules-based: More-detailed bright-line guidance and less judgment result in unintentional emphasis on form over economic substance as in the case of Enron.</li><li data-bbox="820 842 1242 1098">- Conceptual framework has very low status, below industry practices, and is rarely used in applying U.S. GAAP. Preparers mainly rely on FASB's detailed implementation guidance.</li><li data-bbox="820 1146 1242 1549">- No such overriding principle is available to preparers of financial statements. Although the overriding principle is available to an auditor via Rule 203 of the AICPA's <i>Code of Professional Conduct</i>, this rule exception is rarely invoked in practice (FASB, 2008).</li></ul> |

### Inventories

| IFRS   | U.S. GAAP   |
|--|---|
| <ul style="list-style-type: none"> <li>- Allow FIFO and weighted-average. <b>LIFO is not allowed.</b> Standard cost and retail method are allowed if they approximate cost as defined in IAS 2.</li> <li>- Reported at the lower of cost or net realizable value (NRV).</li> <li>- The original cost always remains as the cost basis.</li> <li>- Write-downs to NRV must be reversed when selling price increases up to the original cost.</li> </ul> | <ul style="list-style-type: none"> <li>- Allow FIFO, weighted-average, and LIFO. Do not allow standard cost.</li> <li>- Reported at the lower of cost or replacement cost with a ceiling (NRV) and a floor (NRV – normal profit margin)</li> <li>- The lower market value becomes the new cost basis.</li> <li>- Prohibit a reversal of write-downs to market.</li> </ul> |

During a price-rising period, what would be the impact on net income, cash flows and assets if U.S. firms can no longer use LIFO? Net income and assets will increase and cash flows will decrease due to a higher income tax payment. The U.S. tax law does not allow companies to use LIFO for tax purposes unless they also use LIFO for financial reporting purposes.



### Intangibles with Finite Useful Lives

| <b>IFRS (IAS 38)</b>   | <b>U.S. GAAP</b>  |
|--|---|
| <ul style="list-style-type: none"> <li>- Carry at cost less accumulated amortization (benchmark) or fair value (allowed alternative for intangibles with an active secondary market).</li> <li>- Research expenditures must be expensed as incurred. Development expenditures must be recognized as an intangible asset when all six criteria related to technical and commercial feasibility are met.</li> <li>- If indistinguishable, all R &amp; D must be classified as research expenditures and expensed as incurred.</li> </ul> | <ul style="list-style-type: none"> <li>- Carry at cost less accumulated amortization. Prohibit fair value.</li> <li>- Research and development expenditures must be expensed as incurred with an exception of computer software's development costs which may be recognized as an asset.</li> </ul> |

What would be the impact on net income, assets and the R&D disclosure under IFRS?

IFRS net income and assets will be higher than U.S. GAAP. There will also be more note disclosure about R&D because a firm needs to provide justifications per the six criteria for the capitalization of development expenditures.

**Impairment of Assets (PPE, intangibles, investment in subsidiaries, associates and joint ventures)**

| <b>IFRS (IAS 36)</b>  | <b>U.S. GAAP</b>  |
|---|---|
| <ul style="list-style-type: none"> <li>- An asset is impaired when its carrying amount exceeds its recoverable amount which is the greater of net selling price or value in use.</li> <li>- Value in use is the present value of future net cash flows expected to arise from continued use of the asset and upon its disposal.</li> <li>- Impairment loss is the excess of carrying amount over its recoverable amount.</li> <li>- Require a reversal of an impairment loss in certain situations, except for goodwill.</li> <li>- Goodwill is tested for impairment at either the cash-generating unit (CGU) or group of CGUs which cannot be larger than a segment.</li> </ul> | <ul style="list-style-type: none"> <li>- An asset is impaired when its carrying amount exceeds its future cash flows (undiscounted) expected to arise from its continued use and disposal.</li> <li>- Net selling price is not involved and future cash flows are not discounted to their present value.</li> <li>- Impairment loss is the excess of carrying amount over its fair value.</li> <li>- Prohibit the reversal of a previously recognized impairment loss.</li> <li>- Goodwill is tested for impairment at the reporting unit level which may be higher than CGU under IFRS.</li> </ul> |

When the recoverable amount is value in use, which one, IFRS or U.S. GAAP, will result in a higher likelihood of asset impairment? IFRS because it requires discounted future net cash flows which is likely lower than the carrying amount compared to the undiscounted ones per U.S. GAAP.

