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Clean Sheet or Topside Tweaking for IFRS?

By Tammy Whitehouse — August 5, 2008

Although a clear path toward adoption of International Financial Reporting Standards in the United States hasn't been established, the largest public companies are already mulling their approach toward converting to a new accounting system.

Given the massive complexities such a conversion is likely to involve—especially when moving from the highly prescriptive U.S. Generally Accepted Accounting Principles to a more flexible, principles-based IFRS—it's no wonder companies are looking at the full spectrum of options for how to arrive at the end result.

Danita Ostling, a partner at Ernst & Young and the firm's Americas IFRS leader, says several theories of how to make the conversion have already emerged. The most dramatic approach: start with a clean sheet of paper. "With the clean sheet of paper, companies are looking at the once-in-a-lifetime opportunity to step back and challenge the way things are done from the perspective of accounting policies and practices," she says.

For those who want a less daunting path, Ostling says they can also simply try to minimize the differences between IFRS and GAAP reporting. Companies can take stock of how accounting under the two systems is done, note where the differences arise, and then enact changes to reduce and eventually eliminate those gaps.

"It's likely to be a less-complex, less-time consuming, less-expensive exercise than taking the clean-sheet-of-paper approach," she says. "But companies that take that approach will miss the once-in-a-lifetime opportunity to fundamentally reconsider their accounting policies and practices."


Munter

Paul Munter, an audit partner at KPMG and an IFRS expert, says minimizing differences has some validity because IFRS allows companies to exercise more judgment about accounting items; that would give them latitude to decide how a certain item in GAAP would appear if reported under IFRS. The approach "uses GAAP as an anchor, and says we're only going to make changes where absolutely necessary," he says.

Conversely, Munter continues, starting with a clean sheet of paper means companies are *not* anchored to GAAP as a starting point. "They'll develop IFRS policies in a fashion most representative of the business activities and will provide the best financial reporting for the business activities," he says. "That philosophical decision will drive a lot of the activities and priorities within the company's conversion process."

As such, the decision about which approach to take should be made at the highest level of the company, Munter says. The CEO, primary officers, and the audit committee should all be involved.

A third possible approach is to hum along under GAAP, but make topside adjustments at the end of the reporting process to convert the finished financial statements to IFRS. That was a common technique in Europe when the European Commission first required IFRS adoption in 2005, says David Schmid, a partner at PricewaterhouseCoopers.

That's not to say Schmid supports such an approach, though. "Those companies tended to have challenges, because you tend to miss things," he says. The topside approach would likely raise many red flags about internal control over financial reporting; in Europe, it left some corporate managements unable to speak in the same reporting language as the users of financial statements.


Kaplan

Dave Kaplan, PwC's international accounting leader, says the United States should take a lesson from Europe's experience with topside adjustments under a scrambled implementation—namely, think carefully before you do it.

"To be most effective, the best way to go through the conversion process is to embed the basic IFRS accounting into systems, processes, and controls," he says. "It will result in a much more well-controlled organization and will minimize the potential risk of errors in the long run."

Chris Wright, managing director at consulting firm Protiviti, says companies may be considering the topside adjustment approach because they're accustomed to the process already if they operate under different accounting systems in different countries. They may see topside adjustments as a short-term solution, or as a means of progressing from one system to another.


Wright

Life in the Long Term

Wright also believes that as IFRS and GAAP differences are reduced over time, the need to keep separate books and then topside adjustments will fade as well. "Topside adjustments as a long-term solution would seem to defeat the purpose of moving to IFRS," he says.


Albarelli

Rebecca Albarelli, of the consulting firm Jefferson Wells, says the "topside approach" will ultimately complicate conversion to IFRS and consume more time and resources. For example, she says, the topside approach would not capture the right data for measuring inventory or making fair-value measurements, which can cause internal control problems. "Build it the right way in the first place, and in the long run you will build in efficiency," she says.

Implementing IFRS throughout an organization will require companies to get down to the gritty details of accounting policies, according to Hans-Peter Rudolf of the auditing firm Crowe Chizek. Companies will need to develop a conversion framework that examines financial statements line by line, he says, and ensure that framework is applied consistently throughout the business.

And what should that framework examine? How transactions are accounted for under GAAP, how they might differ when accounted for using IFRS, and how IFRS will be applied within the organization to best reflect the economics of the business, Rudolf says. In pension accounting, for example, the company would need to make decisions on issues such as whether to accelerate pension expense under IFRS, then confirm that everyone in the company (as well as outside service providers and specialists) follow the same policies.


Osnoss

Joel Osnoss, leader of Deloitte's global IFRS offerings services group, says companies need to establish their own judgment frameworks to assure a successful implementation. The Securities and Exchange Commission's Committee for Improvements to Financial Reporting might provide some guidance on that front, he says. CIFR has urged the SEC and the Public Company Accounting Oversight Board to consider developing judgment frameworks, so companies might use that recommendation to help them develop judgment frameworks of their own.

"Most big decisions around how to account for something would happen at the corporate level," Osnoss says. "There needs to be tone at the top laid out for the rest of the company."
