AUDIT COMMITTEE INSTITUTE

The Transition to IFRS: The Past Need Not Be the Future

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In this article, we discuss how audit committee members should begin to discern the potential impact that the changeover to IFRS will have on current financial reporting. Audit committee members will want to understand some of the general similarities and differences between Canadian GAAP and IFRS and the accounting policy choices available on changeover, including the elective exemptions on first-time adoption of IFRS.

From 2011, Canadian publicly accountable entities will cease to report under Canadian GAAP and instead use IFRS. While 2011 seems far in the future, Canadian publicly accountable entities should begin formulating their implementation plans now. The transition to IFRS is not merely an accounting exercise—it will affect a company's business systems, processes, and people. It may also impact the company's key performance indicators and performance-related compensation.

Even though the first IFRS financial statements need not be prepared for some time, companies will experience the phased transition to IFRS beginning in 2008. From now until 2011, certain Canadian accounting standards will be converged with IFRS prior to the actual changeover date—all the more reason to get started now!

Why should the audit committee begin considering the adoption of IFRS now?

One of the audit committee's principal responsibilities is to oversee the financial reporting process. Executing this responsibility under a new accounting framework will require obtaining an increased fluency in IFRS, something that will not be achieved overnight. Being aware of the accounting policy choices available under IFRS and the elective exemptions available to the company on changeover will assist audit committee members to oversee more effectively the convergence and overall transition to IFRS.

The changeover provides a one-time opportunity for management to rethink its past accounting policies and approaches and, where choices are available, make changes that are favourable for the company. Significant change can be risky, and management may be tempted to stay with the familiar and defer to past policies where still appropriate. The audit committee should ensure that management takes a long-range view with respect to the changeover, and considers all options.

Certain new accounting policy choices can be made on initial adoption of IFRS.

Overseeing the company's change to IFRS will involve ascertaining whether management has identified all of the relevant impact areas and considered their effect on the company's financial reporting process. Audit committee members should question the accounting policy choices made and elective exemptions taken by management on initial adoption. They should understand the trade-off between the impact on the company's conversion efforts and the effect of these decisions on post-changeover reported earnings and equity. These choices and elections should be made strategically so that the financial reporting impact on the company is acceptable to all.

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General similarities and differences between Canadian GAAP and IFRS

Similar …

Both IFRS and Canadian GAAP are based on similar conceptual frameworks. Many of the basic concepts in IFRS (e.g., the going concern assumption, accrual accounting) are similar to Canadian GAAP. Many recognition and measurement principles are similar, as is the general structure and content of the financial statements.

... yet different

"Similar" does not mean "the same."

Certain IFRS have fundamentally different recognition and measurement principles than Canadian GAAP. Other IFRS are similar, but "similar" does not mean "the same." The devil is in the details and differences still exist in the standards, their application, and their interpretation. How significant they will be for the company will depend on the specific facts and circumstances.

Some key differences include

- Impairment of long lived assets—IFRS require a fundamentally different approach to impairment testing. It could result in more impairment charges because the assessment of impairment is based on discounted cash flows, and IFRS require the reversal of impairment charges when circumstances change.
- Provisions—the recognition and measurement of certain provisions, including asset retirement obligations, is different under IFRS. IFRS also require provisions for onerous executory contracts (which are not generally required under Canadian GAAP), and the discounting of provisions is far more common.
- Defined benefit pension plans—under IFRS, past-service costs must be recognized over the vesting period, resulting in their faster recognition. For those past-service benefits that are fully vested, the entire cost is expensed immediately.
- Securitizations—sale treatment is very difficult to achieve under IFRS, and most Canadian revolving securitization structures will not likely achieve off-balance sheet treatment.

The initial accounting for property, plant and equipment may be onerous if component accounting had not been applied in the past.

The accounting for property, plant and equipment may appear similar to Canadian GAAP, but some differences exist that may require considerable effort to apply on conversion. For example, IFRS requires companies to apply component accounting to all separate physical and non-physical components of PP&E. The concept of component accounting exists in Canadian GAAP but generally is not as rigidly applied in practice.

While IFRS revenue recognition principles are similar to Canadian GAAP, the lack of prescribed rules and "bright lines" in IFRS could result in revenue being recognized later, or even earlier, than under Canadian GAAP. IFRS prohibits the use of the completed contract method to recognize revenue. In addition, there are a number of industry-specific differences affecting insurance, extractive, and rate-regulated entities.

More accounting policy choices to consider

In some cases, IFRS explicitly provide for more accounting policy choices than Canadian GAAP. Canadian companies can therefore depart from their past accounting policies and start anew, even if their current Canadian accounting policies are appropriate under IFRS.

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New accounting policies might recast the look of the company's balance sheet.