### Leases

| <b>IFRS (IAS 17)</b>  | <b>U.S. GAAP</b>  |
|---|---|
| <ul style="list-style-type: none"> <li>- A lease is a finance (capital) lease if it transfers substantially all risks and rewards of ownership to lessee on the basis of five principle-based situations that normally lead to lease capitalization.</li> <br/> <li>- The implicit rate in the lease is the discount rate for computing present value of future payments and interest expense.</li> <br/> <li>- <u>Lessee accounting: Sale and leaseback</u></li> </ul> <p>For a finance (capital) lease, generally any gain or loss on the sale is deferred and amortized over the lease term.</p> <p>For an operating lease:<br/>Gain or loss is recognized immediately if the sale is at fair value.</p> | <ul style="list-style-type: none"> <li>- A lease must be capitalized if it meets any one of four specific criteria, two of which are exactly the same as IFRS and the other two involved bright-line definition (75% vs. major part-IFRS for lease term relative to asset's life, and 90% vs. substantially all-IFRS for the present value of minimum lease payments relative to asset's fair value).</li> <br/> <li>- The lessee's incremental borrowing rate is generally used as the discount rate.</li> <br/> <li>- <u>Lessee accounting: Sale and leaseback</u></li> </ul> <p>For both capital and operating leases:<br/>If a seller relinquishes only a minor part of the use of asset, the gain is generally deferred and amortized over the lease term. If a seller relinquishes substantially all, the gain or loss is generally recognized at date of sale.</p> |

Both boards are currently revising lessee accounting, and recently issued a Discussion Paper proposing an approach that would apply the existing capital (finance) lease model to all leases. Why should capital lease model be applied to operating leases? Because, similar to a capital lease, an operating lease also has characteristics that meet the definition of an asset and a liability. Therefore, an operating lease should also be capitalized to reflect its economic substance.

### Financial Instruments

| <b>IFRS (IAS 32 &amp; 39)</b>  | <b>U.S. GAAP</b>  |
|--|---|
| <p>- Conceptually similar to U.S. GAAP as they are developed on the basis of U.S. GAAP. However, numerous differences exist such as:</p> <p>Convertible debt instrument is accounted for on split basis with proceeds allocated between liability and equity (equity conversion rights).</p> | <p>- All financial instruments are to be measured and reported at fair value. Hedge accounting is allowed when certain criteria are met.</p> <p>- Convertible debt instrument is treated as one unit of accounting and recorded as a liability in its entirety, unless there is a beneficial conversion feature that requires separation.</p> |

Which one, IFRS or U.S. GAAP, reflects a better economic reality of a convertible debt instrument? IFRS because convertible debt has characteristics of both liability and equity. Splitting out the equity component, the value of the conversion option, using option-pricing models would provide a more faithful representation of the impact of the convertible debt. The FASB has issued a Preliminary Views which proposed to converge the accounting for convertible debt with IFRS.

### Cash Flows Statement

| IFRS (IAS 7)   | U.S. GAAP   |
|--|---|
| <ul style="list-style-type: none"> <li>- Bank overdrafts may be included in cash equivalents.</li> <li>- Dividends paid may be classified as an operating or a financing activity.</li> <li>- Dividends received and interest received may be classified as an operating or investing activity. Interest paid may be classified as an operating or financing activity.</li> <li>- Same as U.S. GAAP unless the tax can be identified with a financing or an investing activity.</li> </ul> | <ul style="list-style-type: none"> <li>- Bank overdrafts are excluded from cash equivalents.</li> <li>- Dividends paid must be classified as a financing activity.</li> <li>- Dividends received and interest received or paid must be classified as an operating activity.</li> <li>- Income tax payment is part of operating activity.</li> </ul> |

Per the IFRS, if a firm wants to show higher cash flows from operating activities, how would it classify dividends & interest paid and dividends & interest received? It would classify dividends & interest received as an operating activity, and dividends & interest paid as a financing activity. The FASB and the IASB are currently working on a joint project, Financial Statement Presentation, which could require an income statement and a balance sheet to be presented in a similar format to a cash flows statement

