A Tale of Two Standards:
An Exploration of US GAAP and IFRS

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Senior Capstone Project for Allyson Lagassé

ABSTRACT

The research in this paper has two objectives. Beginning with an examination of the historical development of how financial reporting standards are set in the United States and around the world, the Financial Accounting Standards Board and the International Accounting Standards Board will be studied. Setting financial reporting standards in the United States is currently a responsibility of the Financial Accounting Standards Board, while many countries abroad utilize International Financial Reporting Standards, maintained by the International Accounting Standards Board. After detailing the historical development of each of the two boards and the sets of standards they maintain, the paper continues with an analysis of some of the difficulties that could be faced by the United States if the transition proposed by the Securities and Exchange Commission to International Financial Reporting Standards takes place. General differences between the standards are examined along with the differences relating to the specific area of the treatment of long-term and intangible assets. The second objective of this research was to use the information obtained to develop a case study that was used in an intermediate accounting class at Bryant University. Student responses to the case and the corresponding survey are consistent with the idea that the differences between US Generally Accepted Accounting Principles and International Financial Reporting Standards need to be studied to a much greater extent in the classroom in order to ensure that accounting students are prepared for such a transition upon entering the workforce.

INTRODUCTION

It is the best of times and it is the worst of times in the field of accounting. While many may view the profession as static and unchanging, the field has been, and will continue to be, part of a worldwide phenomenon that will have a significant impact on the financial reporting process of companies within the United States (US) and around the world. As globalization and international trade increase, standard-setting is rapidly progressing as a topic of international debate. While US Generally Accepted Accounting Principles (GAAP) have long been considered the premier accounting principles to use throughout the world, over 100 countries have made the switch to using International Financial Reporting Standards (IFRS.) Despite the apparent global popularity of IFRS, questions remain about the proposed transition for US companies to begin utilizing these standards.

This research will begin with an exploration of each of the standard-setting boards: the Financial Accounting Standards Board (FASB) in the United States and the International Accounting Standards Board (IASB), based in the United Kingdom. Through discussion of each Board's historical development, it will be possible to examine areas in which the two Boards are similar or different. Differences could potentially create significant problems as the two Boards work toward converging or writing new standards in areas that are currently different. One such area of divergence is the treatment of long-term and intangible assets under each set of standards. One purpose of this research is to explain the key components of each of the two reporting methods, the differences between them, and how companies may be affected. The research component will be supplemented with a case study that was used in an intermediate accounting class at Bryant University in order to expose students to some of the potential challenges a company may face as it begins a transition from US GAAP to IFRS.

The conclusions reached through this research will provide Certified Public Accountants, as well as other business professionals and students, with information regarding a large area of divergence between US GAAP and IFRS. While the FASB and IASB are working to converge the two sets of standards before the US potentially transitions to IFRS, the accounting for long-term and intangible assets is one area that the Boards have not yet attempted to converge. If the US adopts current IFRS for the reporting of long-term and

intangible assets, all US companies will be affected by these changes. Because the transition to IFRS has only become a more serious possibility in the recent past, accounting curriculums are still currently focused on teaching students US GAAP. However, students need to be exposed to potential differences that may occur with a transition to the use of IFRS. By surveying students about their experiences in completing the case, it might be possible to understand how current accounting curriculums are introducing IFRS education into the classroom and how well-prepared students would be for the transition.

HISTORY OF THE FINANCIAL ACCOUNTING STANDARDS BOARD

With the passing of the Securities Act of 1934, the Securities and Exchange Commission (SEC) was created and given the power to establish standards for financial reporting of US companies. It was soon determined that this work was better left to the private sector where professionals would be able to provide input and guidance, and thus the power to establish financial reporting standards was moved to the American Institute of Certified Public Accountants (AICPA.) During the time that the AICPA was responsible for establishing accounting standards, two different committees took part in the process: the Committee on Accounting Procedure from 1936 to 1959 and the Accounting Principles Board from 1959 to 1973 (www.fasb.org).

The two committees of the AICPA worked to provide standards that would be beneficial to users and preparers of financial statements. During the 1960s, "it became apparent that standards affecting issuers (business and industry) and users (investors and lenders) of financial information no longer could be established almost unilaterally by public accountants (auditors)" (www.fasb.org). At this point, the AICPA relinquished its standard-setting power to a new organization that would utilize a broader spectrum of participation in order to develop unbiased standards; the Financial Accounting Standards Board (FASB.) With the creation of the FASB in 1973, standard-setting was again focused in the private sector in order to maintain an open environment for opinions to be considered.

The mission of the FASB "is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information" (www.fasb.org). The work of the FASB is an integral part of the United States economy as it demands that financial information put forth by companies is "credible, transparent, and comparable" (www.fasb.org). Without this type of guidance and regulation, financial information would be unusable to many and unreliable to most. In addition to the detailed financial reporting standards, the FASB also works to develop more broad-based accounting concepts for practitioners to consider and use when reporting financial information.

In order to ensure that the most up-to-date information is included in accounting standards, the FASB follows a strict set of "due process" procedures, modeled after the Federal Administrative Procedure Act. These procedures invite many different business professionals to be actively engaged in the formation of the accounting standards that they will be using. This allows for different views and opinions to become a part of the discussion that leads up to the final approval for a new or revised standard. Open dialogue for the creation and implementation of standards is necessary in order to ensure that different possibilities are considered and their impacts on different types of industries can be explored.

The final evaluation needed for approval of any item on the FASB's agenda is meant to address a number of different areas, including the pervasiveness of the issue, technical feasibility, possible consequences, etc. One of the areas that has become more closely examined in the recent past is the possibility of convergence with financial reporting standards used in other countries. The FASB ensures that proper attention is paid to:

> "the extent to which there is an opportunity to eliminate significant differences in standards or practices between the US and other countries with a resulting improvement in the quality of US standards; the extent to which a common solution can be reached; and the extent to which any significant impediments to converge can be identified" (www.fasb.org).

This area of evaluation is especially critical as the US moves closer to the potential adoption of International Financial Reporting Standards (IFRS) to replace US GAAP. More discussion on this topic will follow. The FASB's focus on supporting convergence of the two sets of standards is the first step in this process. Many practitioners in the United States may understand the history of the FASB and US GAAP, and may know that the US is leaning toward making a move to IFRS, but many may not be aware of the history of the International Accounting Standards Board and IFRS and how a change to these standards could directly or indirectly affect them.

HISTORY OF THE INTERNATIONAL ACCOUNTING STANDARDS BOARD

Formed in 1973, the International Accounting Standards Committee (IASC) was created in the same year that the FASB was developed in the United States. As international trade had grown during the 1960s, it had been quickly decided that the world needed centralized guidance for accounting standards. From its very inception, the IASC focused on collaboration among the major players in the global marketplace, and thus input from the United States has always been crucial to the success of the IASC (Parker). Without a strong perceived need for international accounting standards, however, the IASC did not receive much support or credit for its work, as many countries continued to use their own accounting standards. Until the mid-1980s, the IASC worked mainly to harmonize accounting standards and was "often criticized that it was seeking the lowest common denominator with respect to standards" (Flesher). Many argued that quality of the standards was not given enough attention. In 1987, following its own internal direction and under pressure from the International Organization of Securities Commission to create a set of high quality international standards, the IASC made the decision to move toward more conceptually-based standards that could be more widely-used (Parker, 2008).

As time continued from the mid-1980s to the early 2000s, the world economy became much more global and many companies began to realize the benefits that could result from utilizing a single set of international accounting standards. Many European companies had begun using a modified version of US GAAP for the preparation of their financial statements in order to participate in the global economy, as the historical view has been that US GAAP is the premier set of accounting standards. The use of US GAAP around the world prompted the IASC to further promote the use of International Accounting Standards (IASs) as opposed to using US GAAP. Soon after the IASC increased its promotion efforts for IASs, standard-setting authority for these international standards was relinquished to the International Accounting Standards Board (IASB) in 2001. The 41 IASs established by the IASC remain in effect until reviewed by the IASB. Please see Appendix A for a timeline of events related to the two Boards' development.

The stated objective of the IASB is "to develop a single set of high quality, understandable and enforceable accounting standards to help participants in the world's capital markets and other users make economic decisions" (www.IASB.org). The main goal of creating IFRSs is to provide enhanced comparability among companies' financial statements around the world. By utilizing a single set of standards, financial information will be more understandable to more people in different countries. As will be discussed later, IFRSs are principals-based, generally requiring increased use of judgment among practitioners when compared to US GAAP which has many detailed rules.

The way in which the IASB develops its standards is similar to the way in which standards are produced in the United States. Extensive research is performed on certain topics and input is accepted from all possible stakeholders of the proposed standard. Proposals are released, followed by a period of time for public comment. An exposure draft will be released, followed by another comment period, which will ultimately result in the publishing of a new or revised standard, along with a statement of feedback. Once published, the standard is subject to a jurisdictional adoption process and a post-implementation review period by the IASB of two years (www.IASB.org). This public involvement in setting standards is similar to that of the FASB. Because the IASB is responsible for writing standards that are to be used internationally, it is critical that the Board not only receives input from people around the world, but is able to retain an international focus among its members. The IASB is made up of 14 members, representing nine countries, including the United States (www.IASB.org).

<u>FASB & IASB Working Together</u>

The current working relationship between the FASB and IASB is one of mutual aspirations for a single set of high-quality international accounting standards. The US has long been a provider of input to the creation of international standards. In July of 2007, Sir Tweedie, chairman of the IASB, commented on this relationship: "We have a major convergence program with the Financial Accounting Standards Board based on the idea that if the US has a better answer, we should have it – and vice versa" (Pickard, 2007). This relationship was developed at a joint meeting in September of 2002 with the issuing of the Norwalk Agreement. This publication showed that each Board was committed to the task of

developing accounting standards that would be of high quality that could be used by companies, no matter the country in which they reside.

Since the release of the Norwalk agreement in 2002, the IASB and FASB have continued to emphasize their shared goals and priorities in regard to their joint efforts. In February of 2006, the two Boards issued a "Memorandum of Understanding", outlining the priorities for the convergence project between the FASB and IASB and detailed these priorities into specific milestones would need to be reached by 2008 in order for the project to continue. This memorandum was based on three principles:

1. Convergence of accounting standards can best be achieved through the development of high quality, common standards over time;
2. Trying to eliminate differences between the two standards that are in need of significant improvement is not the best use of the FASB's and the IASB's resources – instead, a new common standard should be developed that improves the financial information reported to investors; and
3. Serving the needs of investors means that the Boards should seek convergence by replacing standards in need of improvement with jointly developed new standards (www.fasb.org).