These choices create a unique occasion enabling management, with the audit committee's oversight, to select accounting policies that could potentially recast the look of the company's balance sheet. Management should identify the available choices and provide to the audit committee an analysis of the potential impact of the various choices on the company's financial statements. This analysis will help the audit committee to understand the impact of the choices both on transition and in the future. For example, a move to fair value revaluation for some balance sheet elements may seem more relevant, but it may entail trade-offs such as increased earnings volatility, higher amortization charges, and an increased need for internal or external resources to periodically establish those fair values.

… and even more judgment

A consequence of principles-based standards is the absence of detailed guidance for many specific accounting situations. The IASB's Interpretations Committee issues fewer interpretations than its Canadian or US counterparts.

IFRS has fewer "bright line" rules.

In some areas of IFRS, practice has evolved to allow for various accounting approaches—more choices that will require consideration. Ultimately, more choices coupled with relatively less interpretive guidance and fewer "bright lines" will require more professional judgment, especially when no specific guidance exists. For those accustomed to a rules-based accounting environment, this may seem daunting, particularly for unique and complex transactions. Others may welcome a break from the rules and the move to greater flexibility.

Management will need to identify the significant judgment areas affecting the preparation of the company's IFRS financial statements and communicate these to the audit committee. Management should explain its rationale in selecting specific accounting policies and the judgment applied so that the audit committee can consider whether the choices make sense for the company.

Understanding management's judgment process will be important. Overseeing this process will be key to evaluating that the company has not been too aggressive in selecting its accounting policies.

Adoption of IFRS

Generally the financial statements will be prepared as though the company always had reported under IFRS.

Once management has chosen the company's IFRS accounting polices, it will apply IFRS 1, *First Time Adoption of International Financial Reporting Standards* (IFRS 1) to transition to IFRS. Generally IFRS must be adopted retrospectively, as though the company always reported under IFRS. In preparing an opening balance sheet (e.g., January 1, 2010, assuming a calendar year-end with one year of comparative information) companies will generally need to derecognize from the balance sheet all assets and liabilities not satisfying IFRS recognition criteria and recognize those that do. For example, companies may need to derecognize items such as start-up costs and vested past-service costs in preparing the IFRS financial statements if they were previously recorded under Canadian GAAP.

Companies will also remeasure all recognized items according to IFRS. This process may include remeasuring certain liabilities on a discounted basis. It could also include recording impairment charges on the opening balance sheet date—an impairment test is mandatory for any existing goodwill and indefinite life intangible assets on transition to IFRS. Preparing an opening balance sheet may also require certain reclassification adjustments.

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The net impact of these adjustments will usually be recorded in opening retained earnings (or other equity accounts or goodwill if applicable).

Elective exemptions

IFRS 1 provides certain accommodations and elective exemptions to first-time adopters as "relief" from full retrospective application—companies can pick and choose from the available options. As one-off choices, they need not have any bearing on the accounting policies that the company will choose to apply in the preparation of its IFRS financial statements after the changeover. The audit committee will need to understand which exemptions are available and which exemptions management is considering electing.

Elective exemptions in IFRS 1 may bear little resemblance to past accounting practices.

The elections should be approached tactically—some may affect the company's financial results post-conversion, and "relief" on transition needs to be weighed against any post-conversion effects on earnings. The elections may bear little resemblance to how a company has accounted for certain transactions in the past under Canadian GAAP. Depending on the elections taken, the company may be able to manage how or when certain balances are recognized in income.

For example, a first-time adopter may elect to measure individual items of PP&E at fair value on transition date only. This election is separate from the accounting policy choice to measure PP&E using the revaluation model. Subsequent depreciation will be based on the higher fair value (i.e., deemed cost) post-conversion. This election may be attractive for companies that face the potentially onerous task of reconstructing an asset's cost base under IFRS (e.g., applying component accounting and recalculating capitalized interest). Before deemed cost is elected, a company will need to trade off the benefit of saved effort on transition against the impact of higher depreciation (and lower gains on disposal in the future) on reported earnings.

Consider all the options

The transition to IFRS presents a company with a one-time opportunity to evaluate its current financial reporting and make accounting policy decisions that could significantly affect its financial reporting. Do not underestimate the significance of these decisions because they will be made only once. A company should consider all available options under IFRS. Management should start early in the transition process and take a strategic approach to assess all policy choices, followed by the specific elective exemptions. Certain decisions may give the company an opportunity to change past practices under Canadian GAAP. A company may be able to change the timing of income or expense recognition in future periods. It may also be able to change the amount of reported earnings as some policies will result in gains or losses being expressly included in income or in equity.

These decisions are very important. The audit committee should be asking management to start looking at these matters now. In this way, management can begin to provide the audit committee with an understanding of the company's changeover to IFRS. This knowledge will allow the audit committee to provide effective oversight during this important financial reporting transition.

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