**Contingent Liabilities and Contingent Assets**

| <b>IFRS (IAS 37)</b>   | <b>U.S. GAAP</b>  |
|--|---|
| <ul style="list-style-type: none"> <li>- Requires accrual (a provision) when it is <i>more likely than not</i> that an outflow of resources will be required to settle the obligation.</li> <li>- The provision should be recognized as the <i>best estimate</i> of the expenditure required to settle the obligation which is the expected value when a range of estimates exist; the <i>midpoint</i> within a range if all estimates are equally likely.</li> <li>- Provisions must be discounted to present value if discounting effect is material.</li> <li>- Allows an enterprise “in extremely rare cases” to omit disclosures that “can be expected to prejudice seriously the position of the enterprise in a dispute with other parties”.</li> <li>- Allows earlier recognition of a contingent asset when the realization of income from a contingency is deemed to be <i>virtually certain</i>.</li> </ul> | <ul style="list-style-type: none"> <li>- Requires accrual when it is probable that a loss has occurred, with no guidance as to how the word <i>probable</i> should be interpreted.</li> <li>- Contingent liabilities should be recognized as the <i>low end</i> of the range of possible amounts when a range of estimates exist.</li> <li>- Discounting is not required, but permitted for specific types of provisions.</li> <li>- Does not allow for such an exemption</li> <li>- Generally requires a contingent asset to be realized before it can be recognized.</li> </ul> |

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| <ul style="list-style-type: none"> <li>- Restructuring provision should be recognized when (1) a detailed formal plan exists, and (2) the plan's main features have been announced to those affected by it or implementation of the plan has begun.</li> </ul> | <ul style="list-style-type: none"> <li>- Does not allow recognition of a restructuring provision until a liability has been incurred. The recognition of a restructuring provision may occur at a later date when compared to IFRS.</li> </ul> |
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Which one, IFRS or U.S. GAAP, may result in an earlier recognition of a legal contingency? IFRS due to its *more likely than not* criterion. The SEC Roadmap to IFRS (2008, p 41-42) states that "This recognition threshold is lower than the current recognition threshold in U.S. GAAP, resulting in the potential for an earlier income statement recognition of costs associated with litigation."

### Income Taxes

| <b>IFRS (IAS 12)</b>   | <b>U.S. GAAP</b>   |
|--|--|
| <ul style="list-style-type: none"> <li>- Full provision method is generally used driven by an asset/liability approach that recognizes deferred tax assets/liabilities for temporary differences and for operating loss and tax credit carryforward.</li> <li>- Allow the use of substantially enacted tax rates and tax laws in addition to the entirely enacted ones.</li> </ul> | <ul style="list-style-type: none"> <li>- Similar to IFRS but with many differences in application.</li> <li>- Prohibit the use of substantially enacted tax rates and tax laws. Tax rates and tax laws used must have been enacted.</li> </ul> |

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| <ul style="list-style-type: none"><li>- Deferred tax is re-measured (catch-up adjustment) at each balance date.</li><li>- A deferred tax asset is recognized if it is probable (more likely than not) that sufficient taxable profit will be available against which the temporary difference can be utilized.*</li><li>- Deferred tax assets/liabilities are classified as non-current with note disclosure separating amount expected to be recovered within vs. more than 12 months of the balance sheet date.</li><li>- Deferred tax on revaluation of PPE and intangibles is recognized in equity.</li><li>- Uncertain tax liability is based on the amount of taxes expected to be paid to the tax authorities. Proposed disclosure for uncertain tax positions is less prescriptive than FIN 48.</li></ul> | <ul style="list-style-type: none"><li>- A catch-up adjustment is done when the transaction is settled, not at each B/S date.</li><li>- A deferred tax asset is recognized in full but is then reduced by a valuation allowance if it is more likely than not that some or all of the deferred tax asset will not be realized.*</li><li>- Deferred tax assets/liabilities are either classified as current or non-current, based on classification of the related asset or liability.</li><li>- Not applicable as revaluation of PPE is prohibited.</li><li>- FIN 48 prescribes two-step process: more-likely-than-not recognition threshold and measurement using weighted average probability. Disclosure for uncertain tax positions is more prescriptive.</li></ul> |
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\* The joint convergence project, Income Taxes, favors the U.S. GAAP approach.