Ultimately, both Boards have decided that when significant differences exist between standards for certain topics, completely new standards should be developed instead of trying to negotiate changes. This will help to evaluate the usefulness of current standards and understand how the quality and reliability of standards can be improved. US GAAP has long been considered the foremost set of standards as many nations have used it, or a variation of it, for their own financial reporting standards. This sentiment has decreased, however, as suggested by the chairman of the President's Economic Recovery Advisory Board, Paul Volcker. He has stated that "the logic is international; not 'made in the USA' anymore" (Defelice, 2009). Many professionals believe that US GAAP is truly the best set of accounting standards and are hesitant to see it changed or abandoned. These views are in contrast of those who are strong supporters of change in order to compete in a global marketplace. In late October of 2009, the FASB and IASB announced that they would begin meeting on a monthly basis through a combination of face-to-face and video conferences in

order to accelerate the efforts put forth to develop a common set of accounting standards by the target date of 2011 (Defelice, 2009).

TRANSITIONING

In February of 2009, Sir David Tweedie stated that "by December 2011, US GAAP and IFRS should be pretty much the same" (Campbell, Doupnik, and Tsakumis, 2009). Currently, over 12,000 companies in more than 100 countries, including many European countries, have already adopted IFRS. Many more countries, including Japan, China, India, Brazil, and Canada have made the announcement that they will also pursue a transitional path to IFRS (Mackintosh, 2009). A member of the IASB, John Smith, was quoted as saying that "the financial crisis has emphasized the relevance of the IASB's mission. More than ever, there is a need for a single set of worldwide accounting standards," (Reason, 2009).

These sentiments have been shared by many in the accounting and finance fields as they attempt to balance the increasingly more stringent rules brought about by accounting standards. The Committee on Improvements to Financial Reporting of the SEC, has given multiple suggestions to try to alleviate some of the frustration surrounding the specific details of accounting standards. "Many accounting observers believe a more principles-based approach to financial reporting, putting more trust in professional judgment, would clear up the muddy water created by decades of rules proliferation" (Johnson, 2009). Transitioning to IFRS, which are generally more principles-based, would appease the debates over the proliferation of detailed rules contained within US GAAP. There are varying views on whether or not the United States would be able to maintain principles-based accounting standards. These concerns stem from the fact that US GAAP is has become so detailed in order to minimize the risk of litigation based on financial reporting.

Oftentimes, companies wishing to raise capital in foreign markets have to develop multiple sets of financial statements, in order to comply with different accounting methods in each country. The SEC has held the view that this is cost-ineffective; it is for this reason that in November of 2007, the SEC decided to allow the financial statements of foreign investors prepared using IFRS, without requiring reconciliation to GAAP. This was the first step in the

path to allowing and possibly requiring the use of IFRS for financial reporting in the United States.

Roadmap/Timeline

The extensive involvement of the United States in the development and improvement of IFRS has led many to wonder about the timeline of IFRS adoption in the US. In mid-November of 2008, the SEC issued a roadmap, open for public comment, that outlined its proposed transition to making the use of IFRS mandatory for US public companies. In the proposed roadmap, the SEC did not set any definitive dates for the transition of US companies to begin using IFRS, it did, however, give a general timeline of when and how the transition might occur. Adoption would occur in stages, with large accelerated filers being asked to make the switch in 2014, accelerated filers in 2015, and all other public companies in 2016. Near the same time that the roadmap was released, leaders from the G20 countries issued a statement confirming their support for developing a single set of high-quality global accounting standards. The roadmap for the potential transition issued by the SEC was released by its former chairman, Christopher Cox; his successor, Mary Shapiro, does not appear to share the same determination for the potential transition. Please see Appendix C for a depiction of the original roadmap, which has since been modified.

As of September 18, 2009, Schapiro had made a statement that the SEC would be meeting later in the fall "to refine expectations regarding the potential US transition to International Financial Reporting Standards" (Jaworski, 2009). While Schapiro does believe in the ultimate goal of a single set of international financial standards, she is taking the time to ensure that all of the issues brought forth in the comment letters written in response to the proposed timeline are able to be addressed. After the comment period for the proposed roadmap ended on April 20, 2009, the SEC had received over 200 response letters "from a wide range of constituents" (PriceWaterhouseCoopers.com). The SEC has been working on a summary document of all of these public comments and it has become clear that there is a large array of support for and opposition against the transition and a significant difference of views on how to move ahead with such a transition.

Since the release of the initial roadmap, the SEC has since commented on the progress of the convergence project with the IASB. In a statement released in February of 2010, the SEC announced that it was in the process of developing a work plan that would help "enhance both understanding of the Commission's purpose and public transparency in this area" (SEC, 2010). The statement announced a new timeline that would put 2015 as the earliest possible date to make the use of IFRS required for US companies. The statement also set forth the details of a new work plan that the SEC is developing. Carrying out the new work plan, along with completion of the convergence project, will allow the SEC to make a decision regarding transition to IFRS by 2011. The work plan is meant to be sure that the following issues are addressed in determining whether or not the US should make the move to IFRS:

- Determining whether IFRS is sufficiently developed and consistent in application for use as the single set of accounting standards in the US reporting system.
- Ensuring that accounting standards are set by an independent standard setter and for the benefit of investors.
- Investor understanding and education regarding IFRS and how it differs from US GAAP.
- Understanding whether US laws or regulations, outside of the securities laws and regulatory reporting, would be affected by a change in accounting standards.
- Understanding the impact on companies both large and small, including changes to accounting systems, changes to contractual arrangements, corporate governance consideration and litigation contingencies.
- Determining whether the people who prepare and audit financial statements are sufficiently prepared, through education and experience, to convert to IFRS (Defelice and Lamoreaux, 2010).

Many of the above listed issues that the SEC is addressing directly echo the many comment letters that the SEC received about the original roadmap for conversion. Many practitioners were concerned about the robustness of IFRS and whether or not the IASB was well-enough established to be the standard-setter for the world. Along with these thoughts, there were concerns about the need for more time to ensure that all affected parties, including creators and users of financial statements, would have sufficient time and assistance to prepare for the transition. Just as people were originally concerned that the IASC did not devote enough attention to the quality of standards, many people are concerned that the transition process is being pushed ahead too quickly and quality of the standards is being lost in the process.

As the feelings are mixed about the transition to IFRS, so are the reactions to the latest statement by the SEC. While many are relieved that there will be more time and effort put into ensuring that IFRS is in fact the best that it can be, many companies are frustrated with the lack of structure in the transition process. Some larger companies that already use IFRS for international subsidiaries are optimistic about the switch to IFRS; it will be costly, but they believe that it will be beneficial overall. In order to help ensure quality, the FASB is heavily involved in the SEC's new work plan, and according to Mary Schapiro, the FASB will likely have a significant role in this process even after the transition has taken place.

What will be Left for the FASB?

When and if the United States makes the full transition to using IFRS for financial reporting purposes, there will still be many areas for the FASB to remain active. It will be essential for the FASB to continue governing US GAAP as it is likely that only those companies that are publicly traded will be using IFRS. At the current time, IFRS does not incorporate any coverage for not-for-profit companies, and thus the rules of GAAP will remain in effect for this sector as well (Mackintosh, 2009).

A second, and more important duty of the FASB, will be to provide insight to the IASB about the reactions of US companies to using IFRS and help provide proposals for future work. "The IASB cannot work in isolation, and properly researched input from many nations in the world will be critical to the success of global accounting standards" (Mackintosh, 2009). The FASB will continue to act as a representative for US companies in the global accounting realm in order to ensure that all opinions and questions can be addressed. The creation and use of a single set of accounting standards meant to be used by so many different participants brings about its own set of issues that will need to be given attention. Many are concerned that the IASB does not have the strength to withstand political pressure, but it is hoped that the combination of nations that contribute to the Board that the various needs of different countries and industries can be fulfilled without politics or game-playing.

It is difficult for many people in the US to see the role of the FASB become more of a consultant-type role as it has had such a long and established history of quality in standard-setting. Many feel that the FASB's combination of private sector action and the watchful eye

of the government provide the best source of accounting standards. It is important for people to remember that the FASB will still remain active in the global accounting world, even if the US makes the transition to IFRS. The IASC was created in 1973, the same year as the FASB, and has experienced significant change over the years in order to provide for increased quality and assurance of financial information. Those concerned about the attention to quality exerted for IFRS must remember that the IASB has a similar set of due process procedures as are used by the FASB when developing new standards to ensure that they will provide the most reliable and useful information to the users of financial information.

Conceptual framework

Moving toward a single set of global standards is seemingly the most favored direction for financial accounting, though many still argue that this is not the wisest move. "The debate on global standards has produced several variants of the argument that local conditions demand diverse local accounting standards. One variant of this argument is that financing arrangements differ locally, and these produce diverse financial reporting needs" (Meeks and Swann, 2009). Local laws and regulations vary, which can make the adoption of a single set of accounting standards more difficult for some countries. While the disagreements may still continue about whether or not a single set of standards is the most prudent decision, it is important to remember the reasons why accounting standards are in place. Accounting principles are based on the Conceptual Framework, which is meant to provide structure for the process of creating financial reporting standards.

The foremost goal of accounting standards is to ensure that financial information is reported in a manner that provides relevant and reliable information to users of financial statements. The FASB and IASB have been working on revising the current Conceptual Framework that has been the foundation for US GAAP, and in July of 2006 the two Boards released a preliminary views (PV) document, "Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information." This PV states that relevance should be the most important factor to consider when creating financial statements, with the support that irrelevant information is useless to users. The PV also emphasizes the concept of "faithful representation" to replace

reliability. Reliability has always incorporated the idea of faithful representation, but the PV has brought it into focus for creators of financial statements. Ideally, transparency should govern how financial information is presented. The chief accountant of Standard & Poor, Neri Bukspan, believes that transparent information allows the natural forces of the market to work more efficiently (www.ifrs.com).

