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GAAP and IFRS

Accounting Research Paper

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Research Paper

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GAAP and IFRS are the main accounting systems in the world and determine all the rules and regulations for the accounting done by each country that uses them. GAAP is used principally in the United States, although the Security and Exchange Commission is looking to switch to IFRS by 2015, the system used in the European Union and many other countries. Many countries have their own accounting systems, although most conform to one main system or the other as they work to keep their markets modern. All accounting systems follow double-entry practices that categorize transactions as revenue or expenses, assets or liabilities. The two primary accounting systems have a few differences between them that may affect results in companies.

GAAP is set by the Financial Accounting Standards Board (FASB), mostly seen as an organization of accountants, financial analysts, and regulators who draw up accounting practices to meet ongoing changes in the markets. Every time some new issue comes up, the FASB studies the problem, develops a proposed accounting procedure, and sends it for comment and review to different users of financial statements, including analysts and corporations (acctstandards.com).

Accountants and auditors have a specific meaning in terms of GAAP (generally accepted

accounting principles). The American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct prohibits members from expressing an opinion or stating affirmatively that financial statements or other financial data “present fairly...in conformity with generally accepted accounting principles,” if such information contains any departures from accounting principles spread by a body designated by the AICPA Council to establish such principles (fasab.gov). There are many accounting standards in the world and each country uses their own version of generally accepted accounting principles, known as GAAP. These allow firms to report their financial statements in accordance to the GAAP that applies to them. The United States has been known for wanting to keep their own GAAP rather than converting to the rest of the worlds system which is the IFRS (investopedia.com)

The complication lies within whether the firm does business in multiple countries. How can investors then deal with the multiple standards at hand? Which ones are accurate? How can corporations be compared based on their financials? The answer to these questions is in the adoption of the International Financial Reporting Standards, or IFRS, which is being supported and developed by the International Accounting Standards Board (IASB). With more and more countries adopting the IFRS as their accounting standard, over 120 as of April 2011, investors and analysts should be well advised on how this transition affects company's reporting, and what it means moving forward (investopedia.com). The most widely used explanation for IFRS is that it is “principles based” while U.S. GAAP is “rules based.” Because IFRS has less rules, supporters argue that companies will be able to choose from a wide range of options as to how best to reflect a particular transaction. Furthermore, IFRS financial statements will benefit investors who will be able to compare companies from various countries easier. The assumption that flexibility and comparability can coexist in worldwide financial reporting standards will be a

challenge for young professionals to infer, especially if transactions can be recognized within the broad range of a set of accepted accounting principles (“entities within the same industry could report the same transactions differently, thus leading to decreased comparability of these companies’ financials”) (accountingweb.com).

United States adoption of IFRS is the main topic in the accounting world today. As U.S.-based accountants look ahead to a transition from U.S. GAAP to International Financial Reporting Standards (IFRS), a general agreement is building both in boardrooms and among investors that a reliable set of worldwide accounting standards is the ideal. The Securities and Exchange Commission (SEC) has recommended a gradual transition toward IFRS beginning with large, accelerated filers with fiscal years ending after 12/15/2015 (three-year IFRS balance sheets would need to be presented from 2013-2015). Young professional accountants need to get on the bandwagon with IFRS and embrace this transition as an opportunity to become experts in a field where many superiors may be less knowledgeable. Therefore, here are potential challenges that young professionals should watch for as the U.S. prepares for the transition to IFRS: 1) Flexibility versus comparability 2) IFRS today = U.S. GAAP at inception 3) IFRS may initially increase the cost of capital for U.S. investors (accountingweb.com). While the SEC focuses on disclosure and enforcement, US GAAP and IFRS accounting standards continue to converge. So, like it or not, US companies are currently being impacted by IFRS. Among the most significant changes coming our way are the final standards for Revenue Recognition and the re-Exposure Draft for Leases. Both of these standards will significantly impact companies, so the planning and implementation of these standards should be started well in advance of adoption dates (ifrsusa.wordpress.com). The United States is working its way towards converting to IFRS method but it will be a gradual progression. In the end, it will help them and add advantages to

the accounting system. The SEC does not want to make any loop holes to allow the US to have concepts from both systems so they must be willing to have IFRS and only IFRS; no exceptions for otherwise.