### Derecognition of Financial Assets

| IFRS (IAS 39)  | U.S. GAAP  |
|--|--|
| <ul style="list-style-type: none"> <li>- Financial assets are derecognized if an entity transfers substantially all <i>risks and rewards</i> of ownership of the assets.</li> <li>- Control (based on transferee's ability to sell the assets) is secondary test.</li> </ul> | <ul style="list-style-type: none"> <li>- Derecognition is primarily based on <i>control</i> governed by three key tests.               <ol style="list-style-type: none"> <li>1. Legal isolation of transferred assets.</li> <li>2. Ability of transferee to sell or pledge the assets.</li> <li>3. No right or obligation of transferor to repurchase assets <i>before</i> their maturity.</li> </ol> </li> </ul> |

Which one, IFRS or U.S. GAAP, likely results in derecognition of receivables upon sales of receivables with recourse, and hence, enabling a transferor to report lower bad debt expense?

U.S. GAAP because the transferor has no obligation to repurchase receivables before their maturity. The obligation arises *after* the maturity date when the receivables have defaulted. On the other hand, IAS 39 would require the receivables to remain on the balance sheet because the seller has not transferred substantially all risks to the buyer, i.e., the seller is obliged to buy back defaulted receivables.

**Consolidated Financial Statements**

| <b>IFRS (IAS 27)</b>  | <b>U.S. GAAP</b>  |
|---|---|
| <ul style="list-style-type: none"> <li>- Based on <b>effective</b> control defined as the power to govern the financial and operating policies. Owning less than 50% of voting rights may provide control when the investor has the power:                             <ul style="list-style-type: none"> <li>- Over &gt; 50% of the voting rights thru agreements with other shareholders.</li> <li>- To cast the majority of votes.</li> <li>- To appoint or remove majority of the BOD members.</li> <li>- To set financial and operating policies due to existing agreements.</li> </ul> </li> <li>- Consolidate SPE where the substance of the relationship indicates control. It provides four indicators including the SPE conducting activities on behalf of the investor and the investor holding the majority of the risks and rewards of the SPE.</li> <li>- For joint ventures, both proportionate consolidation &amp; equity method are allowed.*</li> </ul> | <ul style="list-style-type: none"> <li>- ARB 51 uses “controlling financial interest” without specifically defining what controlling means. U.S. firms have used majority voting rights (&gt;50%) or <b>legal</b> control.</li> <li>- For variable interest entities (VIE) including many special-purpose entities (SPE), FASB FIN 46(R) is based on <b>effective</b> control. Consolidation is required if a company has control over the most significant activities of a VIE, and the right to receive benefits or the obligation to absorb losses.</li> <li>- For joint ventures, equity method is required.</li> </ul> |

\* The IASB has proposed to eliminate the proportionate consolidation.

Which one, effective control or legal control, is more appropriate for the ownership structure of Japanese firms in a keiretsu? Effective control because a keiretsu involves a great deal of cross share-holding which enables control without owning more than 50% of voting shares.

### Revenue Recognition

| IFRS (IAS 18 & IAS 11)  | U.S. GAAP  |
|---|--|
| <ul style="list-style-type: none"> <li>- Generally require revenue recognition when:               <ol style="list-style-type: none"> <li>1. risks, rewards and control have been transferred, and</li> <li>2. revenue and costs can be measured reliably.</li> </ol> </li> <li>- Require percentage-of-completion method for construction contract. Prohibit completed contract method, and require cost recovery method when % of completion cannot be determined.</li> </ul> | <ul style="list-style-type: none"> <li>- Focus on revenue being realized or realizable and earned (completed or virtually complete the earnings process).</li> <li>- Various sources of detailed industry-specific guidance may lead to significant differences in the timing of revenue recognition especially for multiple element contracts.</li> <li>- Allow percentage-of-completion method and completed contract method (when % of completion cannot be determined).</li> </ul> |

Which one, IFRS or U.S. GAAP, likely results in an earlier revenue recognition in multiple-element contracts (common among computer software companies) that contains both a product and ongoing support services?