These changes will be important to the creation and use of financial reports. Stacey Hekkert, a partner at Anton Collins Mitchell in Denver, Colorado has stated, "There will be an impact on the end-user of financial statements. Although it hasn't been widely discussed yet, the investment community, bankers, and other users of the financial statements will need to be educated on the differences between GAAP and IFRS" (Wolosky, 2009). Users of US GAAP have become accustomed to the fact that the standards are developed around the concepts of relevance and reliability. If IFRS is to be used for financial reporting purposes, users will have to understand the differences related to how the standards are developed and what aspects are considered to be more important during their development. This is important for the users of financial statements and their creators. The application of different accounting principles is often determined by the goal of financial reporting and the concepts that are considered most important. When applying an accounting rule, it is expected that financial managers will keep in mind the requirements of the Conceptual Framework in order to produce the most congruent results. If a single set of accounting standards is used worldwide, there could be significant differences in how people interpret what a rule means and how it should be applied. It is possible that the FASB and IASB will work to develop a joint Conceptual Framework in attempt to minimize differing interpretations relating to what each Board has historically emphasized.

Cultural Differences Posing Potential Problems

One of the most significant differences between US GAAP and IFRS is related to the fact that IFRS makes more use of professional judgment than is allowed by US GAAP. This is not to say that US GAAP does not also leave plenty of room for interpretation, but generally, IFRS will require more discussion when applying them. The rules set forth in US GAAP tend to be very specific as required by the litigious environment in the US. Rules of GAAP are now

contained in the new FASB Codification, discussed later, which is made up of over 17,000 pages of text; IFRS is contained in only 2,500 pages (Cohn, 2009). The sheer difference in size suggests that IFRS leaves much more room for, and requires increased interpretation of, the standards through the use of professional judgment. There are mixed views as to which type of standard is better. While many observers hold the belief that a more principles-based approach to financial reporting may help to clear up some of the confusion regarding the application of standards by allowing the use of judgment, many also argue that detailed rules are necessary in order to ensure people do not use the flexibility for an illegal advantage or to protect professionals from legal liability.

Many argue that the detailed rules of US GAAP do not eliminate liability. Michael Young, a litigation partner with Willkie, Farr, & Gallagher LLP said,

> "Think of all the restatements by well-meaning people trying to adhere to sometimes counterintuitive rules…Some say we need the protection of the rules, but I've spent 25 years defending accountants and have come to the conclusion that conforming to the rules does not necessarily get you off the hook" (www.ifrs.com).

One of the reasons why US GAAP is so detailed in comparison to IFRS is simply related to the fact that US GAAP has been in existence longer and has had more time to accumulate more defined rules and regulations; meaning that IFRS may too become more detailed as time continues. While most people within the US feel that the detailed rules of GAAP are necessary, it is often cited to be the cause of frustration as these rules can become cumbersome and confusing. There has been a favorable reaction to the Codification, which helps to clarify what qualifies as authoritative US GAAP through its organization of accounting information by topic.

The fact that IFRS requires greater use of professional judgment could create significant differences when comparing financial statements and the estimates used to develop them from country to country. Rules can be interpreted in many different ways, which can lead to widely varying results when applying the same rule. A cross-cultural survey conducted by social psychology researcher Geert Hofstede collected close to 116,000 surveys from employees of a multinational firm. The data collected from these surveys showed that there

were four main dimensions that differed between cultures that could impact the reporting of financial information. These four dimensions are: uncertainty avoidance, individualism, achievement orientation, and power distance. All of these dimensions make up a nation's culture which will greatly impact those within the society using the principles-based system of IFRS. Differences that exist from country to country are important to consider because they can "lead to inconsistent interpretation and application of converged financial reporting standards" (Campbell, Doupnik, and Tasakumis, 2009).

Along with looking at the differences that could be faced from country to country, if IFRS is adopted worldwide, it is important to look at the differences that could exist just within the US. One of the most-voiced concerns about IFRS is the fact that while many companies will benefit by the increased comparability with companies located in other countries, many companies will see no benefit from the transition at all. One such company that does not foresee any future benefits arising from a transition to reporting with IFRS is the Davey Tree Expert Company, a tree service company based out of Ohio. Davey has never offered its stock on a public market because most of its employees own common stock in the company. The company is still required to file with the SEC, meaning that it would be required to use IFRS when mandated. For the company's controller, Nick Sucic, because the company does not plan to list its shares on a public market, or require international capital, there are no visible benefits to this transition and many associated costs (McCann, 2009).

The situation at Davey Tree Expert Company is reflected in many other smaller companies; for them, IFRS is not the answer. There are many companies, however, that will see great benefit from a successful transition to IFRS. The controller and chief accounting officer of Tyco International, John Davidson, believes that despite the great amount of time and effort that will go into making Tyco ready for IFRS, the results will be positive. Using IFRS will allow the company to prepare and analyze financials using the same basis worldwide and will also allow the company to move accounting staff to areas of the company where they are most needed, no matter the geographic location (McCann, 2009). While Davey Tree Expert Company and Tyco International ultimately fall at two ends of the spectrum in terms of

support for the adoption of IFRS, most companies fall somewhere in between – unsure of the costs and benefits associated with transitioning to IFRS.

Advice from Experts

International finance experts met at a conference in late 2009 to supply advice for companies about the potential transition to IFRS. The panel of presenters all spoke to a common theme, outlined by Margaret M. Smyth, Vice President and Controller of United Technologies Corporation (UTC): "Start now, treat it as an opportunity, and make sure your entire organization is invested in the change" (www.ifrs.com). In her presentation, Smyth discussed the fact that getting top management to support the transition before getting every other level of the organization on board is essential. The largest piece of advice for users to take away from this conference was for companies to look at the potential transition as an opportunity and not a hassle. " 'How often does one get an opportunity to start with a blank sheet of paper? asked Smyth. 'IFRS implementation is much more than adopting new accounting policies; it's a complete corporate transformation'" (www.ifrs.com).

Large corporations, such as UTC, are certainly seeing benefits from the anticipated adoption of IFRS. Not only is it allowing them to take a fresh look at business operations and accounting procedures, but many are even working in conjunction with the FASB to help the Board understand the ramifications of different proposed changes and how it will affect businesses. Along with being able to educate the FASB about the challenges companies are most concerned about, these discussions are allowing large corporations to get many levels of personnel involved to better understand what is needed for the transition. Despite the ability of large US corporations to be involved in the convergence project, there remains much work to be done.

Areas Still to Be Worked

The Memorandum of Understanding, released in 2006, outlined eleven areas that the two Boards have identified as requiring the most attention. More than half of these areas have already been addressed either by the completion of a common standard, joint conclusions being met, or by current work on a joint standard. Other areas, however, are at different

stages and do not appear on the agenda for the Boards to work toward convergence (www.fasb.org).

One such area is the reporting for long-term and intangible assets, including how and when to record impairment of these assets. This topic is not currently a part of the active agenda of the two Boards but is vital to business operations, and thus some sort of agreement must be reached on how long-term and intangible assets will recorded. As noted in the summary of Statement of Financial Accounting Standard No. 142, "Analysts and other users of financial statements, as well as company managements, noted that intangible assets are an increasingly important economic resource for many entities and are an increasing proportion of the assets acquired in many transactions" (FASB 2001). Related to the reporting of long-term and intangible assets is the method used to record these assets as impaired. The remainder of this paper will serve to overview the procedures utilized for recording impairments of long-term assets and intangible assets under each set of standards and to compare and contrast the similarities and differences between them.

THE ACCOUNTING STANDARDS CODIFICATION

As mentioned earlier, July 1, 2009 marked a major change in the way that US Generally Accepted Accounting Principles are organized. FASB Statement No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles – a replacement of FASB Statement No. 162*, the last statement to be issued in that format, was released on June 30, 2009. The FASB released the Accounting Standards Codification (ASC) or Codification for short, which organizes thousands of US GAAP pronouncements by accounting topic area, approximately 90 in total and reduces the hierarchy to two levels: authoritative and non-authoritative. Many users found the wide range of pronouncements confusing to navigate and understand, and thus a restructuring of the pronouncements was deemed necessary in order to better serve users.

Items contained in the Codification include pronouncements by the FASB, the Emerging Issues Task Force, and the AICPA, along with "relevant portions of authoritative content issued by the SEC; however, FASB ASC is not the official source of SEC guidance and does

not contain the entire population of SEC rules, regulations, interpretive releases, and SEC staff guidance" (AICPA). Accounting standards will now be released as Accounting Standards Updates (ASUs) to the Codification. Although it is required that users begin referencing the Codification for all research purposes, this paper utilizes the original format of Statements of Financial Accounting Standards for referencing as it was begun before the Codification took effect.

SFAS 142 – GOODWILL AND OTHER INTANGIBLE ASSETS

Overview and Objectives

Statement of Financial Accounting Standard No. 142 defines intangible assets as "Assets (not including financial assets) that lack physical substance." The initial recognition of an intangible asset, if acquired, is based on its fair value. Fair value is determined as how market participants would value the asset in a similar transaction. When a company containing goodwill is acquired, the goodwill will be shown on the balance sheet of the acquiring company as the amount by which the purchase price exceeds the fair value of the net identifiable assets of the acquired company. The amount of goodwill may also include amounts related to intangible assets that do not meet the requirements to be recognized as such. SFAS No. 142 provides guidelines for the accounting of goodwill and other intangible assets upon their initial acquisition and beyond. The focus of this section will be on how these items are accounted for after the initial acquisition. This standard replaced Opinion 17 for the reporting of goodwill and other intangible assets, which required amortization of goodwill. The FASB concluded that discontinuing the process of amortizing goodwill, but instead testing it for impairment annually, allowed the information produced to conform to the concept of representational faithfulness, a part of the Conceptual Framework upon which accounting standards are based (FASB 2001).

When an intangible asset, other than goodwill, is initially acquired, it will be measured based on its fair value, to be determined based on assumptions that would be used by market participants for a similar transaction. If a group of intangible assets is acquired in any transaction other than a business combination, cost will be allocated to each individual asset based on its relative fair value (FASB 2001, Parargraph 9). Intangible assets that are acquired

as part of a business combination that are used in research and development activities will be considered to be indefinite-lived assets until the associated project is completed or abandoned (FASB 2001, Paragraph 16). The costs associated with internally generated intangible assets that are not identifiable, have indeterminate lives, or are necessary to the continuing of the business, must be expensed when incurred and not capitalized as part of the asset.

Intangible assets, excluding goodwill, must be amortized in a rational manner based on the asset's useful life. If the useful life of an intangible asset is unknown, but the useful life can be determined to be finite, a best estimate of the useful life must be used to determine the amount of amortization. In addition to being amortized, assets will be reviewed for impairment under the provisions of SFAS No. 144, to be discussed later. Impairment testing will also be done annually for intangible assets not subject to amortization, such as goodwill. SFAS No. 142 discusses the impairment of goodwill.

