By Stuart H. Deming

# International Financial

## Their Importance to

**Historically, the accounting standards used by U.S. companies to report on their financial status have played a dominant role in the conduct of domestic and international business. U.S. accounting standards have also played a critical role in the drafting of legal instruments. But the primacy of U.S. accounting standards can no longer be assumed. Many countries have adopted and now require the use of international accounting standards. These international accounting standards are already having a major impact on U.S. business and legal practice. Their importance will continue to grow with the convergence of U.S. and international accounting standards.**

### US GAAP

Over the years, most countries have developed a set of accounting principles that serve as a common basis for reporting the financial status of businesses operating within their borders. These common accounting principles are formally referred to as Generally Accepted Accounting Principles (GAAP). They are, in theory, unique to each country. Their purpose is to provide a common and accepted standard for evaluating and comparing the financial status of businesses.

The national accounting standards applicable to the United States are often referred to as "US GAAP." No single source of US GAAP exists. It is derived from a composite of principles, standards, and preferred practices established by U.S. regulators and standard-setters. Statements, interpretations, and other forms of guidance of the Financial Accounting Standards Board (FASB), the Securities and Exchange Commission (SEC), and the American Institute of Certified Public Accountants are the primary sources of US GAAP.

Given the dominant role of the United States as a source of capital, foreign companies are accustomed to using US GAAP in order to raise capital in the United States. Much like the use of English in the conduct of international business, the use of US GAAP has generally been assumed. US GAAP is pervasive because it impacts on all aspects of decision-making with respect to the conduct of U.S. business and in the conduct of business in many parts of the world. Though typically unstated, US GAAP governs how transactions are structured and how legal instruments are drafted.

### International Financial Reporting Standards

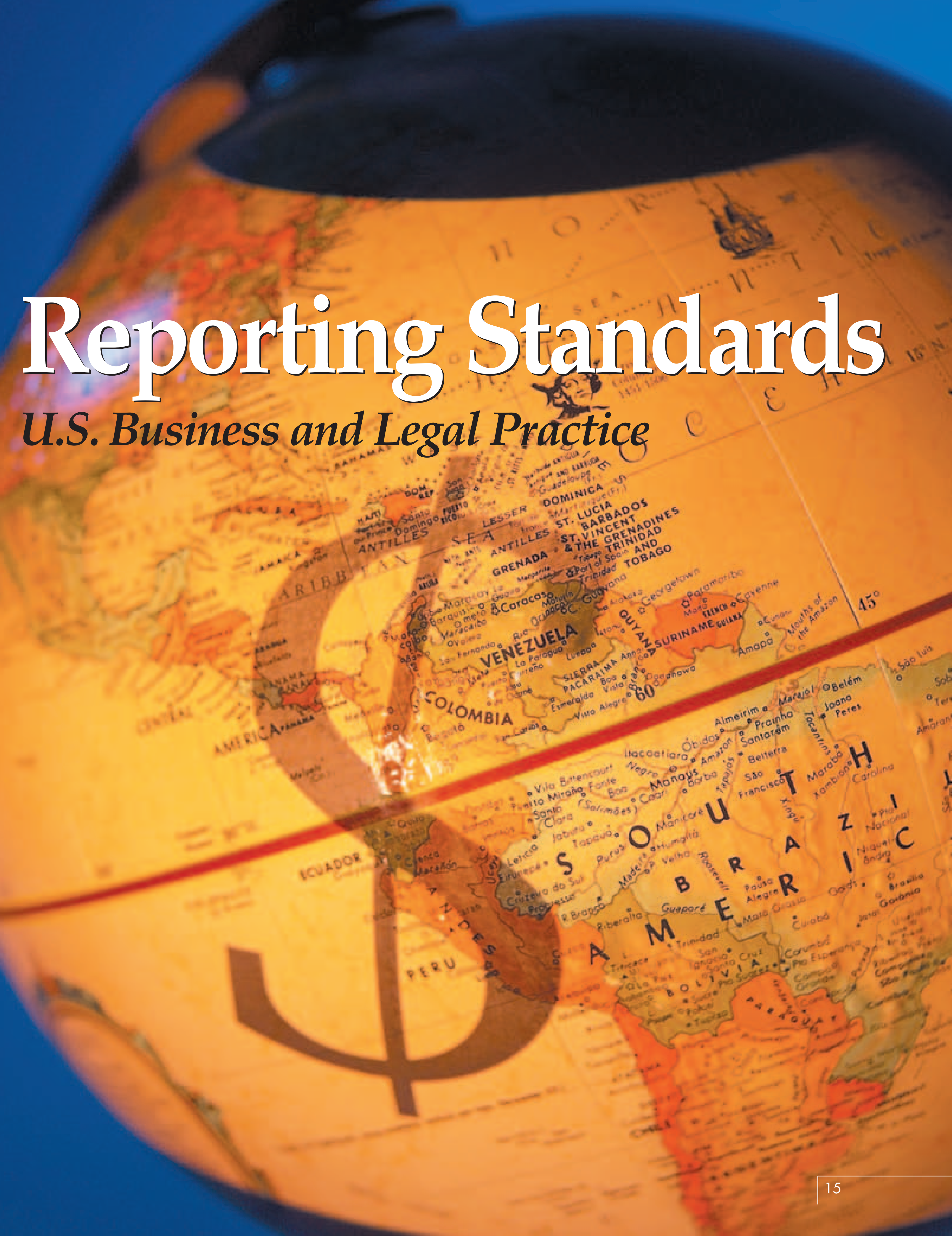
No longer can it be assumed that US GAAP will continue to be the primary means by which businesses and business relationships are evaluated. U.S. companies, financial institutions, investors, and the lawyers for each must increasingly take into consideration international accounting standards, and their implications, on a wide range of issues relating to the operation of a business.