IFRS because it is not as prescriptive as U.S. GAAP, i.e., AICPA SOP97-2 and SEC SAB 101 & SAB 104. A company using IFRS has more leeway in structuring sales transactions so that revenue may be recognized upon the product shipment rather than deferring and recognizing revenue pro rata over the contract term per U.S. GAAP (Cain, 2008). Cain further states that this could result in a significant competitive advantage for foreign IFRS companies because investors might perceive them as more successful than U.S. competitors due to their faster sales growth, and these companies may have more flexibility to negotiate favorable terms without any adverse accounting effects. The FASB and the IASB are currently working on a joint project, Revenue Recognition, which will specifically address and converge the accounting treatment for multiple-element sales contracts.

**Employee Benefits (Defined benefit plan)**

| <b>IFRS (IAS 19)</b>  | <b>U.S. GAAP</b>   |
|---|--|
| <ul style="list-style-type: none"> <li>- Past service cost related to retirees and vested active employees is expensed immediately.</li> </ul>  | <ul style="list-style-type: none"> <li>- Require past service cost related to retirees be amortized over their remaining expected life.</li> </ul>                                   |
| <ul style="list-style-type: none"> <li>- Past service cost related to nonvested active employees is recognized on a straight-line basis over the remaining vesting period.</li> </ul> | <ul style="list-style-type: none"> <li>- Past service cost related to active employees is to be amortized over their remaining service period.</li> </ul>                            |
| <ul style="list-style-type: none"> <li>- Do not require minimum liability recognition.</li> </ul>   | <ul style="list-style-type: none"> <li>- Require recognition of at least the unfunded accumulated pension benefit obligation as a minimum liability on the balance sheet.</li> </ul> |
| <ul style="list-style-type: none"> <li>- Actuarial gains and losses may</li> </ul>  | <ul style="list-style-type: none"> <li>- Actuarial gains and losses may</li> </ul>   |

|  |   |
|--|---|
| <p>be deferred, or recognized immediately either in net income or in a separate component of stockholders' equity.</p> <p>- There is a limitation of the amount of pension asset to be recognized.</p> | <p>not be deferred, and are recognized in accumulated other comprehensive income with subsequent amortization to the income statement.</p> <p>- There is no limitation of the amount of the pension asset to be recognized.</p> |
|--|---|

Which one, IFRS or U.S. GAAP, likely results in an earlier recognition of expenses related to employee benefits? IFRS due to its requirement regarding past service cost.

### **IFRS AND U.S. GAAP CONVERGENCE**

The convergence efforts took off in September 2002 when the FASB and the IASB issued *Norwalk Agreement* in which they acknowledged their commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. The FASB and the IASB pledged to use their best efforts: (1) to make their existing standards fully compatible as soon as practicable, and (2) to coordinate their future work programs to ensure that once achieved, compatibility is maintained. To achieve these objectives, both boards will not only try to eliminate differences in their existing standards but also to develop new common standards that improve the financial information reported to investors.

In February 2006, the FASB and the IASB issued a *Roadmap for Convergence between IFRS and U.S. GAAP: 2006-2008*, which identified a number of issues for convergence. The Boards recognized the relevance of the *Roadmap* for the removal of the requirement to reconcile net income and stockholders' equity

to U.S. GAAP for non-US companies that use IFRS and are registered in the U.S.

Since then significant progress has been made regarding the effective implementation of IFRS across companies and jurisdictions, and measurable progress in addressing priority convergence issues, therefore, the SEC decided to remove the reconciliation requirement for non-U.S. IFRS registrants effective for reporting periods ending on or after November 15, 2007.

However, the most important event happened in August 2008 when the SEC proposed a roadmap that could lead to the use of IFRS by U.S. public companies. The SEC recently announced on February 24, 2010 that it will decide by 2011, assuming completion of convergence projects and its staff's Work Plan, whether to incorporate IFRS into the U.S. financial reporting system, and if so, when and how. Consequently, the FASB and the IASB have agreed to aggressively accelerate their convergence efforts so that an estimated publication of final standards will be no later than 2011. These rapid developments will require U.S. accountants and educators to quickly retool in order to keep up with the latest changes in both U.S. GAAP and IFRS.

To help accountants and educators understand and appreciate the convergence progress that has been made, this section of the paper provides an overview of major accounting issues that converged as of March 2010. These issues are categorized into three groups: (1) IFRS converged with U.S. GAAP, (2) U.S. GAAP converged with IFRS, and (3) convergence as a result of joint projects between the FASB and the IASB.<sup>3</sup> Information about these convergence issues came from the web site of the FASB ([www.fasb.org](http://www.fasb.org)) and the IASB ([www.iasb.org](http://www.iasb.org)).