Impairment of Goodwill

Goodwill is an intangible asset, such as a "strong brand, reputation, or high employee morale" which provides a company with a competitive advantage (InvestorWords.com). Only through a business combination will goodwill be recorded in a company's financial records; internally generated goodwill is not recognized as an asset. Although not amortized, goodwill must be tested for impairment at least annually. Impairment testing for goodwill is completed through a two-step process carried out at the reporting unit level. "A reporting unit is an operating segment or one level below an operating segment (referred to as a component)" (FASB 2001, Paragraph 30). Reporting units may contain a number of components that have similar economic characteristics. SFAS 131 - *Disclosures about Segments of an Enterprise and Related Information* is used to determine the reporting units of an entity. When testing for impairment, acquired assets and assumed liabilities will be assigned to the reporting unit as long as "the asset will be employed in or the liability relates to the operations of a reporting unit and the asset or liability will be considered in determining the fair value of the reporting unit" (FASB 2001, Paragraph 32). If an asset or liability is related to multiple reporting units, its value can be assigned in a proportional manner based on the benefits received by the reporting unit or its relative fair value.

Certain events and circumstances may warrant additional impairment testing for goodwill between the annual tests. These events may include:

- A significant adverse change in legal factors or in the business climate
- An adverse action or assessment by a regulator
- Unanticipated competition
- A loss of key personnel
- A more-likely-than-not expectation that a reporting unit or significant portion of a reporting unit will be sold or otherwise disposed of
- The testing for recoverability under Statement 144 of a significant asset group within a reporting unit
- Recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit (FASB 2001, Paragraph 28).

Management's discretion is the deciding factor as to whether or not impairment of goodwill has occurred. Goodwill impairment testing must be done on a regular basis from year to year, but management may determine that interim impairment testing is appropriate. The first step in impairment testing of goodwill is to compare the fair value of the reporting unit with its carrying amount, including goodwill. If the carrying amount is below the fair value, goodwill is not considered to have been impaired and no further analysis is necessary. If the carrying amount is above the fair value, the second step of the impairment test must be completed.

If the carrying amount of the reporting unit is higher than its fair value, the amount of the impairment loss must be determined by comparing the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill (FASB 2001, Paragraph 20). The implied fair value of goodwill refers to the excess of the fair value of a reporting unit over the amounts assigned to its identifiable assets and liabilities. If the carrying amount of the goodwill is greater than the implied fair value of the goodwill, the excess is determined to be the amount of the impairment loss, not to exceed the carrying value. This process was outlined by Alfred King into nine specific steps:

The company has to split up its business into discrete reporting units

1. The fair value of each reporting unit must be determined as of the testing date
2. The fair value of the reporting unit is compared to the book value of the reporting unit, and one of two situations exist:
3. The fair value exceeds the book value
4. The fair value is less than the book value
5. If the fair value of the reporting unit exceeds the book value (the total dollar amount on the reporting unit's balance sheet), you stop because the FASB defined goodwill impairment this way, and by their definition, there is no impairment
6. If the fair value of the reporting unit is less than the book value, then you have to go on to Phase II
7. Phase II is identical in definition and methodology to an allocation of purchase price. One must determine the fair value on an individual basis of all assets and liabilities
8. The sum of the fair values is subtracted from the fair value of the reporting unit
9. The difference between the fair value of the reporting unit and the sum of the fair value of all the assets and liabilities is the new "computed" goodwill
10. The newly computed goodwill is subtracted from the goodwill currently on the books, and the difference is the dollar amount of the impairment charge.

If material, goodwill shall be presented in aggregate on a company's balance sheet as a separate line item. Impairment losses associated with goodwill must be presented as a separate line item before the subtotal *Income from Continuing Operations* on the income statement (King, 2008). Impairment testing for other long-lived assets is discussed next.

SFAS 144 – ACCOUNTING FOR THE IMPAIRMENT OR DISPOSAL OF LONG-LIVED ASSETS

Overview and Objectives

Statement of Financial Accounting Standards No. 144 provides guidelines to account for the impairment or disposal of long-lived assets. The focus of this section will be on when and how to test for impairment. In order to test assets for impairment, the recoverability of an asset's value must be determined. Long-lived assets should be tested for recoverability when certain circumstances or events make it possible that the current carrying value of the asset may not be recoverable. Some of these circumstances could include:

- A significant decrease in the market price of a long-lived asset
- A significant adverse change in the extent or manner in which a long-lived asset is being used or in its physical condition
- A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset, including an adverse action or assessment by a regulator
- An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset
- A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset
- A current expectation that, *more likely than not*, a long-lived asset will be sold or otherwise disposed of significantly before the end of its previously estimated useful life (FASB 2001b, Paragraph 8).

Despite the extensive list provided in SFAS No. 144 of possible indicators of impairment, it is still up to management to exercise significant judgment as to whether it is possible that impairment has occurred due to other circumstances. When testing for and measuring impairment, long-lived assets are grouped together such that testing is done at the lowest level at which cash flows can be determined to be independent of the cash flows from other groups of assets. For the remainder of this section, the terms "asset" and "asset group" will be used interchangeably. Goodwill is only included in the asset group if it is or includes a reporting unit. Whenever goodwill and another asset group within a reporting unit are to be tested for impairment, the other assets will be tested for impairment before goodwill (FASB, Paragraph 29).

<u>Procedures</u>

Impairment testing of intangible assets is completed through a two-step process. First, undiscounted cash flows that are expected to result from the use of an asset are compared to the carrying amount of that asset. If the carrying amount exceeds the sum of the undiscounted cash flows then the asset's value is deemed to be not recoverable. If the carrying amount of a long-lived asset is determined to not be recoverable an impairment loss must be recognized. The excess of the carrying amount over the fair value of the asset is the amount of the impairment loss to be recorded (FASB 2001b, Paragraph 7). An impairment loss is allocated among assets within a group as follows:

> "The loss shall be allocated to the long-lived assets of the group on a pro rata basis using the relative carrying amounts of those assets, except that the loss allocated to an individual long-lived asset of the group shall not reduce the carrying amount of that asset below its fair value whenever that fair value is determinable without undue cost and effort" (FASB 2001b, Paragraph 14).

The estimates of future cash flows should be based on the expected future cash inflows less the future cash outflows associated with the use and eventual disposition of an asset. These estimates must be based on the same assumptions that the company uses for other estimates in the same period. Estimates include discount rates and certain assumptions about the current and future state of the company and the economy.

IAS 38 – INTANGIBLE ASSETS

Overview

International Accounting Standard 38 (IAS 38) defines an intangible asset as "an identifiable non-monetary asset without physical substance" (IASB 2009b, Paragraph 8). Examples of intangible assets include copyrights, patents, customer lists, market share, and customer loyalty. The requirements to recognize an intangible asset as such include being identifiable so as to separate it from goodwill that may be acquired in a business combination. As discussed later, goodwill is treated differently than other assets. In order to be identifiable, an asset must be separable or arise from contractual or other legal rights. Ultimately, a company must be able to somehow transfer the asset individually from other assets (separable), even if it does not intend to, or is legally entitled to the asset through a contract. Because an asset is defined as a "resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity" (IASB 2009b, Paragraph 8), a company must analyze the expected future earnings and benefits related to the intangible asset. If it is probable that these future earnings or benefits will flow to the company and the cost of the asset can be reliably measured, then an intangible asset shall be recognized (IASB 2009b, Paragraph 21).

Acquired Intangible Assets

The initial recognition of an intangible asset is based on its cost. For an acquired intangible asset, the cost will include the actual purchase price and any costs that can be attributed

directly to preparing the asset for its intended use. "Recognition of costs in the carrying amount of an intangible asset ceases when the asset is in the condition necessary for it to be capable of operating in the manner intended by management" (IASB 2009b, Paragraph 30). It is not common for subsequent expenditures to be included in the carrying amount of an intangible asset as it is generally difficult to distinguish these asset development costs from business development costs (IASB 2009b, Paragraph 20).

The original purchase price, and any other associated costs, will be used as the cost basis for the intangible asset on an entity's books. It is assumed that the purchase price reflects expectations about the future economic benefits to be gained from owning the intangible asset. The purchase price will incorporate other elements used to determine fair value as well. While quoted market prices in an active market generally provide the most reliable measure of fair value, these are likely to be unavailable for intangible assets, thus other methods of valuation must be used. These can include what the company would have paid in an arm's length transaction between knowledgeable and willing parties, or other techniques that have been developed by companies such as discounting estimated future net cash flows from the asset, or the asset's estimated replacement cost.

Internally Generated Intangible Assets

As under US GAAP, internally generated goodwill is not recognized as an asset, and therefore does not qualify for the treatment outlined in the following section. It is often difficult to assess whether other internally generated intangible assets qualify for recognition because it may be unknown whether there will be an asset that will generate future economic benefits and its cost may not be separable from other business maintenance costs (IASB 2009b, Paragraph 51). This is why additional recognition and measurement procedures exist for internally generated intangible assets other than goodwill. In order to determine whether one of these internally generated intangible assets qualifies for recognition as such, a company must classify its generation into two phases: a research phase and a development phase – if a development phase cannot be determined as described below, the company will treat the project as if it only existed in the research phase.

Any expenditures incurred during the research phase are expensed because "an entity cannot demonstrate that an intangible asset exists that will generate probably future economic benefits" (IASB 2009b, Paragraph 55). Once the company has moved the project into the development phase, an intangible may be recognized if an entity can demonstrate all of the following:

- The technical feasibility of completing the intangible asset so that it will be available for use or sale.
- Its intention to complete the intangible asset and use or sell it.
- Its ability to use or sell the intangible asset.
- How the intangible asset will generate probably future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself, or if it is to be used internally, the usefulness of the intangible asset.
- The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
- Its ability to measure reliably the expenditure attributable to the intangible asset during its development (IASB 2009b, Paragraph 57).

Ultimately, the company must be able to demonstrate that it can and will complete the project, the kind of returns that the project will produce, and it must be able to measure the associated costs. The date at which the intangible asset first meets the recognition criteria, is when expenditures may be booked as costs and no longer immediately expensed. These expenditures include all "directly attributable costs necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management," (IASB 2009b, Paragraph 66); similar to the costs associated with an acquired intangible asset.

<u>After Initial Recognition</u>

Once an intangible asset has been initially recognized in its accounting records, a company has the option to choose either the cost model or the revaluation model for subsequent measurement. If an entity chooses to use the revaluation model, all other assets in its class must be measured using the revaluation method, unless no active market exists for these assets. It is important to note that "the items within a class of intangible assets are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the

financial statements representing a mixture of costs and values as at different dates" (IASB 2009b, Paragraph 73).

