

## WHAT IS IFRS AND WHAT DOES IT MEAN FOR IN-HOUSE COUNSEL?<sup>1</sup>

### What is IFRS?

IFRS refers to International Financial Reporting Standards, a set of accounting standards used in more than 100 countries around the world.<sup>2</sup> On August 27, 2008, the Securities and Exchange Commission (SEC) announced that it will be issuing a proposed “roadmap” to require U.S. public companies to use IFRS instead of U.S. Generally Accepted Accounting Principles (U.S. GAAP) in the preparation of their financial statements filed with the SEC.<sup>3</sup> As the basis for moving towards IFRS, the SEC cited the growing desire for a single standard of accounting standards for global capital markets that would give investors greater comparability and transparency of financial reporting.<sup>4</sup>

The SEC’s proposed roadmap would permit early adoption of IFRS for year-end 2009 by approximately 110 of the largest U.S. public companies.<sup>5</sup> For other companies, the SEC’s roadmap will likely establish a timeline for voluntary and mandatory adoption

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<sup>2</sup> The American Institute of CPAs (AICPA) has created a website compiling resources relating to IFRS at [www.ifrs.com](http://www.ifrs.com).

<sup>3</sup> Press Release: *SEC Proposes Roadmap Toward Global Accounting Standards to Help Investors Compare Financial Information More Easily*, No. 2008-184 (Aug. 27, 2008), at <http://www.sec.gov/news/press/2008/2008-184.htm> (“8/27/08 SEC Release”). The SEC’s proposed roadmap is expected to be released shortly to the SEC’s website at <http://www.sec.gov/spotlight/ifrsroadmap.htm> and will be subject to a 60-day comment period.

<sup>4</sup> *Id.*

<sup>5</sup> AICPA Update: *SEC Unanimously Approves Exposing Proposed Roadmap for Public Comment*, posted on August 27, 2008 at [www.ifrs.com](http://www.ifrs.com).

with a proposed plan for all U.S. public companies being required to report under a two-year phase-in schedule beginning in 2014.<sup>6</sup> In 2011, the SEC is expected to evaluate whether certain milestones have been achieved (such as improved accounting standards, education and training in the U.S. relating to IFRS, accounting and funding of international accounting oversight organizations, and improved ability to use interactive data for IFRS reporting) before deciding whether to mandate the use of IFRS by all issuers.<sup>7</sup>

### **What Does IFRS Mean for In-House Counsel?**

There are significant differences between IFRS and U.S. GAAP.<sup>8</sup> From a conceptual standpoint, U.S. GAAP is more rule-based whereas IFRS is more principles-based.<sup>9</sup> IFRS involves more application of judgment to determine how to account for a transaction and therefore, IFRS will require more disclosures to explain the choices made.<sup>10</sup> According to the AICPA, specific accounting differences include:

- “IFRS does not permit Last In First Out (LIFO) as an inventory costing method.
- IFRS uses a single-step method for impairment write-downs rather than the two step method used in U.S. GAAP, making write-downs more likely.
- IFRS has a different probability threshold and measurement objective for contingencies.

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<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> IFRS, An AICPA Backgrounder at p. 5, at <http://www.ifrs.com>.

<sup>9</sup> See *id.*

<sup>10</sup> See *id.*

- IFRS does not permit curing debt violations after year-end.
- IFRS guidance regarding revenue recognition is less extensive than GAAP and contains relatively little industry-specific instruction.”<sup>11</sup>

These accounting differences increase the risk that companies will experience changes in their patterns of earnings and financial position. With such risk comes the possibility that there will be litigation, including suits by investors who complain that a company did not adequately or accurately disclose the accounting changes and financial impact and/or claims by employees or other parties who allege that agreements were breached by a company’s failure to meet certain contractual financial metrics.

The switch to IFRS will impact almost every segment of a company’s operations from its accounting policies and systems, to its information technology infrastructure, to its compensation plans to its financial reporting requirements. Not only will accountants in U.S. companies need to be trained in IFRS, other professionals will need to be knowledgeable about how it affects their respective areas of expertise. Below are some of the areas that will likely need the input and support of legal counsel to implement a smooth accounting conversion.

- **Debt Agreements.** Companies will need to review and consider whether any debt covenants based on U.S. GAAP metrics need to be revised. With regards to financial information that a company is required to supply to a lender, contracts may need to be re-worded to replace U.S. GAAP with IFRS.
- **Other Contracts.** Differences in accounting treatment such as revenue recognition also may impact existing contracts with vendors and customers as

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<sup>11</sup> *Id.*

well as the design of future contracts. Accordingly, not only must existing contracts be reviewed for any potential impact by a switch to IFRS, companies also must consider the appropriate structure for future agreements.

- **Compensation and Employee Benefit Plans.** Since the conversion to IFRS will affect corporate financial statements and results, companies will need to evaluate how the accounting change will impact performance-based pay. For example, sales commission programs and bonus targets keyed to financial reporting metrics will need to be assessed. In addition, differences in timing of revenue recognition also may affect performance-based compensation. Accordingly, employment agreements and broad-based compensation plans will need to be reviewed and possibly rewritten in light of IFRS.
- **Disclosures to Investors.** Companies need to have clear, consistent and timely communications to their investors to ensure that they understand the potential impact of implementing IFRS. Such communications will help reduce the risk of misunderstandings and unexpected results. In order to make adequate disclosures, a company needs to assess when and how accounting changes are likely to occur. Once a company gets a handle on how its own company's earnings and financial position may change under IFRS, the company must also be prepared to disclose how its numbers compare to its peer companies.
- **Financial Projections.** The switch to IFRS may change a company's pattern of earnings and impact a company's ability to project future earnings. The accounting change also will likely impact budget and planning functions.

Executives will need to understand how a company's earnings will be calculated under IFRS so that they will be able to support the company's projections of future performance. Companies likewise will need to consider any impact IFRS may have on key performance factors used for measuring successes and trends as well as for comparisons to competitors. The federal securities laws provide a safe-harbor for forward-looking statements, such as projections, that are accompanied by meaningful cautionary statements. Accordingly, companies will need to evaluate and update their risk disclosures to include the potential impact of IFRS.

- **Certification of Financial Statements.** Public company executives will be required to make their certifications on IFRS financial statements that companies file with the SEC. Accordingly, companies will need to develop procedures to document the support for the accounting judgments made under IFRS.
- **Regulatory Requirements.** An analysis needs to be made whether changes in financial reporting requirements may impact compliance with any regulatory requirements, including any foreign jurisdictions that tax based on earnings in financial statements.
- **D&O Insurance.** Because converting to IFRS may result in changes to patterns of earnings or financial results, it is possible that companies, boards and executives will be subject to securities claims due to alleged misstatements in financial statements and/or disclosures relating to IFRS. Accordingly, the switch

to IFRS should prompt a review regarding the adequacy of insurance levels to protect against any increased risk.

### **What Can In-House Counsel Do Now?**

Below are a few suggested steps for in-house counsel to take now to start the process for a smooth and successful transition to IFRS:

- (1) Check out the resources available at the AICPA's website for IFRS at [www.ifrs.com](http://www.ifrs.com).
- (2) Get an understanding as to what IFRS means for your company.
- (3) Ask your CFO what plans, if any, are underway to approach a conversion to IFRS.
- (4) Get plugged into your company's planning process for the switch to IFRS.
- (5) Evaluate what areas of your company's operations will need legal analysis and support for the transition.