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<sup>3</sup> Please note that Statement of Financial Accounting Standards (SFAS) quoted in this section have been superseded by FASB Accounting Standards Codification since July 1, 2009. They are, however, quoted here because the convergence projects were completed when these statements were still effective.

**IFRS Converged with U.S. GAAP**

There are five completed projects and one project expected to be completed later in 2010.

**IFRS 3, *Accounting for Business Combination and Goodwill*, converged with SFAS 141, *Business Combination*.** IFRS 3 requires the acquisition (purchase) method and no longer allows the pooling of interest method. Similar to SFAS 141, IFRS 3 requires goodwill and indefinite-lived intangible assets to be tested annually for impairment. Amortization is no longer allowed.

**IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, substantially converged with SFAS 144, *Accounting for Impairment or Disposal of Long-Lived Asset*.** Entities are required to recognize and disclose financial results as discontinued operations when those operations are disposed of or when the assets in the operations are classified as “held for sale” and the entity will not have any significant continuing involvement in the component’s operations after the disposal transaction. This revised timing is generally later than the timing per the superseded IAS 35, i.e., on the earlier of the dates on which: (a) an enterprise entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation, or (b) its board of directors approved a detailed formal plan for the discontinuance and for making an announcement of the plan. Definition of a component of an entity that can be classified as discontinued under IFRS is similar to but narrower than that under U.S. GAAP.

**Revised IAS 23, *Borrowing Costs*, converged with U.S. GAAP, *Capitalization of Interest Cost*.** IAS 23(R) requires the capitalization of borrowing costs which are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. The IASB removed the benchmark treatment of expensing all borrowing costs in the period incurred.

It also narrowed the borrowing-cost definition to be consistent with SFAS 34 by excluding other costs in connection with the borrowing of funds such as foreign exchange gains and losses on foreign currency borrowings.

**IFRS 8, *Operating Segments*, superseded IAS 14 and converged with SFAS 131, *Segment Reporting*.** IFRS 8 adopted the “management approach” required by U.S. GAAP. Under this approach, the segment information would be what management uses internally for evaluating segment performance and deciding how to allocate resources to operating segments. This would allow investors to review the operations through the eyes of management, and would enable entities to provide timely segment information at little extra cost. Similar to SFAS 131, IFRS 8 permits any managerial accounting approach even when the approach (e.g., variable costing) is not allowed for preparing financial statements, and does not require geographic segment disclosure which was required under IAS 14. In addition to SFAS 131 requirements, IFRS 8 requires explanations of the basis on which the segment information is prepared and reconciliations to the amounts recognized in the income statement and the balance sheet.

**Fair value definition and amendment to IFRS 7, *Disclosures*.** The IASB has recently accepted the same definition of fair value as SFAS 157, *Fair Value Measurements*. That is fair value is defined as the exit price, i.e., the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In the Exposure Draft of Fair Value Measurement project, the IASB also proposed a three-level fair value hierarchy that categorizes observable and non-observable market data used as inputs for fair value measurement. This hierarchy which is similar to SFAS 157 has been incorporated into the recent amendments to IFRS 7, *Financial Instruments: Disclosures*.

Additionally, IFRS on joint ventures is expected to converge with U.S. GAAP. The Exposure Draft, *Joint Arrangements*, issued by the IASB in late 2007, would eliminate the proportionate consolidation method and require the use of the equity method for investments in joint ventures. The final standard is expected later in 2010.

### **U.S. GAAP Converged with IFRS**

There are six completed convergence projects.

**SFAS 123 (Revised), *Share-Based Payments*, converged with IFRS 2, *Share-Based Payment*.** SFAS 123 eliminates the use of intrinsic value method and requires that compensation cost relating to share-based payments be recognized in financial statements. The compensation cost is to be measured on the basis of the fair value of the equity or liability instrument issued.

**SFAS 151, *Inventory Costs*, aligned with IAS 2, *Inventories*.** Abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) are to be excluded from inventory costs, and recognized as current-period expenses. Similar to IAS 2, it requires the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities.

**SFAS 153, *Exchange of Non-monetary Assets*, converged with IAS 16, *Property, Plant and Equipment*.** SFAS 153 no longer allows the book value, and requires fair value as the measurement basis for exchanges of similar productive assets. The use of fair value necessitates an entity to immediately recognize gains or losses on the exchanges in the income statement.