One problem is that the U.S. GAAP uses a rules-based approach for their accounting standards, while IFRS uses a principle-based, also known as an objectives-oriented approach. A rules-based approach sets very specific rules that must be followed precisely in order to comply with the regulations. The IFRS' principle-based method, however, has a few specific rules but little guidance on how to implement them. It requires ethical professionals to make sure the financial statements fairly and accurately represent the principles (Principles-Based Accounting Definition, 2012). In the case with the revenue recognition, US GAAP consists of several industry-specific and transaction-specific requirements that can result in different accounting for economically similar transactions. IFRS, by contrast, has fewer requirements that can be difficult to apply to complex transactions as they provide little guidance on difficult topics.

An example that helps compare the two approaches is accounting for leases. A long-term lease can be classified as either a capital lease or an operating lease. U.S. GAAP requires that for a capital lease the leased property be recorded as an asset along with a liability to pay for that asset. An operating lease does not require an asset or liability to be recorded. A problem arises from this standard because companies try to avoid reporting debt. Therefore, companies will stretch the rules in order to bypass FASB's four criteria for identifying capital leases that will result in a recorded liability. The FASB implemented the four criteria in order to help aid the accountant in deciding whether ownership of the asset has been transferred. IASB's lease accounting standard allows an accountant to use their professional judgment in order to determine if "risk and reward" of ownership has been transferred. Since the FASB's criteria is

designed to help the accountant decide whether the risks and rewards have been transferred, some professionals believe that this has allowed accountants to avoid using their professional judgment altogether and simply focus on the rules. Proponents of the objectives-based approach claim that since it focuses primarily on professional judgment, there are fewer rules to sidestep; thereby allowing accountants to arrive at an appropriate accounting treatment. Others argue that no rules will result in a large amount of abuse. Even in the absence of abuse, however, reliance on professional judgment may result in different interpretations for similar transactions which increases fears about comparability.

An example of an American company that avoided using their professional judgment is Global Crossing. They were a communication services company who filed for bankruptcy protection in the middle of an accounting scandal in which they were being charged of dishonest accounting, fraudulent swapping of assets and liabilities, falsely misleading shareholders, and the enrichment of top executives as other employees lost millions along with shareholders (Ackman, 2002). They did this by inflating earnings using capacity swaps which deals with the exchange of telecommunications between carriers that is recorded as a revenue without the occurrence of a monetary exchange (Global Crossing). Since U.S. GAAP permits a company to record revenue for a sales-type lease, Global Crossing purposely structured the contracts for these capacity swaps to meet one of its criteria. In order to be classified as a sales-type lease, the contract needs to meet one of the following four criteria: 1) the agreement specifies that ownership of the asset transfers to the lessee; 2) the agreement contains a bargain purchase option; 3) the non-cancelable lease term is equal to 75% or more of the expected economic life of the asset; and 4) the present value of the “minimum lease payments” is equal to or greater than 90% of the fair value of the asset. In addition to meeting one of previous criteria, the contract must also meet

both of the following statements: 1) the collectability of the minimum lease payments is predictable; and 2) no important uncertainties surround the amount of reimbursable costs to be incurred (Spiceland, 2012). Although their contract may meet the criteria for a sales-type lease, since there is no monetary substance being received, it is not economically sound to record revenue. This is an example where a rules-based accounting approach allows a company to disregard their professional judgment and make an inappropriate entry because the “rules” allow it. Due to U.S. GAAP’s framework, Global Crossing was able to incorrectly record revenue without being detected for several years until they went bankrupt. In 2005, they settled with the SEC, after it was determined that it did not comply with numerous accounting laws. This well-known scandal demonstrates that U.S. GAAP’s principles for revenue recognition has several flaws and needs to be updated.

As an accounting student with the professional world coming up ahead, it is uncomfortable to know that the methods being learned are going to be altered at some point. On the other hand, one should realize that accounting standards are frequently updated so that they can continuously improve. Therefore, it seems logical that this change needs to occur in order for financial statements to be comparable. Although the costs required by companies to implement this change will be substantial, the benefits will eventually outweigh these initial costs. Companies are becoming more and more international; therefore it is time to make accounting standards international as well. The costs and problems associated with the new standards are going to be extensive if the principles are put into effect this year or 20 years from now. The SEC has to realize this and agree to withdraw some of their control in order for accounting to become more international. The Boards have thoroughly researched revenue recognition from contracts with customers and spent several years perfecting the new standard. It is time to make

use of their hard work and have all countries use the same standards. This will cause for positive progression.

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