VIEW/REVIEW:

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THE LANGUAGE OF ACCOUNTING: PRACTICE DIFFERENCES IN THE U.S. AND AROUND THE GLOBE

There has been a great deal of chatter over the last few years about whether International Financial Reporting Standards, or IFRS, are going to become the official standards of the United States. The whims of politics, though, have rendered the eventual decision of the Securities and Exchange Commission (SEC) a little less certain than it seemed a decade ago. Such is the effect of changes in leadership and the appetite for additional reporting changes after those wrought by the rule-making activities following the 2008 financial meltdown. But whether the SEC requires IFRS for U.S.-listed companies is a bit of a moot point. IFRS are already here. Many U.S. entities, organizations that have to report financial information, are subsidiaries of companies listed on international exchanges requiring IFRS or with IFRS reporting requirements in a non-U.S. regulatory regime. U.S. entities may be traded on such international exchanges. The U.S. standard setter, the Financial Accounting Standards Board (FASB), has worked closely with its international counterpart, the International Accounting Standards Board (IASB), to jointly develop and improve several key standards. And for several years, the SEC has permitted foreign private issuers traded on U.S. exchanges to file IFRS financial statements without reconciliation to U.S. standards.

Thus it is important for anyone reading and comparing financial statements to gain a working knowledge of some of the major differences between IFRS and U.S. standards, known as U.S. GAAP (generally accepted accounting principles).

A common misconception is that U.S. GAAP are "rules-based," despite their name as generally accepted accounting *principles,* and IFRS are "principles-based." A related idea is that IFRS allow companies to be more "aggressive," while U.S. GAAP are more "conservative" and thus result in better information. Neither is particularly true.

U.S. GAAP have often served as a model for the development of IFRS over time – either as one to emulate or to avoid. While there are many similarities, there are also many differences, and both have changed over time as the boards have continued to improve the standards.

What follows is a brief discussion of two of the bigger, but lesser-known, differences in the standards.

1 - CONTINGENCIES

An entity records and reports a liability when it owes something to another entity or individual. The FASB's *Conceptual Framework* definition of this financial element is: "Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events." The IASB's *Conceptual Framework* contains a virtually identical definition.

Sometimes it's unclear whether a "present obligation" exists. Sometimes the dollar amount of the obligation is uncertain. The entity's accountants must apply professional judgment to determine whether and how to record a provision, a sort of "just in case" liability. U.S. GAAP and IFRS handle such situations differently.

Under both U.S. GAAP and IFRS, an entity first figures out whether it is probable that it will have to pay something. For example, if an entity's normal mode of manufacturing results in environmental damage, there might be laws in place that require the company to repair the damage. The company knows it has a future obligation–if it manufactures *anything* in the future it is (more than) probable that it will have to pay *something*. Since the company doesn't yet know for sure how extensive the damage will be, it has to estimate the repair bill in order to record the provision.

The key differences here are what "probable" means and how to estimate the dollar amount. U.S. GAAP does not define the term "probable." IFRS defines it as "more likely than not," which means a probability greater than 50 percent. **UNDER BOTH SETS OF STANDARDS, IF THE "PROBABLE" THRESHOLD IS REACHED, THE ENTITY MUST RECORD THE MOST LIKELY ESTIMATE OF WHAT IT WILL HAVE TO PAY TO SETTLE THE OBLIGATION. IF ALL ESTIMATES ARE EQUALLY LIKELY, U.S. GAAP REQUIRES THE ENTITY TO RECORD THE MINIMUM ESTIMATE; IFRS REQUIRES THE MEDIAN ESTIMATE.** Entities reporting under IFRS standards typically have contingencies reflected in their balance sheets sooner and for a greater amount.

2 - DEPRECIATION

An asset is the opposite of a liability; rather than a "sacrifice," it is a future economic benefit. As the benefits are used up, the asset is expensed on the income statement. For some assets, this happens quickly. For others, such as buildings and equipment, it takes much longer. Entities depreciate such assets, recognizing a bit of depreciation expense in every period on each period's income statement until the expected benefits are exhausted.

