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Accounting 101

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IFRS vs. GAAP

Group

Good research paper

IFRS vs. GAAP (Development Cost, Consolidation, and Inventory Portion)

For many years, countries have had their own unique accounting practices. However, with the great need for globalization, it has become necessary to unify these accounting standards. By the late 90's, the two most prominent systems were IFRS and U.S. GAAP. Presently, GAAP is potentially going to converge with IFRS, causing the U.S. to change their practices. This melding of systems would possibly have an immensely negative impact on the United States and its businesses, due the differences between IFRS and GAAP.

IFRS stands for International Financial Reporting Standards. It was created by the IASB, or International Accounting Standards Board. IFRS is becoming the global standard for the preparation of financial statements for public companies. Approximately 120 countries are required to use IFRS for domestic listed companies, while around 90 nations are confirmed as using this system. The advantage of using IFRS is that by adopting this policy, a business can present its financial statements on the same basis as foreign competitors. This makes comparisons much easier.

GAAP is the Generally Accepted Accounting Principles. By definition, GAAP are a combination of authoritative standards, and commonly accepted ways of reporting and recording accounting information. This practice is used by the United States only. GAAP is implemented by measurement principles and disclosure principles. Measurement principles recognize and

determine the timing and basis of items that enter the accounting cycle and impact the financial statements, such as the period in which transactions will be recorded. Disclosure principles determine what specific numbers and other information are essential to be presented in financial statements. GAAP and IFRS differ in many ways; the greatest difference being that IFRS provides fewer detailed rules than GAAP. IFRS also contains very limited industry specific guidance.

Development costs are total of all costs incurred from initiation to implementation of a project. Subsequent costs are called operational costs. International Financial Reporting Standards are designed as a common global language for business affairs so that company accounts are understandable and comparable across international boundaries. (http://en.wikipedia.org/wiki/International_Financial_Reporting_Standards) Generally Accepted Accounting Principles refer to the standard framework of guidelines for financial accounting used in any given jurisdiction; generally known as accounting standards or standard accounting practice. (http://en.wikipedia.org/wiki/Generally_accepted_accounting_principles)

Under International Financial Reporting Standards development costs are capitalized if certain criteria is met. Under IFRS, in accordance with IAS 38 "Intangible assets" certain internal development costs are capitalized when it can be demonstrated that they will generate probable future economic benefits to the company. In addition, it is required that the company has the intention and the resources to complete, use and obtain the benefits from an intangible asset. The internally generated intangible asset is amortized over its expected economic life. (http://www.metso.com/corporation/ir_eng.nsf/WebWID/WTB-061017-2256F-42066) Under Generally Accepted Accounting Principles development costs are expenses.

Under IFRS, in connection with the Aker Kvaerner Pulping and Power acquisition consummated on December 29, 2006 Metso recognized capitalized development costs of $2 million, which will be amortized based on its economic life. Under U.S.GAAP, in-process-research-and-development acquired in a business combination, which has no future alternative use, qualifies as an intangible asset as of consummation date but is charged to income immediately afterwards. The $2 million of acquired development costs have been subsequently expensed for US GAAP. (http://www.metso.com/corporation/ir_eng.nsf/WebWID/WTB-061017-2256F-42066)

In GAAP the development costs are expensed as incurred unless addressed by guidance in another ASC Topic. Development costs related to computer software developed for external use are capitalized once technological feasibility is established in accordance with specific criteria (ASC 985-20). In the case of software developed for internal use, only those costs incurred during the application development stage (as defined in ASC 350-40, Intangibles — Goodwill and Other — Internal-Use Software) may be capitalized. (http://www.ey.com/Publication/vwLUAssets/US_GAAP_v_IFRS:_The_Basics/$FILE/US%20GAAP%20v%20IFRS%20Dec%202011.PDF)

In IFRS the development costs are capitalized when technical and economic feasibility of a project can be demonstrated in accordance with specific criteria, including: demonstrating technical feasibility, intent to complete the asset, and ability to sell the asset in the future. Although application of these principles may be largely consistent with ASC 985-20 and ASC 350-40, there is no separate guidance addressing computer software development costs. (http://www.ey.com/Publication/vwLUAssets/US_GAAP_v_IFRS:_The_Basics/$FILE/US%20GAAP%20v%20IFRS%20Dec%202011.PDF)

SFAS 2, Accounting for Research and Development Costs, requires that R&D generally be expensed as incurred and that each year's total R&D be disclosed in the financial statements. SFAS 2 views the research component of R&D as a "planned search or critical investigation aimed at discovery of new knowledge" that could result in a new or improved product, service, process, or technique. The development component of R&D is translating "research findings or other knowledge into a plan or design" for a new or improved product, service, process, or technique. Development includes conceptual formulation, design, and testing of product alternatives; construction of prototypes and operation of pilot plants; but not routine alterations to existing products, processes, or operations. Materials, equipment, and facilities used in R&D activities are expensed as consumed, including depreciation over useful lives if they have alternative future uses. If they have no alternative future uses, these items are expensed as acquired or constructed, never depreciated. Similarly, purchased intangibles are amortized into R&D costs over their useful lives if they have alternative future uses but are expensed as incurred if they do not. Additional R&D costs may include salaries, wages, and other personnel costs; contract services; and a reasonable allocation of indirect corporate costs unless they are not clearly related to R&D activities. Costs incurred before technological feasibility for the product is established are expensed as incurred under SFAS 2. Technological feasibility is determined upon completion of a detailed program design or completion of a working model. Then the product's second life segment, software production, begins, and the company capitalizes all relevant costs. Once a software product is available for general release to customers, amortization begins for capitalized costs, and subsequent outlays are again expensed as incurred. Amortization of capitalized costs is computed by using a ratio of current and future gross revenues for the product, or by using a straight-line charge-off over the remaining economic life,

