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Canadians Speak a New Reporting Language in 2011: The Transition from the Generally Accepted Accounting Principles to the International Financial Reporting Standards

As governments enter into trade agreements and lower trade barriers, the economy becomes more global every day. International trade, however, does not happen seamlessly. Oftentimes there are language barriers that hamper effective communication. Other times, international players have language problems of another type: they do not speak the same "business language." One area where this arises is in the "language" of accounting. What is required, then, is some uniformity.

In an effort to promote uniformity as well as public accountability, the Canadian Accounting Standards Board (ASB) and the Public Sector Accounting Board (PSAB) have adopted, effective January 1, 2011, the International Financial Reporting Standards (IFRS) for publicly accountable enterprises (PAEs) and government business enterprises (GBEs). Private enterprises, for their part, were given the option to adopt IFRSs or the new Canadian standards developed specifically to meet the needs of users of their financial statements for fiscal years beginning on or after January 1, 2011.

The IFRS are a uniform set of global accounting standards developed by the International Accounting Standards Board (IASB). The IFRS are currently in use in over one hundred countries, including countries in the European Union and much of the Pacific Rim, as well as India, Japan, Brazil and now, Canada. The United States will be joining the trend later this year.

The IFRS are intended to displace Generally Accepted Accounting Principles (GAAP). As a result, adoption of the IFRS comes with a steep learning curve as entities will be required to learn and implement a whole new set of accounting rules. For some, the changes will have no material effect on reported performance, financial position and cash flow. For others, there may be material differences in nearly every financial statement line item.

The IFRS differ from the GAAP in the following respects, amongst others:

- Impairment – Under IFRS, impairments will generally be triggered more often but unlike Canadian GAAP, these impairments will be reversible;
- Securitization – IFRS are fundamentally different in this area from Canadian standards; and
- Re-valuations – Some IFRS, such as those relating to property, plant and equipment, investment property and intangibles allow the re-valuation of assets under certain circumstances.

The following are examples of potentially significant issues faced by financial institutions:

- Under the IFRS, securitized receivables are more likely to be treated as collateralized borrowings than as sales (this reflects the fact that sales focus more on transferring the risks and rewards of ownership and focus less on control);
- Variable interest entities not consolidated under GAAP may be consolidated as special purpose entities and vice versa; and
- Stock compensation programs are likely to be treated differently under IFRS, potentially affecting income, liabilities, and equity.

The transition to the IFRS, however, extends beyond the financial reporting process - it affects a wide range of contractual agreements which rely on the Canadian GAAP standards. Credit agreements which use GAAP to determine financial terms, for example, will have to be amended so as not to prejudice the borrower's ability to meet its financial covenants under the agreement. The same is true for the array of agreements which require calculations in accordance with GAAP standards or which are driven by reported earnings, such as banking, royalty, joint venture, sales, employment compensation, bonus plans, and licensing agreements. Arrangements as a result of mergers and acquisitions will also be affected by the transition and special attention will have to be paid to the impact of the change on purchase price adjustments, earn out agreements, and post-acquisition earnings. Contracts drafted to support specific accounting results for leases, derivatives, and securitizations will have to be carefully analyzed as requirements will change. Reporting, disclosure requirements, risk factors and internal controls under securities laws will also be substantially affected by the transition. Finally, corporations will have to implement protocols, policies and procedures to insure a smooth transition to the IFRS and avoid the risk of litigation based upon the application of principles and the use of management's judgments and estimates.

Although the IFRS aim at enhancing transparency, consistency, and global comparability, the level of effort required to adopt the IFRS and make a successful transition, should not be underestimated. In light of this, the IASB introduced the First-time Adoption of International Financial Reporting Standards (IFRS 1), which are intended to provide relief to companies changing over to IFRS. Under the IFRS 1, there are optional exemptions for the retrospective application of IFRS to certain areas. These exemptions are intended to make the transition easier and less costly.

Key success factors in implementing the IFRS include having appropriate project planning activity and incorporating business units outside of the finance function. Those entities implementing the IFRS should engage senior executives, directors, investors, analysts, lenders, regulators, and legal counsel in understanding the wide implications of a move to the IFRS. ■

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