# ACCOUNTING FOR STANDARDS

Adoption of international accounting standards mandates rethinking strategy. BY ERIK SHERMAN

To T.J. Rodgers, Cypress Semiconductor Corporation's CEO, US GAAP accounting standards have a credibility gap. An investor called, worried about a low cash position. Rodgers knew there was plenty of cash and yet couldn't find it in the report. He went to speak with his finance department. "They had it in four different line items," he says, and for one of them the cash was only a portion.

That's when it hit home just how befuddling and misleading accounting could be. Rules and directives almost never match the economic reality of corporate operations. When a change happens to the rules, like expensing stock options, CEOs can find that some part of their strategy turns upside down. Then they must spend their time with arcane financial considerations rather than focusing on bringing revenue in the door. And what will soon face U.S. companies and their leaders is the biggest set of rules changes ever: the International Financial Reporting Standards, or IFRS.

Adopted by over a hundred countries to date, IFRS is meant to provide a level of transparency necessary to a global economy. The Securities and Exchange Commission (SEC) has shown support for a shift from GAAP to IFRS and even set some tentative dates for further decisions on the topic, with 2014 floating as a potential conversion deadline. But many companies will find that IFRS can significantly revamp their balance sheets and income statements, introduce unwanted volatility into their financial results and otherwise shake up business as usual. It could also let companies finally make choices that could let financial reports more accurately reflect the economic realities of the business.

Not only will CEOs have to spend time communicating the changes to their investors, they will also need to reconsider basic strategic decisions and preside over a system and process overhaul that could make Sarbanes-Oxley look easy. It could literally take two years just to find out how extensive the impact will be.

"Strategy can be impacted because we all have to worry about reported earnings," says Grant Thornton CEO Edward Nusbaum. "You're changing the scorecard, and when you change the performance metrics, that changes behavior."

The idea behind IFRS seems sound enough. Instead of having the entire world financially Balkanized by different approaches to accounting, IFRS would, in theory at least, provide a single transparent standard for the world's capital markets. Suddenly the wrought-iron patio furniture maker in the Czech Republic would have financial reports that were directly comparable to those of its Brazilian competitor. Inventors, customers and business partners could understand how a company was really doing because they would all speak the same financial language.

Not only could companies then compete more effectively for global capital, but having unified reporting standards could make the merger and acquisition process smoother. All interested parties look to data from financial reports to inform their decisions, but identically labeled information can actually mean wildly different things under various financial reporting schemes.

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"In order to analyze the company and understand whether an acquisition is going to be something of value, you need to look at the target company in a consistent way with how [your] company is reporting," says Chris Mann, managing director, MorganFranklin Corp. Global financial standards would certainly make that easier.

But when financial standards change, so do all the meanings of the numbers that investors examine and that CEOs use in making their decisions. Those transformations can be extreme. Look at Vodafone. When the rest of the UK moved from UK GAAP to IFRS a few years ago, so did the telecommunications company. In its 2004 fiscal year, Vodafone suddenly shifted from a pre-tax loss of about £16 billion to a profit of more than £9 billion, according to Clare Finch, content manager at Kaplan UK.

How it happened was simple. In the 1990s, Vodafone acquired a German firm for about $140 million.

"Under UK GAAP they had to amortize the good will," Finch explains. But IFRS doesn't allow good will amortization, so Vodafone suddenly had an enormous profit as previously written-off value was restored to the books as is necessary under the new accounting standard. Nothing had changed at all in the company's economics—except it now faced a walloping tax bill.

It's not that IFRS is a dogmatic body of precepts any more than any other standard. In fact, it enjoys a reputation of being, on the whole, more flexible than US GAAP and considerably less voluminous. "Just look at the sheer volume of the standards," says DJ Gannon, a Deloitte partner who heads the firm's US IFRS solutions center. "You've got roughly 25,000 pages in US GAAP and 2,000 in IFRS." The reason is that IFRS focuses more on principles than as complete a set of rules as possible. Management teams are expected to make decisions of how their companies can best embrace the principles in the context of how they need to do business.

But each system has its own vision of what companies should do, and there are some fundamental differences (see sidebar). For some, the shift may be wildly positive. For example, Rodgers looks forward to amortizing R&D costs over the expected life of one of his company's chips, as development costs for a new product can run as high as $100 million, a big hit to profitability when recognized all at once. IFRS would allow Cypress to portray itself in a way more in keeping with its underlying economics. But the same principle will force many companies to associate R&D with specific product lines. "Companies generally do not have systems to track those costs to products," says Laura Bustamante, PwC Owner, and that could mean investing in more procedures and systems.