The cost model simply carries an intangible asset at its cost reduced by any accumulated amortization or impairment losses. The revaluation model assess the fair value of the asset as of the date of revaluation, reduced by an accumulated amortization or impairment losses, and uses this amount as the carrying amount of the asset. While IAS 38 does not give specific requirements for the frequency of such measurements, it does state that revaluations should be done frequently enough so that the carrying amount of an asset at the end of a reporting period does not differ significantly from its fair value. If an active market does not, or ceases to exist for an intangible asset, this may be used as an indication that impairment may have occurred and impairment testing should be completed as under IAS 36, discussed later.

If the carrying amount of an intangible asset is increased because of the revaluation, the amount of the increase will be recognized in *Other Comprehensive Income* and accumulated in equity under *Revaluation Surplus.* If the increase offsets a previously recognized decrease in value, then the increase will be recognized in profit or loss by the amount that it offsets the decrease. The opposite is true for decreases in value. If the carrying amount of an intangible asset must be decreased because of the revaluation, the amount of the decrease will be recognized in profit or loss. If the decrease creates a credit balance in the *Revaluation Surplus* account for that asset, that amount will be recognized in *Other Comprehensive Income*. Once realized, generally upon disposal or retirement of the related asset, the cumulative revaluation surplus may be transferred to retained earnings. The use of the revaluation model is a large departure from US GAAP and one of the significant differences with which companies may have to adapt when and if the US transitions to IFRS. Other differences exist in the measurement of impairment for long-lived and intangible assets, discussed below.

IAS 36 – IMPAIRMENT OF ASSETS

Overview and Objectives

The objective of IAS 36 is "to ensure that assets are carried at no more than their recoverable amount, and to define how recoverable amount is calculated" (Tohmatsu, 2009). This

standard applies to all assets that fall under the following categories: land; buildings; machinery and equipment; investment property carried at cost; intangible assets; goodwill; investments in subsidiaries, associates, and joint ventures; and assets carried at revalued amounts under IAS 16 and IAS 38 (Tohmatsu, 2009).

Impairment involves the process of examining assets to determine whether or not they may have become impaired, meaning that the carrying value may be higher than the greater of fair value or value in use. The actual impairment testing is done only if the examination reveals that there are any environmental (internal or external) indicators that impairment may have occurred. Some indicators of impairment include, but are not limited to:

External Sources

- Market value declines
- Negative changes in technology, markets, economy, or laws
- Increases in market interest rates
- Company stock price is below book value

Internal Sources

- Obsolescence or physical damage
- Asset is part of a restructuring held for disposal or the asset is expected to become idle
- Worse economic performance than expected (IASB 2009, Paragraph 12).

These are only examples of impairment indicators and companies may determine other factors as being indicative of possible impairment. The following asset types must be examined annually, whether there are indicators that they may be impaired or not: an intangible asset with an indefinite useful life; an intangible asset not yet available for use; or goodwill acquired in a business combination.

<u>Procedures</u>

If it has been determined that an asset may have been impaired, the first step in impairment testing is to determine the asset's recoverable amount. Recoverable amount is defined as the higher of an asset's fair value less costs to sell and its value in use. This amount should be

determined for an individual asset whenever possible. If this is not possible, then the recoverable amount for the asset's cash-generating-unit (CGU) can be used. A CGU can be defined as the smallest identifiable group of assets "that generates cash inflows from continuing use and that are largely independent of the cash inflows from other assets or groups of assets" (Tohmatsu, 2009). It is important to note that once a CGU is defined, it must be identified consistently from period to period. The carrying amount of a CGU includes the carrying amount of the assets that can be directly linked, or allocated consistently and reasonably, to the CGU and that will generate future cash flows that will be used to determine its value in use. If the CGU contains a specific liability that would need to be included if it were to be sold, the carrying amount of the CGU must be reduced by the carrying value of the liability. For example, any type of liability related to the purchase of an asset must be included in the calculation to reduce the carrying value of the CGU to its net carrying value.

Fair Value less Costs to Sell and Value in Use

Fair value less costs to sell can be determined by a number of different methods. First, would be to ascertain if there is an active market for an asset of that type, and if so, to use the market price, reduced for disposal costs. Using the market price requires looking for current bids, but the most recent transaction of such an asset may be substituted when necessary. If no such active market exists, an estimate of selling price may be used instead. If the company already has a sales agreement for an asset, the price being paid may be used for the fair value amount. It is important to note that any costs of disposal may not include existing costs, overhead, finance costs, or income tax expense, and thus should only be direct added costs (Tohmatsu, 2009).

An asset's value in use will automatically be used as the recoverable amount if the fair value less costs to sell cannot be determined. Value in use is the present value of the future cash flows expected to be derived from the asset. It is calculated to include the following aspects:

- An estimate of the future cash flows the entity expects to derive from the asset in an arm's length transaction;
- Expectations about possible variations in the amount or timing of those future cash flows;

- The time value of money, represented by the current market risk-free rate of interest;
- The price for bearing the uncertainty inherent in the asset; and
- Other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset (IASB 2009, Paragraph 30).

When calculating cash flow projections, assets should be evaluated based on their current condition. Any plans to restructure or improve the asset's performance should not be factored into the calculation (Tohmatsu, 2009). Projections should be based on reasonable assumptions about the economic conditions that will exist over the remaining life of the asset, with special attention paid to external factors; these types of assumptions will be reflected in the discount rates used for the present value calculations. The reasonableness of assumptions will be based on past performance of the asset.

IAS 36 explicitly states that estimates of future cash flows shall include:

- Projections of cash inflows from the continuing use of the asset;
- Projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset (including cash outflows to prepare the asset for use) and can be directly attributed, or allocated on a reasonable and consistent basis, to the asset; and
- Net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life (IASBb 2009, Paragraph 39).

An asset's value in use is ultimately an estimate of the present value of the future cash flows that will be earned by the continued use and final disposal of the asset. When an asset's recoverable amount is less than its carrying value, it is impaired and its carrying value must be reduced. An entity must remember to adjust the depreciation for that asset for future periods to reflect this new carrying value.

KEY DIFFERENCES/PROBLEMS TO BE FACED UPON TRANSITION

General First-Time Adoption Issues

For an entity making the transition to reporting under IFRS, there must be at least one year's worth of financial statements prepared retrospectively for the purposes of comparison. In addition, it is important to note that:

> "An entity's estimates in accordance with IFRSs at the date of transition to IFRSs shall be consistent with estimates made for the same date in accordance with previous GAAP (after adjustments to reflect any difference in account policies), unless there is objective evidence that those estimates were in error (IASBe 2009, Paragraph 14).

When an entity is recreating prior year's statements in accordance with IFRS it must use the same inputs and assumptions previously used under GAAP for the same dates in order to develop certain estimates, as long as those assumptions are still consistent with IFRS. This means that even if a company has subsequently learned that its estimates originally used to prepare its financial statements using US GAAP have been proven to be inaccurate, the company may not alter them for purposes of restating the IFRS financial statements for the same year. The only way that the company is permitted to make changes to these estimates it is found that they were made in error. If information received after the date of transition to IFRS reveals that previous estimates were incorrect, the company will make adjustments to the financial statements by making adjustments to profit or loss for the year of transition. The previous year's statements will not be affected.

Another issue that pertains to first-time adoption relates to how property, plant, and equipment (PPE), intangible assets, and investment property are carried on a company's balance sheet. These items that are carried under the cost model under US GAAP may be valued using the revaluation method, as discussed earlier. This means that the re-created financial statements could show significant increases in the amounts reported on companies' balance sheets. How these assets are valued in subsequent years could also differ if the revaluation method is used.

Certain intangible assets, as recognized under GAAP, are not permitted to be recognized under IFRS. These include expenditures on research; start-up, pre-operating, and pre-opening costs; training; advertising and promotion; and moving and relocation costs. These items must be removed from an entity's balance sheet when transitioning to IFRS (Tohmatsu, 2009b). Companies should be aware that in subsequent business combinations after adoption of IFRS, some items that had would have been classified as identifiable intangible assets under GAAP may be required to be classified as goodwill because they do not meet the definition of an intangible asset under IAS 38, as discussed earlier. Finally, it should be noted that any adjustments required to move from GAAP to IFRS should be recognized directly in retained earnings, or another equity category if appropriate.

Recognition/Measurement of Intangible Assets

The recognition requirements for intangible assets are relatively similar under both sets of standards. IFRS further defines requirements for internally generated intangible assets, forcing companies to divide the work into two phases: a research phase and development phase. The treatment of costs are different under each phase. Under GAAP, R&D must be expensed. Under IFRS, research is expensed, while development costs are capitalized. This means that companies with high amounts of R&D will show higher reported income in the beginning with a transition to IFRS, but then those capitalized amounts will be amortized, reducing income in future years.

For acquired intangible assets, both sets of standards require that acquired assets be recorded on the acquiring company's books at or near fair value. GAAP explicitly states that these assets must be recorded at fair value, while IFRS states that they are to be recorded at the purchase price, plus any additional costs. The purchase price is likely to be a close estimation to the asset's fair value. The key difference between the two standards relating to the treatment of intangible assets is that IFRS allows the use of the cost model or the revaluation model for subsequent measurement of the assets. The revaluation model allows the company to reassess the value of the asset on a periodic basis and adjust it within the financials. Once, a revaluation surplus account is established; impairment charges on the associated assets will reduce the revaluation surplus first.

Procedural Differences for Impairment Testing

The essential difference between US GAAP and IFRS for impairment testing is that GAAP utilizes a two-step process compared with the one-step process of IFRS. The first step for impairment testing under GAAP is to compare the carrying amount of an asset with the undiscounted cash flows it is expected to generate. If the undiscounted cash flows are higher than the carrying amount, then there has not been any impairment and no further testing is required. If the carrying amount is higher than the undiscounted cash flows, then the following second step must be completed in order to determine the impairment loss. The impairment loss is calculated as the difference between the carrying amount of the asset and its fair value. Since the first step of impairment testing requires comparison with undiscounted future cash flows, which are likely to be large, impairment charges are not likely to be taken as often when compared to those that would be taken under IFRS (Brice, 2009). Because it is less likely for a company to take an impairment charge on an asset, many assets are never written down to their fair value even if losses have occurred, thus inflating balance sheets.