Neither set of standards gives a lot of detail on how this process should happen other than that it should be reasonable and systematic. If practicable, depreciation should mimic the pattern of consumption; if the entity expects to get most of the benefit early on, it should recognize more depreciation expense early on. Most entities, though, evenly distribute the benefit over time. To figure out how much to depreciate, the entity needs to estimate the useful life of the asset and how much it thinks it will be able to sell the asset for when it's done (called "salvage value" under U.S. GAAP and "residual value" under IFRS).

THE BIGGEST DIFFERENCE IS THAT IFRS REQUIRES COMPONENT DEPRECIATION. With this system, an entity needs to break its large assets, generally purchased in one large bundle, into component pieces based on estimated useful life. For example, a building might be comprised of the main structure which will last 20 years, a roof which needs to be replaced every 10 years, and air-conditioning and electrical systems to be replaced every five years. Under IFRS, each of those components must be depreciated separately, requiring separate estimates of useful lives and of residual values.

U.S. GAAP permits entities to use component depreciation, but none do. When a major renovation takes place, like the replacement of a roof, the entity figures out whether the renovation will extend the useful life of the asset or just allow it to continue operating until the original useful life is over. If it's the latter, the entity expenses the entire renovation. Under IFRS, that major renovation would have been a separate component, and so the entity would record a new depreciable asset.

Another big difference involves "salvage value" versus "residual value." **SALVAGE VALUE, UNDER U.S. GAAP, IS WHAT THE ENTITY THINKS IT CAN SELL THE ASSET FOR AT THE END OF THE USEFUL LIFE. OFTEN, THE ANSWER IS ZERO, BECAUSE ANY OTHER NUMBER IS TOO DIFFICULT TO REASONABLY ESTIMATE.** For example, estimating what a 20-year-old building will sell for in 20 years can be challenging. Residual value, under IFRS, is what the entity could sell a similarly used-up asset for today. In other words the estimation would change to what a 20-year-old building is selling for now. This answer is a little easier to estimate.

The net effect of all of these differences isn't clear. Depreciation expense is not always smaller under IFRS than U.S. GAAP, or vice versa. The difference is more about what's being estimated and when. IFRS requires more estimation about current conditions at the time of the asset's purchase, while U.S. GAAP requires more estimation about the future and as things progress over time.

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NOT THE END OF THE STORY

These are only two examples of differences in the standards. There are many more. Some of those are going to be reduced over time, as with the boards' current joint project on revenue recognition. Both sets of standards began with broad revenue recognition guidance, applicable to all types of companies and requiring a great deal of judgment to apply. Given the importance of revenue as the first line on the income statement, the SEC wanted to prevent companies from being overly aggressive with this number. The U.S. standards thus accumulated a large number of highly specific pieces of guidance. The piecemeal approach, though, led to some very similar transactions being reported very differently depending on the company's industry. The IFRS standard, meanwhile, was criticized for remaining overly broad and allowing companies too much leeway. The new standard that resulted from the joint project, which will replace the current guidance in both sets of standards, requires a single revenue recognition process general enough for all companies but with enough structure to satisfy critics of current IFRS.

There are also current similarities in the standards that may become differences over time, as with the boards' current joint project on financial instruments. Originally, both sets of standards were very similar; the IASB adopted the majority of the existing U.S. standard when it wrote its version. The FASB is moving slowly with its changes. It is leaning toward a model in which the value of these instruments on the balance sheet more often reflects their current selling price (fair value). The IASB is proceeding more quickly, generally providing more opportunities for entities to report an adjusted cost number on the balance sheet.

It may seem like accounting standards represent some objective truth about an entity's financial position, and that those standards, therefore, are black-and-white and unchanging. The truth is that a lot is uncertain and subject to estimation. Different groups have come to different conclusions about how to handle those uncertainties. Changes in business model, processes and technologies affect the extent of the uncertainties and our ability to reasonably estimate their effects. **STANDARDS CHANGE AND EVOLVE OVER TIME. WHAT DOES NOT CHANGE IS THE GOAL: TO PROVIDE USEFUL, TRUSTWORTHY INFORMATION, SO MARKETS AND ECONOMIES CAN WORK.** Without that kind of accounting...well...game over.