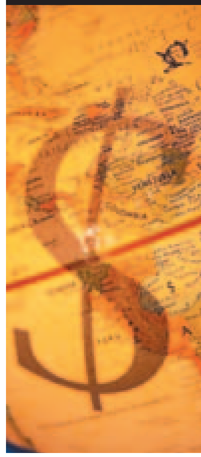
Recognized international accounting standards do exist and are formally known as the International Financial Reporting Standards (IFRS). IFRS includes the standards and interpretations issued by the International Accounting Standards Board (IASB) as well as the International Accounting Standards (IAS) and interpretations of the International Accounting Standards Committee.[1]

The governing organization for the IASB is the International Accounting Standard Committee Foundation (Foundation). Paul A. Volcker, former chairman of the U.S. Federal Reserve Board, is the current chairman of the Foundation, which includes 19 trustees. The United States is well-represented; including Mr. Volcker, four trustees have U.S. ties. The Foundation plays the critical role in appointing members of the IASB, the standards-setting body, and the other components of the

# Reporting Standards

## *U.S. Business and Legal Practice*





## Fast Facts

**U.S. companies, financial institutions, investors, and the lawyers for each must increasingly take into consideration international accounting standards, and their implications, on a wide range of issues relating to the operation of a business.**

**Parties need to review legal instruments linked to information contained in financial statements of entities now in the process of converting, in whole or in part, to international accounting standards to determine the impact of the change.**

**Agreements dependent on information in financial statements should clearly define what accounting standards govern the financial statements to which they are linked.**

Foundation that work with the IASB in setting international accounting standards.

## The Need for High-Quality Standards

The Foundation's objective is the development of a single set of "high-quality" international accounting standards that are transparent, understandable, and enforceable, and that are rigorously applied. The Foundation also seeks to use the standards it develops through the IASB as the basis for the convergence of national accounting standards and IFRS into a single set of high-quality international accounting standards.

The Foundation mandated that the international accounting standards developed by the IASB be of high quality. Otherwise, the establishment of IFRS will be of little benefit if the ultimate result of convergence is a set of standards based on the lowest common denominator. They would be subject to a wide range of interpretations, and they could not be expected to be rigorously and consistently applied. In such circumstances, IFRS would be useless because no reasonable reliance could be placed on them.