Under IFRS, the only step that must be performed to test for impairment is to compare the carrying amount of the asset with its recoverable amount. If the recoverable amount is higher than the carrying value, then the difference is the impairment loss. It is important to note that under IFRS, if an impairment has been identified and is related to an asset carried under the revaluation model that had previously resulted in a revaluation surplus, the impairment loss is first set against the revaluation surplus, with any excess impairment being recognized in profit or loss. Again, the single step for impairment testing under IFRS is likely to result in assets being written down to fair value more frequently than would be done under US GAAP's two-step impairment testing method. US GAAP is actually designed to prevent a large number of impairment charges from being taken because once an asset is written down, it is a permanent decline in value and may not be written back up if conditions change.

IFRS allows impairment losses to be reversed on the books if there has been a change in the estimates used to determine the previously impaired asset's recoverable amount. This means that an asset that was written down due to impairment may be written up to fair value if it is

determined at a later date that the recoverable amount of the asset is higher than the previously written down carrying amount because assumptions and estimates originally used have changed. This utilizes the same process for assessing the recoverable amount, but the reversal of an impairment charge is recognized as income. The reversal of impairment may not bring the asset's value to an amount higher than what it would have been had the original impairment charge not been taken in the first place (Tohmatsu, 2009). Just as consideration of impairment must be done at least annually, an assessment of whether there are circumstances indicating that prior impairment losses no longer exist or may be reduced will be conducted by a company on an annual basis.

Impairment of Goodwill

Under US GAAP, goodwill is tested for impairment at the reporting-unit level, and again uses a two-step approach to test for impairment, beginning with a comparison of the fair value and carrying amount of the unit, including goodwill. If the fair value is less than the carrying amount, the second step must be completed to determine the amount of impairment. This amount is defined as the excess of the carrying amount of the goodwill over its fair value, which is calculated as the difference between the fair value of the reporting unit and the fair value of the various assets and liabilities that make up that unit. If an impairment loss is determined, it is included in operating income, and may not be greater than the original carrying amount of goodwill (Brice, 2009).

Under IFRS, goodwill must be "allocated to each of the acquirer's cash-generating units, or groups of cash-generating units, that are expected to benefit from the synergies of the combination" (Tohmatsu, 2009). Impairment testing of goodwill requires only one step: the recoverable amount of the CGU (as defined earlier as the higher of fair value minus costs to sell and the value in use) is compared to the carrying value. If the carrying amount is higher, the difference is recognized as an impairment loss in operating income. This loss must first be taken against the recorded goodwill and then on a pro rata basis to other assets of the CGU. These impairment charges may not reduce the value of an asset below the highest of its fair value less costs to sell, its value in use, or zero. Impairment testing of cash-generating units, done annually, may be done at any point during the period, as long as it is completed at the

same time from year to year. When examining a CGU, any assets within it that can be individually recognized as impaired will be written down first, before the total unit is tested for impairment (IASB 2009, Paragraph 66).

Under US GAAP, impairment of goodwill is tested at the reporting unit level, which is typically an operating segment or one step below an operating segment. The measurement for goodwill impairment is done at lower level under IFRS than under US GAAP. As defined above, a CGU represents the lowest level at which cash flows can be measured as well as the lowest level for which goodwill is monitored. A CGU should be no larger than an operating segment. The fact that impairment testing is typically done at a lower level means that there may actually be more occurrences of impairment charges using IFRS than under US GAAP. This is because when testing for impairment at a higher level, increases in asset values, including internally generated goodwill, may offset decreases, therefore masking impairment charges. When testing at lower levels, there is less opportunity for this type of offsetting, resulting in impairment being recognized when it exists. Under US GAAP, new acquisitions can be incorporated into existing reporting units, meaning an under-performing acquisition may not ever actually require an impairment write-down. Under IFRS, impairment is measured at lower levels, which would mean that an unprofitable acquisition would not be as easily hidden amongst a successful unit.

Along with the possibility for a greater number of impairment losses to be taken, the size of impairment losses may also be larger under IFRS. US GAAP does not permit a goodwill impairment to exceed the carrying value of goodwill. IFRS has no such restriction, and thus any excess impairment over the carrying value of goodwill is further taken on assets within the CGU used to test for impairment (Brice, 2009). For a summary of the differences between US GAAP and IFRS regarding the treatment of long-term and intangible assets please see Appendix C.

PUBLIC VIEW ON IMPAIRMENTS

Since it appears likely that IFRS will possibly increase the occurrence and/or amount of impairment charges, it is important to understand whether or not this could positively or

adversely affect a company. When impairment charges are taken, many companies emphasize the fact that it is a noncash charge related to a technical accounting matter. This allows the public markets to not view impairments as a negative event for a company, despite the fact that impairment of intangible assets does in fact relate to an outflow of cash, even if not recently. "An impairment charge is a reflection that something about previous decisions turned out worse than expected" (King, 2008). While the public may not penalize a company for an impairment charge, it may in fact penalize a company that makes more than one within a short time period.

It is believed that the market is future-oriented, and thus is able to look past management's past mistakes in order to focus on the future after an impairment charge. When a second impairment charge is taken, management's abilities may be questioned. Under SFAS 144, most long-term assets that are being amortized or depreciated will not need to be impaired because the use of undiscounted cash flows provides a large number to which the carrying value must be compared and is not likely to exceed. Management also has quite a bit of leeway in the estimates to be used for the determination of the undiscounted future cash flows.

When examining the impairment of goodwill, if a reporting unit has been performing poorly, managers are likely to favor a one-time larger impairment charge than taking numerous smaller charges. This means that managers may in fact continue to use estimates that would not lead to an impairment charge being taken even though impairment may exist. They may continue this for many years until the loss is too large to ignore and one massive impairment charge is taken, the market looks past it, and the company is able to move forward. The single-step process used by IFRS may not provide management with the same ability to delay impairment charges and the public may react unfavorably to the increased amount of impairment charges being taken.

CONCLUSIONS

The current environment for the accounting profession is one of discussion and uncertainty. Despite the proposed timeline and roadmap for the possible transition from US GAAP to IFRS as the set of standards to be used in the US, strong opposition remains. There are many reasons for the resistance, including the fact that IFRS is assumed to be principles-based, whereas US GAAP is more rules-based. Many creators of financial statements within the US prefer the detailed rules in order to avoid possible litigation over financial information. In 2004, the FASB released a statement regarding the attitudes of many preparers and auditors of financial statements:

> In addition, the Board's recent experience suggests that many preparers and auditors have become less willing to exercise professional judgment in areas involving accounting estimates, uncertainties, and inherent subjectivity. Instead, they have been requesting detailed rules and bright lines in an apparent effort to reduce the need for the exercise of judgment in inherently subjective areas (Krumwiede, 2007).

This shows that many accounting professionals within the US have long supported and even requested the more detailed rules contained within US GAAP. It would seem that these sentiments go against the adoption of IFRS' principles-based methods. Because principles-based accounting allows for and requires a much greater use of professional judgment, significant differences may result from the interpretation of different standards. These differences could be from company to company or country to country, and could significantly reduce the comparability of financial statements, which is one of the main goals of the use of a single set of international accounting standards.

Using IFRS will provide managers with a new focus for how they conduct business. While GAAP encourages companies to produce a profit with less focus on the balance sheet, IFRS will likely encourage managers to focus on economic net worth. Mr. Alfred M. King, a valuation expert, spoke to the fact that because IFRS has a stronger focus on fair values than does US GAAP, it can be expected that the use of IFRS would produce volatile changes in a company's balance sheet as impairment charges are taken and then assets are able to be subsequently written back up to fair value if the need arises. Mr. King believes that managers

will become too focused on increasing asset value instead of on operations, meaning that they could take their eye off sales and production, the items that are needed in order to increase profits (King, 2010). These sentiments are echoed by many other professionals opposed to the potential transition from US GAAP to IFRS.

Another major reason behind the opposition to transitioning to IFRS is the fact that many feel that US GAAP simply provides a superior set of standards and current differences between the two sets may never be able to be effectively converged. One such area of divergence is the impairment of long-term and intangible assets, including goodwill. As highlighted throughout this paper, significant differences exist in the procedures used for impairment testing between the two sets of standards. As intangible assets have become such a large portion of the balance sheet for many companies, it is unlikely that the SEC will move forward with the transition to IFRS until this area can be effectively addressed.

If transition to IFRS does occur without changes to this area, users need to be aware of the key differences between the two sets of standards. Procedurally, IFRS requires a one-step test while US GAAP requires a two-step test to test for impairment of long-term and intangible assets. The one-step test under IFRS may result in more frequent impairment charges. Also, under IFRS, assets previously impaired may be written up to fair value if subsequent events show that circumstances used as a basis for the estimates originally used for the impairment testing have changed.

It is important to note that there are three basic paths that the transition for US companies to begin using IFRS could take. First, the joint project between the FASB and IASB could continue to address all of the differences between the two sets of standards and make changes to both in order to arrive at the best possible solutions. This is what the two Boards are currently working on, and it is quite possible that the two sets of standards will become nearly identical because of changes made to both sets of standards. Another possibility is that if IFRS is adopted within the US, it could actually be a modified version of the standards with some pieces of US GAAP still retained. Adopting a modified version of IFRS is something that many countries have done. Finally, adoption of IFRS could take place without the

differences between the two sets of standards being addressed. This kind of adoption is not likely to happen, but it is still a possibility.

Whether the US transitions to utilizing IFRS for financial reporting in the near future or not, accounting students in the US need to be aware of the history and principles of IFRS. Through learning about both US GAAP and IFRS, students will become more knowledgeable accounting professionals, better able to provide the input necessary to ensure that due process can successfully be carried out for the FASB and the IASB. As trade becomes increasingly international and companies more global, students must be able to analyze and understand the differences between financial statements created using US GAAP and IFRS. Even if the US does not require that US companies use IFRS for the creation of their financial statements, a large majority of companies do business around the world and accountants must be aware of the differences that can result from using the two different sets of standards.

CASE DISTRIBUTED TO INTERMEDIATE ACCOUNTING CLASS (ACG 302-A/B)

Impairment of Long-Lived Tangible Assets: NewTech, Inc.

John Davidson is the founder and owner of NewTech, Inc., a software manufacturing company based out of San Antonio, Texas. Mr. Davidson has watched the company grow substantially over the past decade both financially and in reputation. NewTech is considered to be the foremost manufacturer of digital music mixing software packages to be used on personal computers. Over the last five years, NewTech has worked to increase earnings through the use of acquisitions believing that it is more efficient and effective than through organic growth. Several years ago, NewTech had the financial strength to acquire a smaller manufacturing company, SmallTech.