**SFAS 154, *Accounting Changes and Error Corrections*, converged with IAS 8, *Accounting Policies, Changes in***

***Accounting Estimates and Errors.*** SFAS 154 requires retroactive applications of the direct effects of a change in accounting policy, unless it is impractical to determine either the cumulative effect or the period-specific effects of the change. The retroactive approach requires that an entity: (a) applies the new accounting policy to all financial statements presented on a comparative basis, and (b) adjusts the cumulative effect of the change against the opening balance of retained earnings for the period of change. This approach improves comparability across periods. Similar to IAS 8, SFAS 154 requires that a change in method of depreciation, amortization, or depletion for long-lived, non-financial assets be accounted for as a change in accounting estimate with a prospective application. The rationale for this requirement is that the new depreciation method is adopted in recognition of a change in estimated future benefits or the pattern of consumption of those benefits, therefore the effect of the method change is inseparable from the effect of the change in estimate.

***SFAS 155, Accounting for Certain Hybrid Financial Instruments, and SFAS 159, Fair Value Option for Financial Assets and Financial Liabilities, converged with IAS 39, Financial Instruments: Recognition and Measurement.*** Similar to IAS 39, SFAS 155 and SFAS 159 permit entities to choose to measure at fair value many financial instruments including hybrid ones that contain an embedded derivative, and firm commitments that would otherwise not be recognized at inception and that involve only financial instruments.

***SFAS 140(R), Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, converged with IAS 27, Consolidated and Separate Financial Statements.*** SFAS 140(R) eliminated the exemption from consolidation for qualifying special-purpose entities (QSPE), making QSPE subject to FIN 46(R) revised guidance on consolidations of variable interest entities. This is consistent with IAS 27, that has no

concept of a QSPE, i.e., all SPEs are subject to its consolidation guidance. This QSPE rule change is in response to the financial crisis, and could result in billions of dollars of loans being brought onto bank's balance sheets (Gordon, 2009). It takes effect for companies' annual reporting periods starting after November 15, 2009.

### **Convergence Due to Joint Projects between FASB and IASB**

There are two completed projects and a completed first phase of two major joint projects, Conceptual Framework and Financial Statement Presentation.

***Business Combinations: Applying the Acquisition Method – SFAS 141 (Revised December 2007) and IFRS 3 (Revised January 2008).*** The FASB made more substantial changes to SFAS 141 than the IASB made to IFRS 3 as listed below.

- Establish the acquisition-date fair value as the measurement basis for: (a) all assets acquired and liabilities assumed, and (b) all assets and liabilities arising from contractual contingencies. Acquisition date is when control is achieved, as opposed to the business-combination agreement date. It no longer allows the parent company concept which measures the acquired assets and liabilities at book value plus the parent's ownership percentage of the difference between fair value and book value at the acquisition date.
- Require recognition of the full fair values of acquired assets and assumed liabilities in a business combination achieved in stage.
- Require acquired in-process R&D to be recognized as a separate intangible asset, rather than immediately written off as an expense.
- Negative goodwill resulting from a bargain purchase is to be recognized in the income statement as a gain, rather than reducing fair values of assets acquired on a pro-rata basis.

- Require only restructuring costs, that the acquirer is obliged to incur, to be recognized as expenses at acquisition date. Anticipated restructuring costs are not recognized until they are incurred.
- Require disclosure of the factors that make up goodwill.

Major changes (improvements) to both IFRS 3 and SFAS 141 are as follows.

- Simplify measurement of goodwill in a step acquisition. Goodwill is measured as the difference, at the acquisition date, between the fair value of net assets acquired and the fair value of any investment in the business held before the acquisition plus the consideration transferred.
- Acquisition-related costs are recognized as expenses (rather than included in goodwill).
- Require the acquirer to recognize contingent consideration at fair value at the acquisition date.
- Require the acquirer to disclose all relevant information about the nature and financial effect of the business combination.

***Noncontrolling Interests in Consolidated Financial Statements: SFAS 160 & Revised IAS 27.*** A significant change to align SFAS 160 with IAS 27 is requiring entities to report noncontrolling (minority) interests in subsidiaries as *equity* in the consolidated financial statements. A major change/improvement to both IAS 27 and SFAS 160 is requiring transactions between the entities and noncontrolling interests be treated as equity transactions. These changes eliminate the diversity that currently exists in accounting for noncontrolling interests.