In short, this isn't a dreamland where everything you want is possible, particularly when a company shifts from US GAAP to IFRS. "In the U.S., most companies that hold inflationary products and inventory are using LIFO [because] it limits their taxes," says Hackett Group finance advisory practice leader Bryan Hall. By associating the high-

## Some Key US GAAP and IFRS Differences

**Revenue/Expense Recognition.** Depending on the specifics of the situation, companies might find sales or expense recognition either accelerated or delayed. For some companies, IFRS will add an unavoidable increased volatility to reporting.

**Impairments.** Under US GAAP, when an asset's value is impaired, the company must write down the excess. Under IFRS, a company must continue monitoring the fair market value of the asset and, should conditions change accordingly, restore the associated amount of value.

**Componentization.** Under IFRS, a company must determine the life expectancies of an asset's components and depreciate each separately. So the walls and foundation of a building might have one amortization period; the roof, another; the boiler, a third; the wiring and plumbing, a fourth; and a fifth for the parking lot.

**Amortization.** The rules for amortizing expenses and revenue can be significantly different, with actions allowed under one standard disallowed and yet allowed under the second.

**Benchmarking.** More of a secondary effect, but a real one: Companies may find that they can choose not to reveal as much internal information about their operations as before. One corporation might find it more difficult to benchmark its operations against industry competition.

**Contracts.** Many contracts contain financial measurements—financial covenants in loans, for example, or conditions for bonuses in executive compensation agreements. Change the metric and a company could suddenly find itself in breach of a covenant in a critical line of credit or insurance policy, or even find that it was grossly under- or overpaying executives.

**Defending Decisions.** Between the U.S. courts' business judgment rule and the number of absolute directives under GAAP, companies have been able to fend off many lawsuits. But under IFRS, where companies make decisions based on principles, there is at least the possibility that someone could challenge the rationale employed. Although IFRS may have many fewer pages, companies will have to add some significant documentation of their own to justify their choices and positions.

er cost of recent inventory with a sale, profit appears smaller and taxes are lower. IFRS doesn't recognize LIFO, so converting to the standard would cause a big tax hit.

Some industries—computers and software, regulated utilities, or such extractive industries as mining, timber or oil and gas—can wind up on the painful side of change. For example, regulated industries currently report so-called regulatory assets: costs that regulators allow a company to pass on to customers over some number of years. Under GAAP, a company treats these as assets and depreciates them over time. But IFRS does not recognize a different treatment of regulatory assets, treating them as expenses when they occur. Companies may face greater revenue and profit volatility as a result.

Nevertheless, a company could develop an advantageous position. Company A might find itself in the grips of greater sales volatility while company B, which more advantageously structured its IFRS adoption accordingly, might mitigate much of the volatility and make its stock more attractive to investors. That translates into higher stock prices and enhanced economic muscle to expand and acquire other companies.

"The global companies feel there are efficiencies they can get," says David Kaplan, international accounting consulting services leader of PwC. They might be able to have a single accounting department for the entire company or reduce compliance costs by eliminating multiple filings.

Although the SEC has not set a hard date for a changeover, it has been strongly leaning toward the standards for some time. Given the country's need to reestablish itself in world financial markets after the current economic turmoil, the move toward IFRS is unlikely to end. Even looking at a 2014 date should give little comfort. Moving to IFRS is a complex process that, according to many experts, will likely be even more extensive and complex than adopting Sarbanes-Oxley.

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To intelligently adopt IFRS to its advantage, a company must plan on a few years to make the shift. One reason is a dark irony, as there is currently not a single version of IFRS that all countries use. Although not quite as fragmented as the various editions of GAAP, accounting standards groups are trying to bring the various versions into harmony, so chances are good that today's "official" version of IFRS will not look exactly the same as the one eventually adopted.

However, waiting isn't an intelligent option, because it can take a long time to grasp exactly how the shift will affect a given company. "For the biggest companies, even if they put all their efforts into it, I think it would take at least a couple of years to understand the impact," Nusbaum says.

Microsoft started its initial work in July. Yet, closing its books in IFRS "may take three years at least," says Bob Laux, senior director of financial accounting and reporting. Although the planning is demanding and requires participation by the highest levels of management, the time-consuming portion will be the actual implementation. "We use SSAP and there's a module for doing separate books on IFRS, but you need to get the information," he says. "It's not as easy as plug and play."

An IFRS adoption will need to examine and address at least the following: align accounting decisions with corporate strategies; ensure that the IT infrastructure, including legacy systems, supports IFRS; review all financial metrics to see how they might change; review all legal contracts for mentions of financial metrics and negotiate needed changes; examine whether controls and processes are still accurate and adequate; generate the additional information that IFRS might require and prepare communications to help investors understand and accept the changes.

This will likely be a massive and possibly expensive undertaking, reminding CEOs of the pain of implementing Sarbanes-Oxley. And yet it will also give CEOs a rare chance to make over their companies' financial structures to reflect how their companies actually operate—and maybe head off a few investors' questions.