SmallTech was a successful, yet small graphics design software manufacturing company located in Roswell, New Mexico. Because of the distance between the two factories, Mr. Davidson did not want any of the New Mexico workers to have to relocate, so SmallTech continued its manufacturing operations under the NewTech name. Despite NewTech's efficient manufacturing processes, sales revenue for its products has continued to decline. The decline is because it has become much more convenient for many consumers to simply download the software packages from the internet, without having to actually purchase the physical CD packages. NewTech charges less for downloads than it does for a comparable CD package.

Near the end of the current year (Year 1), Mr. Davidson is instructed by NewTech's CFO that impairment testing must be completed for the company's long-lived tangible assets. The land and buildings for each plant are leased and for financial reporting purposes, revenue and expense records are maintained on a plant-by-plant basis. Relevant information as of December 31, Year 1 is shown below:

	San Antonio Plant	**Roswell Plant**	**Total NewTech**
Original Cost of Assets	$1,400,000	$900,000	$2,300,000
Accumulated Depreciation	(800,000)	(400,000)	(1,200,000)
Estimated Future Cash Flows			
Year 2	300,000	200,000	500,000
Year 3	150,000	100,000	250,00
Year 4	100,000	50,000	150,000
Year 5	50,000	5,000	55,000
Year 6	20,000	--	20,000

For Year 1, the market risk-free rate is 2% and management determines that a risk premium of 10% will be sufficient to account for the risk inherent in NewTech's operations and the current and expected future state of the economy. Based on this information, future cash flows should be discounted at a 12% interest rate (2% + 10%).

Questions:

1. According to the FASB Codification, provide two examples of indicators that impairment may have occurred (please limit your answer to two examples, and be sure the examples are directly from the Codification.)
2. Why did NewTech's CFO decide that impairment testing needed to be conducted for its long-lived assets? (Limit your answer to one short paragraph).
3. At what level will impairment testing be conducted under US GAAP for New Tech (the company as a whole or at the plant level)? Justify your answer based on the FASB Codification. (Limit your discussion to one short paragraph.)
4. Calculate the amount of impairment, if any, that NewTech would record using US GAAP. Please show and label your work.

5. If NewTech does record an impairment, how will depreciation, net income, and cash flows be affected in future years as a result of the impairment charge?

During Year 1, the SEC makes the final announcement that all US companies will be transitioning to use International Financial Reporting Standards (IFRS) for financial reporting for the year ending December 31, Year 2. For an entity making the transition to reporting under IFRS, there must be at least one year's worth of financial statements prepared retrospectively for the purposes of comparison.

NewTech is now charged with the task of restating its financial statements from Year 1 as if completed using IFRS. The first thing they wish to examine is the impairment charge taken during Year 1 using US GAAP. Because of the technical nature of NewTech's business, all of its machines have been custom-designed, meaning that the fair value for all of its equipment is difficult to find as there is no active market for the machines. Thus, the company will utilize value in use as the recoverable amount for an asset or asset group when using IFRS.

In Year 2, the market risk-free interest rate remains at 2%. Because of changes in the economy and even further decreased demand for NewTech's products, management now realizes that their original assumption of 10% for a risk premium from Year 1 was too low. Management believes that a risk premium of 13% would have been more appropriate to use for a risk premium for Year 1. Use the financial information previously provided to complete impairment testing for year Year 1 as it would have to be done under IFRS and answer the questions below. Assume that the CFO instructs you to use the original assumption (of a 10% risk premium and 12% discount rate) instead of a 13% risk premium and 15% discount rate.

<u>Questions:</u>

1. In general, is impairment testing completed at the same level under US GAAP and IFRS? (Please read the attached page from International Accounting Standard No. 36). Limit your answer to one short paragraph.
2. What is the amount of impairment, if any, that NewTech would record using IFRS for the recasted Year 1 financial statements?

3. Since the impairment charge originally taken in Year 1, according to US GAAP, more information has become available about the level of risk associated with the company's future cash flows. In your opinion, was management correct in using a 10% risk premium to recast its financial statements to comply with IFRS? Or, should the risk premium of 13% have been used to restate Year 1's impairment charges according to IFRS? Use the attached page from International Financial Reporting Standard No. 1 to provide support for your answer. Limit your answer to one paragraph. Note: you will be graded on the logic of the support for your answer.
4. Compare impairment testing under US GAAP and IFRS. What conclusions can you draw about impairment testing and any corresponding impairment charges from the experience of NewTech (e.g., will more impairment charges be recorded under US GAAP or IFRS)? Limit your answer to one paragraph.

Answers Provided to Students

1. According to the FASB Codification, provide two examples of indicators that impairment may have occurred (please limit your answer to two examples, and be sure the examples are directly from the Codification.)

Any two of the examples listed below are acceptable. The following language and examples are directly from the Codification (FASB ASC paragraph 360.10.35.21):

A long-lived asset (asset group) shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. The following are examples of such events or changes in circumstances:

a. A significant decrease in the market price of a long-lived asset (asset group)

b. A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition

c. A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator

d. An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)

e. A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)

f. A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life. The term *more likely than not* refers to a level of likelihood that is more than 50 percent

2. Why did NewTech's CFO decide that impairment testing needed to be conducted for its long-lived assets? (Limit your answer to one short paragraph.)

The decreased demand for NewTech's software packages means that the manufacturing equipment has likely lost value and the equipment may soon become obsolete. Other answers are acceptable. For example, you could have referred to example c. above from the Codification regarding a significant adverse change in the business climate. Note that the Codification only provides examples. Any indicators of impairment would require impairment testing.

3. At what level will impairment testing be conducted under US GAAP for New Tech (the company as a whole or at the plant level)? Justify your answer based on the FASB Codification. (Limit your discussion to one short paragraph.)

According to the FASB ASC paragraph (360.10.35.23), assets will be grouped, for purposes of impairment testing, at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets. For NewTech, impairment testing will be completed at the plant level as this is the lowest level at which identifiable cash flows are independent from cash flows related to other assets.

4. Calculate the amount of impairment, if any, that NewTech would record using US GAAP. Please show and label your work.

<u>San Antonio Plant:</u>

Original Cost of Equipment…… $1,400,000

Accumulated Depreciation…….. (800,000)

Book Value…….. $600,000

Sum of Undiscounted Future Cash Flows…… $620,000

Because the sum of the undiscounted future cash flows exceeds the book value of the equipment, no impairment charge is required for the assets of the San Antonio Plant.

Roswell Plant:

Original Cost of Equipment…… $900,000

Accumulated Depreciation…….. (400,000)

Book Value…….. $500,000

Sum of Undiscounted Future Cash Flows…… $355,000

Net Present Value Future Cash Flows…….…… $297,080 (calculated below)

Roswell			
Year	Cash Flows	PV Factor @ 12%	Present Value
1	200,000	0.893	178,600
2	100,000	0.797	79,700
3	50,000	0.712	35,600
4	5,000	0.636	3,180
5	-	-	-
Total	$ 355,000.00	-	$ 297,080.00

Because the sum of the undiscounted future cash flows is less than the book value of the equipment, an impairment charge is required in the amount of $202,920

(book value of 500,000 less the net present value of future cash flows of $297,080).

Total Impairment = $202,920.00

5. **If NewTech does record an impairment, how will depreciation, net income, and cash flows be affected in future years as a result of the impairment charge?**

The carrying value of the assets in the Roswell plant is reduced by the impairment charge of $202,920. The amount of depreciation taken annually will be based on the newly reduced carrying value of the assets, no matter what method of depreciation is utilized. Because the carrying amount of the assets has been reduced, the amount of depreciation taken every year in the future will be reduced. Future net income would increase because of the decreased amount of depreciation expense to be taken each year in the future. Future cash flows will not be affected by the impairment charge because an impairment is a non-cash charge.

6. **In general, is impairment testing completed at the same level under US GAAP and IFRS? (Please read the attached page from International Accounting Standard No. 36). Limit your answer to one short paragraph.**

The following language is directly from IAS 36, paragraphs 66 and 68:

> "If there is any indication that an asset may be impaired, recoverable amount shall be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an entity shall determine the recoverable amount of the cash-generating unit to which the asset belongs. . . an asset's cash-generating unit is the smallest group of assets that includes the asset and generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets."

This means that, in this situation, the level at which impairment testing is completed will be the same under US GAAP and IFRS because the lowest level at which cash inflows are independent of other cash inflows is at the plant level.

7. **What is the amount of impairment, if any, that NewTech would record using IFRS for the recasted Year 1 financial statements?**

<u>San Antonio Plant:</u>

Original Cost of Equipment…… $1,400,000

Accumulated Depreciation…….. (800,000)

Book Value…….. $600,000

Net Present Value of Future Cash Flows…… $501,790 (calculation below)

San Antonio			
Year	Cash Flows	PV Factor @ 12%	Present Value
1	300,000	0.893	267,900
2	150,000	0.797	119,550
3	100,000	0.712	71,200
4	50,000	0.636	31,800
5	20,000	0.567	11,340
Total	$ 620,000.00	-	$ 501,790.00

Because the net present value of the estimated future cash flows is less than the book value of the equipment, an impairment charge in the amount of $98,210 is required for the San Antonio Plant

(book value of $600,000 – NPV of 501,790)

Roswell Plant:

Original Cost of Equipment…… $900,000

Accumulated Depreciation…….. (400,000)

Book Value…….. $500,000

Net Present Value Future Cash Flows…….…… $297,080 (calculation below)

Roswell			
Year	Cash Flows	PV Factor @ 12%	Present Value
1	200,000	0.893	178,600
2	100,000	0.797	79,700
3	50,000	0.712	35,600
4	5,000	0.636	3,180
5	-	-	-
Total	$ 355,000.00	-	$ 297,080.00

Because the net present value of the estimated future cash flows is less than the book value of the equipment, an impairment charge is required for the Roswell Plant in the amount of $202,920 (book value of 500,000 – NPV of 297,080)

Total Impairment = $301,130 (98,210+202,920)

8. **Since the impairment charge originally taken in Year 1, according to US GAAP, more information has become available about the level of risk associated with the company's future cash flows. In your opinion, was management correct in using a 10% risk premium to recast its financial statements to comply with IFRS? Or, should the risk premium of 13% have been used to restate Year 1's impairment charges according to IFRS? Use the attached page from International Financial Reporting Standard No. 1 to provide support for your answer. Limit your answer to one paragraph. Note: you will be graded on the logic of the support for your answer.**

For an entity making the transition to reporting under IFRS, there must be at least one year's worth of financial statements prepared retrospectively for the purposes of comparison. The following language is taken directly from IFRS 1, paragraph 14:

> "An entity's estimates in accordance with IFRSs at the date of transition to IFRSs shall be consistent with estimates made for the same date in accordance with previous GAAP (after adjustments to reflect any difference in account policies), unless there is objective evidence that those estimates were in error (IASBe 2009, Paragraph 14).