**Conceptual Framework Phase A: Objectives of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information.** Major convergence issues are summarized below.

- The objectives pertain to financial reporting *as a whole*, not just financial statements.
- The objectives are based upon the *entity perspective* (rather than a proprietary perspective) with the focus on meeting information needs of *all capital providers*.
- Relevance and faithful representation (not reliability) are *fundamental* qualitative characteristics.
- Comparability, verifiability, timeliness and understandability are *enhancing* characteristics which distinguish more useful from less useful information.
- Two pervasive constraints are materiality and cost.
- Conservatism/prudence should remain excluded from the qualitative characteristics.

The FASB and the IASB are working jointly on three other phases of Conceptual Framework project: Phase B: Elements and Recognition, Phase C: Measurement, and Phase D: Reporting Entity.

**Financial Statement Presentation (FSP) Phase A:** What constitutes a complete set of financial statements and the requirements for presenting comparative financial information. Both boards agree that a complete set of financial statements should include:

1. Statement of financial position at the beginning of the period.
2. Statement of financial position at the end of the period.
3. Statement of comprehensive income that present a total for comprehensive income (nonowners' changes in financial position) and a subtotal for net income.
4. Statement of changes in equity.
5. Statement of cash flows.

The boards are working jointly on the other three FSP phases: Discontinued Operations, Presentation of Other Comprehensive Income, and Replacement of IAS 1, *Presentation of Financial Statements*, and IAS 7, *Cash Flow Statements*.

## **CONCLUDING REMARKS**

Regardless of the substantial progress in converging the two sets of standards, many key differences between IFRS and U.S. GAAP still remain. As of March 2010, the IASB and the FASB are working on 13 convergence projects, three of which are major joint projects that will have pervasive effects on financial reporting.

Because of the significance of these projects, the Boards agreed to conduct them simultaneously by sharing staff resources and research, and working to coordinate the eventual issuance of their Exposure Drafts and final standards. These three major projects are Conceptual Framework, Financial Statement Presentation, and Revenue Recognition.

The Boards issued a final chapter of Conceptual Framework - Phase A: Objectives and Qualitative Characteristics in the fourth quarter of 2009. The Boards issued a discussion paper with their preliminary views on the other two major projects, and expect to issue an exposure draft in 2010 followed by a final standard in 2011.

The other 10 convergence projects in the order of an expected year of final standard include consolidation (2010), derecognition (2010), fair value measurement guidance (2010), joint venture (2010), emissions trading schemes (2011), financial instruments-IAS 39 replacement (2010), financial instruments with characteristics of equity (2011), insurance contracts (2011), leases (2011), and post-retirement benefits (2011). Educators, auditors, preparers and other users of financial statements may keep abreast of the progress of these projects by regularly visiting the web site of the FASB ([www.fasb.org](http://www.fasb.org)), the IASB ([www.iasb.org](http://www.iasb.org)), the AICPA ([www.ifrs.com](http://www.ifrs.com)) and major accounting firms (e.g., [www.iasplus.com](http://www.iasplus.com), [www.deloitte.com/us/ifrs](http://www.deloitte.com/us/ifrs)) as well as signing up for a monthly IFRS Report of the AICPA at [www.smartbrief.com/cpa/?campaign=0108trial](http://www.smartbrief.com/cpa/?campaign=0108trial).

Accounting educators may also find many useful IFRS classroom materials at AAACommons-PWC site (<https://commons.aaahq.org/signin>) and KPMG Faculty Portal ([www.amr.kpmg.com/facultyportal](http://www.amr.kpmg.com/facultyportal)).<sup>4</sup> Additional online resources are also discussed in Krom (2009). Educators who want an in-depth detail of each standard may want to pay \$25 to become a member of the International Association for Accounting Education and Research ([www.iaaer.org](http://www.iaaer.org)) in order to access an electronic version of IFRS (eIFRS).

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<sup>4</sup> KPMG will send an educator a CD-Rom containing IFRS cases and solutions upon registering with the Faculty Portal. Solutions to the three KPMG cases are in the CD-Rom.

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