From the perspective of the United States, both the SEC and FASB are, in concept, very supportive of convergence. Formal efforts are currently underway to narrow differences. But the movement towards convergence will continue to be incremental. A number of major differences have yet to be resolved. Many of these differences cannot be resolved until the SEC and FASB are adequately assured that the important protections afforded by US GAAP will not be lost.

## Advantages of a Single Set of Standards

A single set of accounting standards, like IFRS, offers a number of advantages. First of all, IFRS will mean a reduced cost of capital because the same standards will apply regardless of location. The time and expense of applying different accounting standards will be greatly reduced with the use of one consistent reporting standard. In essence, it is like using the same language. Translation costs are eliminated.

Secondly, the information for decision-making is enhanced by a single set of accounting standards. A similar basis for comparison is established. "Apples to apples" will be the basis of comparison and decision-making, as opposed to an "apples to oranges" basis for comparison. The latter is inexact, and the degree of the disparity is often uncertain and subject to varying interpretations.

## The Emergence of IFRS as a Set of Global Standards

The emergence of IFRS has coincided with the requirement of their use by the European Union. Beginning in 2005, virtually all publicly-held companies listed on exchanges in the European Union are required to use IFRS. Australia, New Zealand, Hong Kong, Singapore, and the Philippines have adopted IFRS, as have many countries bordering on the European Union. Most countries, including China, are moving towards IFRS. Many small or developing countries have turned to IFRS as their national GAAP. As they become the prevailing international accounting standards, IFRS' impact on US GAAP will only increase with convergence.

But even with the emergence of IFRS, a difference can still exist between IFRS as adopted by the IASB and as adopted by the European Union or a particular country. Much like the adoption of uniform laws by individual states in the United States, in adopting IFRS, the European Union and some countries have made relatively modest modifications. As a result, any reference to IFRS should not be unqualified. Reference to the adopting body is always prudent as a means of clarification. IFRS, as adopted by the IASB, should be the point of reference for the unaltered standards. For example, IFRS as adopted by the European Union or a particular country should be referred to as the respective version of IFRS for the European Union or the particular country.

## Impact of IFRS on U.S. Companies

For U.S. companies, the broader their international activities, the more significant will be the effect of IFRS. Differences between the two standards exist. Unlike US GAAP, which does not require a parent and subsidiaries to conform their accounting policies, IAS 27 under IFRS requires a parent to present consolidated financial statements for subsidiaries it controls using uniform accounting policies.

U.S. subsidiaries of companies operating in jurisdictions like the European Union, where IFRS is the accepted standard, will need to follow the same accounting standards as their corporate parent. A subsidiary's accounting policies must conform to its parent's accounting policies under IFRS for similar transactions and events. For example, IAS 2 under IFRS prohibits the valuation of inventory on the basis of the last-in, first-out method. But the last-in, first-out method is permitted under US GAAP. The U.S. subsidiary of a parent company located in the European Union would have to use the average cost or first-in, first-out methods—whichever is used by its parent—as the method of valuing its inventory.

Similarly, U.S. joint ventures with a venture partner operating in countries requiring the application of IFRS will need to follow the same accounting standards as their venture partner. If a listed European Union company has a major investment in a U.S. company, the U.S. company will have to prepare information according to IFRS for purposes of its investor's equity accounting.

Even for companies not required to adopt IFRS for reporting purposes, many U.S. companies looking to new markets will need to adopt IFRS to secure licenses, raise capital, or comply with requirements of local regulators. Foreign customers, vendors, or lessors may also require IFRS financial statements. To facilitate more accurate comparisons to foreign competitors, some U.S. companies may view IFRS as an opportunity to supplement their current reporting with reporting or commentary based on IFRS.