whichever is greater. Remaining capitalized costs are reported at the lower of unamortized balances or net realizable value of the product, with any write-offs reflected year by year. IFRS is used in many parts of the world, including the European Union, India, Hong Kong, Australia, Malaysia, Pakistan, GCC countries, Russia, Chile, South Africa, Singapore and Turkey. As of August 2008, more than 113 countries around the world, including all of Europe, currently require or permit IFRS reporting and 85 require IFRS reporting for all domestic, listed companies, according to the U.S. Securities and Exchange Commission. It is generally expected that IFRS adoption worldwide will be beneficial to investors and other users of financial statements, by reducing the costs of comparing alternative investments and increasing the quality of information. Companies are also expected to benefit, as investors will be more willing to provide financing. Companies that have high levels of international activities are among the group that would benefit from a switch to IFRS. Companies that are involved in foreign activities and investing benefit from the switch due to the increased comparability of a set accounting standard. (http://en.wikipedia.org/wiki/International_Financial_Reporting_Standards)

Another main difference between IFRS and GAAP is the way inventory is recorded. Under IFRS, LIFO cannot be used.IFRS also allows reversals of prior inventory write-downs to be made and recognized in income, unlike U.S. GAAP. However, GAAP provides the company with a choice between LIFO and FIFO. LIFO is the method of recording inventory where the latest goods purchased are the first to be sold. This method is primarily used for goods stored in piles, such as coal or wood. FIFO is the method of recording inventory where the goods that were purchased first, are the first to be sold. This is considered to be the most common method for recording the value of inventory. If IFRS is adopted with no changes made in the current standards and the current tax laws, then companies will have to pull the LIFO reserve back into

their taxable income over a four-year period. IFRS reports inventory at the lower of cost or net realizable value. US GAAP reports inventory at the lower of cost or market, where market is defined as a replacement cost with a floor and a ceiling. IFRS also includes intangible assets produced for resale, such as software, within the calculation of inventory, and storage costs are generally expensed.

Another aspect is consolidation. Consolidation refers to the aggregation of financial statements of a group company as consolidated financial statements. The term taxation consolidation refers to the treatment of a group of companies and other entities as one entity for tax purposes. Consolidation can also be described as a blending together of two or more undertakings into one undertaking, when the shareholders of each blending company, become the shareholders of the blended undertakings. Consolidated financial statements is a representation of how the holding company is doing as a group. The consolidated accounts should provide a true and fair view of the financial and operating conditions of the group. The goal of consolidated financial statement is to show the performance of the group as if it was a single entity. Consolidation is based on a control model– the power to govern, either directly or indirectly, the financial and operating policies of an entity to obtain benefits from its activities. A special purpose entity (SPE) is an entity created to narrow and define objective. SPE are consulted based on control. The determination of control includes an analysis of the risks and benefits associated with an SPE. Consolidation is based on a controlling financial interest mode, which differs in certain statements from IFRS.

IFRS is a principles-based framework, and the approach to consolidation reflects that structure. IFRS provides indicators of control, some of which individually determine the need to consolidate. However, where control is not apparent, consolidation is based on an overall

assessment of all of the relevant facts, including the allocation of risks and benefits between the parties. The indicators provided under IFRS help the reporting entity in making that assessment. Consolidation in financial statements is required under IFRS when an entity has the ability to govern the financial and operating policies of another entity to obtain benefits.

US GAAP has a two-tier consolidation model: one focused on voting rights (the voting interest model) and the second focused on a qualitative analysis of power over significant activities and exposure to potentially significant losses or benefits (the variable interest model).Under US GAAP, all entities are evaluated to determine whether they are variable interest entities (VIEs). Consolidation of all non-VIEs is assessed on the basis of voting and other decision-making rights.

Under both US GAAP and IFRS, the determination of whether entities are consolidated by a reporting entity is based on control. Although differences exist in the definition of control. All entities subject to the control of the reporting entity must be consolidated– although there are limited exceptions in US GAAP in certan industries. The consolidated financial statements of the parent and its subsidiaries may be based on different reporting dates as long as the difference is not greater than three months, under both sets of standards.

For many years, countries have had their own unique accounting practices. However, with the great need for globalization, it has become necessary to unify these accounting standards. By the late 90's, the two most prominent systems were IFRS and U.S. GAAP. Presently, GAAP is potentially going to converge with IFRS, causing the U.S. to change their practices. This melding of systems would possibly have an immensely negative impact on the United States and its businesses, due the differences between IFRS and GAAP. It has different aspects in it. It has Development Cost, Consolidation, and Inventory Portion.