When an entity is recreating prior year's statements in accordance with IFRS it must use the same inputs and assumptions previously used under GAAP for the same dates in order to develop certain estimates, as long as those assumptions are still consistent with IFRS. This means that even if a company has subsequently learned that its estimates originally used to prepare its financial statements using US GAAP have been proven to be inaccurate, the company may not alter them for purposes of restating the IFRS financial statements for the same year. The only way that the company is permitted to make changes to these estimates it is found that they were made in error. If information received after the date of transition to IFRS reveals that previous estimates were incorrect, the company will make adjustments to the financial statements by making adjustments to

profit or loss for the year of transition. The previous year's statements will not be affected.

This means that NewTech must still use the same estimated future cash flows originally used for testing under GAAP as well as the risk premium originally used in Year 1. This may raise questions to management about the appropriateness of the estimates used in Year 1 if conditions have changed since then, but they are not allowed to use the new risk premium to restate the financials from Year 1.

9. **Compare impairment testing under US GAAP and IFRS. What conclusions can you draw about impairment testing and any corresponding impairment charges from the experience of NewTech (e.g., will more impairment charges be recorded under US GAAP or IFRS)? Limit your answer to one paragraph.**

   The purpose of this question is mainly to open a discussion on the differences between US GAAP and IFRS in relation to impairment testing of long-term assets. Students may comment on the fact that because the first step for impairment testing under US GAAP is to compare the undiscounted future cash flows to the book value of an asset, it is less likely that an impairment charge will be taken under GAAP. In contrast, the single step of IFRS of simply comparing value in use (fair value) to book value means that it is more likely that impairment charges will be taken and the amount of impairment charges may be greater under IFRS than under US GAAP. Students may also comment about the change in net income and amount of depreciation that companies will experience.

<u>Survey Distributed with NewTech Case</u>
Please take a few minutes to fill out this survey regarding assignment 1 on impairments. Please do not place your name on this survey. Your answers will remain anonymous.

Rate the statements below using the following scale, where 1 = strongly disagree and 5 = strongly agree

	Strongly Disagree	Somewhat Disagree	Neutral	Somewhat Agree	Strongly Agree
I have studied IFRS before	**1**	**2**	**3**	**4**	**5**
This assignment presented new information to me about issues regarding the transition from GAAP to IFRS	**1**	**2**	**3**	**4**	**5**
The assignment helped me realize some of the problems companies may face when transitioning from GAAP to IFRS	**1**	**2**	**3**	**4**	**5**
This assignment helped me understand some of the differences between GAAP and IFRS	**1**	**2**	**3**	**4**	**5**
This assignment was interesting	**1**	**2**	**3**	**4**	**5**
I would like to work on similar assignments	**1**	**2**	**3**	**4**	**5**

Survey Responses
Total Responses = 55

		Max	Min	Avg	Mode
I have studied IFRS before		5	1	3.11	4
This assignment presented new information to me about issues regarding the transition from GAAP to IFRS		5	2	4.44	5
The assignment helped me realize some of the problems companies may face when transitioning from GAAP to IFRS		5	3	4.05	4
This assignment helped me understand some of the differences between GAAP and IFRS		5	2	4.35	5
This assignment was interesting		5	1	3.45	4
I would like to work on similar assignments		5	1	3.51	4

Some conclusions can be drawn from the surveys handed out to students along with the NewTech case. Looking at the modes for each of the responses, it seems that most students have had at least some exposure to IFRS. Despite a high frequency of students saying they have studied IFRS, this assignment clearly presented new information regarding the transition from US GAAP to IFRS. This case helped students to analyze the differences between the two sets of standards – something that they might not have reason to do otherwise. It is vital for students to not only be exposed to IFRS, but to understand the differences between the two sets of standards and the implications of those differences as well. The ideas brought forth in the NewTech case were simple in design, but can have significant effects in a real-world situation.

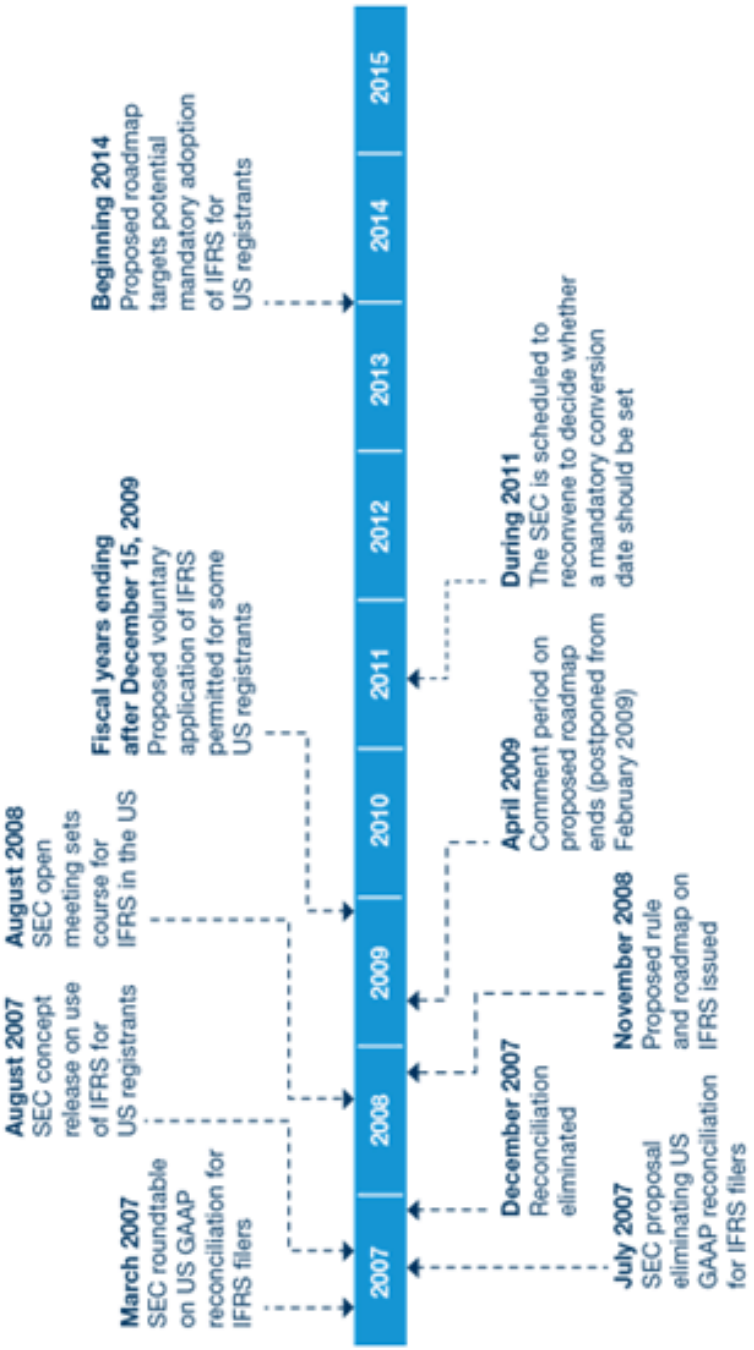
Students were exposed to the differences that are likely to result from the different methods used for impairment testing under each set of standards. Along with this exposure, discussion was opened for how the use of assumptions and estimates can drastically affect financial statements. Through the use of this simple case, it is easy to see that IFRS education has a long way to go. If the SEC holds to its current general timeline, companies could begin making the transition to requiring the use of IFRS starting in 2015. This does not provide much time for practitioners to begin learning the new set of standards. It is vital that students are exposed to IFRS while still in school so that they will be better prepared for the impending transition. The AICPA supports the IFRS transition and has actually stated that the Uniform CPA Examination will begin including IFRS topics on January 1, 2011 (Journal of Accountancy, 2009). This means that it is crucial for current accounting students to not only be exposed to IFRS but to really begin to study the standards in-depth so as to provide a solid understanding of what is to come.

APPENDICES

Appendix A – (Timeline of Accounting Events)

Creation of SEC – ***1934***	
	1936 – AICPA becomes responsible for standard-setting
Creation of FASB – ***1973***	***1973*** – Creation of IASC
	1987 – IASC moves toward conceptually-based standards
IASC relinquishes standard-setting to IASB – ***2001***	
	Sep 2002 – Norwalk Agreement is released
Both Boards issue Memorandum of Understanding – ***2006***	
	Nov 2007 – SEC allows financial statements of foreign investors prepared using IFRS without requiring reconciliation to US GAAP
SEC releases the proposed roadmap for transition to IFRS – ***Nov 2008***	
	Feb 2009 – Sir David Tweedie believes by Dec 2011, GAAP and IFRS will be "pretty much the same"
Comment period for proposed roadmap ends – ***April 2009***	
	Oct 2009 – IASB and FASB begin meeting monthly to reach convergence goals
FASB releases Codification – ***July 2009***	
	Nov 2009 – international finance experts meet and present advice for companies
Earliest date for large accelerated filers to begin using IFRS – ***2015***	

Appendix B – (Original Proposed SEC IFRS Conversion Roadmap)
For Illustration Purposes Only - Changes Have Been Made Since the Release of this Document



(PriceWaterhouseCoopers).

Appendix C – (Summary of Differences)

	US GAAP	IFRS
Internally Generated Intangible Assets	• R&D must be expensed	• Research is expensed; development is capitalized
Subsequent Measurement of Intangible Assets	• Does not provide for subsequent fair value assessment	• May be carried under cost model or revaluation model
Impairment Testing Procedures	• Two steps • Use undiscounted cash flows for comparison • Impairment charges may be taken less often	• One step • Compare carrying amount to recoverable amount
Reversal of Impairment Charges	Not allowed	Allowed
Impairment Testing for Goodwill	• Done at the reporting unit-level • Two step process	• Done at the cash-generating unit-level • One step process
Goodwill Impairment Charges	• Cannot exceed the carrying value of the recorded goodwill	• Any impairment charge in excess of the value of goodwill may be charged against the assets in the associated CGU

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