## Differences between IFRS and US GAAP

In an overall sense, IFRS and US GAAP are far more similar than they are different. The influence of US GAAP and U.S. practices on IFRS is substantial. In addition, many of the trustees of the Foundation and many of the members of the board of IASB are U.S. practitioners, U.S. trained experts, or practitioners with years of experience working with US GAAP on behalf of their clients.

As opposed to historical cost, both IFRS and US GAAP are increasingly based on a fair value asset and liability model. IFRS is generally viewed as being more principles-based in orientation than US GAAP, which is viewed as being more rule-based. By analogy and practice, IFRS has more of a common law approach, whereas US GAAP has more of a civil law approach.

## Importance of Differences to Lawyers

Despite their common heritage and the movement toward convergence, the differences between IFRS and US GAAP can at times be significant. From a legal standpoint, the differences can have dramatic ramifications. Special care must be exercised in the drafting of legal instruments that are tied to the financial statements of a company. The following provides a few examples of how these issues can arise.

Loan covenants associated with financing agreements present a classic scenario. IAS 32 under IFRS requires convertible debt instruments to be split in their liability and equity components at the time of issuance. Under US GAAP, except when warrants are detachable, convertible debt instruments are to be treated entirely as a liability. Where the debt-to-equity ratio governs the default provisions of a finance agreement, the net result of a change to IFRS from US GAAP is that a lender's risk is enhanced and the borrower's risk of default is reduced.

For compensation agreements, a senior officer's bonuses or benefits may be based on ordinary income before taxes. Events not tied to the day-to-day operation of the business are more apt to play a role as to whether the executive is given a bonus. Under US GAAP, extraordinary items are permitted but restricted to infrequent, unusual, and rare items that affect profit and loss. Extraordinary events, like an accounting change or natural disaster, are less likely to play a role in whether the executive receives a bonus. But under IAS 1 under IFRS, extraordinary items cannot be separated out. They must be included in ordinary income.

For acquisitions, if and when a transaction takes place and how it is structured can be influenced by whether IFRS or US GAAP is used. Certain transactions may present very different characteristics under IFRS than under US GAAP. In counseling clients, special care must be exercised to determine whether a change in accounting standards will alter the legal advice that is provided. For securities lawyers, a conversion to IFRS may prompt disclosure obligations or affect the timing of disclosures.

## Current and Future Practice Considerations

For legal instruments linked to information contained in financial statements of entities now in the process of converting to IFRS, the parties to those instruments and their attorneys need to review the provisions of the legal instruments to determine the impact of the change to IFRS. The provisions may need to be revised or clarified or, alternatively, new arrangements may need to be negotiated. But the impact of the change to IFRS cannot be disregarded.

Henceforth, agreements dependent in whole or in part on information in financial statements should, much like choice-of-law provisions in contracts, clearly define what accounting standards govern financial statements to which they are linked. Drafters of legal instruments must take into consideration what accounting standards apply or are likely to apply and the implications of their application.

But the designation of applicable accounting standards must be an informed decision. Simply designating the governing standards can be counterproductive if conversion costs are not adequately considered. In many situations, conversion costs can be substantial. At times, incurring substantial conversion costs may be warranted. Yet, in many situations, the conversion costs cannot be justified, and functionally equivalent alternatives may need to be identified.

Other financial ratios or line items might be used to provide similar information that will not change, depending upon whether IFRS or US GAAP is used. Reference might also be made to financial information that is entirely separate from financial statements or data that cannot be affected by a change in accounting standards.

## Conclusion

Whatever the context, US GAAP can no longer be assumed to be governing the preparation of financial statements. Special care needs to be exercised to determine what standards apply and what the implications of those standards may be. Once that determination is made, precision is required in the drafting of legal instruments to ensure that any linkage to financial instruments is appropriately qualified by applicable accounting standards and by the context in which those standards are to be applied. ◆

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### Footnote

1. The IASB is the successor organization to the International Accounting Standards Committee. The International Accounting Standards Committee was created in 1973 as a result of an agreement reached by the accountancy bodies of a number of countries, including the United States.