

## Global Financial Reporting Growing Prominence of IFRS: Implications for Transactional Attorneys

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### What are International Financial Reporting Standards and why should attorneys care?

International Financial Reporting Standards (IFRS) are rules that govern the preparation of general purpose financial reports, as established by the London-based International Accounting Standards Board (IASB). Created in 2001, IASB is the successor to the International Accounting Standards Committee (IASC), which had been established in 1973 in an effort to foster the development of high-quality standards for worldwide usage, to overcome the limitations of having widely divergent financial reporting standards under various national regimes of generally accepted accounting principles (GAAP).

Prior to 1973 (and for most of the years subsequent to that date), each nation – whether via private sector professional bodies or by government sanctioned regulations – dictated the financial reporting standards to be adhered to by businesses and other reporting entities domiciled there. For example, US GAAP – a highly developed, prescriptive set of requirements that had evolved over the twentieth century

as the only formally recognised rules for financial reporting by commercial enterprises – was officially endorsed by the Securities and Exchange Commission (SEC) for public company financial reporting in the United States, while UK GAAP was similarly endorsed for British company financial reporting, but important differences existed between these two sets of rules. Other discrepancies (sometimes having more fundamental effects) existed between US GAAP and, say, German, French and Italian standards, and so forth.

Having different financial reporting standards obviously served as an impediment to international commerce, capital flows and economic growth, as investors, creditors, vendors and customers struggled to interpret financial statements prepared in accordance with other national GAAP standards. The effect of such difficulties largely mirrors that caused by tariffs or other forms of restrictions on international trade – these all serve as artificial restraints on economic development, which harms nations imposing barriers as well as those against whom those constraints are directed.

The IASC (and later, the IASB) has been committed to developing financial reporting standards that would be suited for universal adoption, but has faced a number of daunting obstacles, including the fact that, as a private sector international organisation, it has never had the authority to impose standards on any nation's financial reporting rule-making bodies. Thus, it was only able to use moral suasion as a tool to achieve its stated goals. For most of the first 20 years of its existence, it struggled to find common ground among the various national GAAP sets of rules, effectively endorsing what many perceived to be 'lowest common denominator' standards that encompassed many, if not most, of the specific requirements that had been set down by the major nations' accounting standard setting bodies.

The effect was to permit, under what were then known as International Accounting Standards (IAS), a wide variety of specific accounting methods for identical economic transactions – eg allowing both historical cost and current value (ie revaluation) methods for accounting for productive plant assets, and as many as five different costing methods for inventories – which

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meant that nominally uniformly IAS-based financial statements could vary greatly in how income was measured and how assets and liabilities were being reported. As a practical matter, until the mid to late 1990s, IAS had a major impact only on lesser-developed nations – those lacking accounting standard setting bodies of their own, which eagerly embraced IAS as a ready-made set of standards where previously there had been none (or where standards bequeathed by former colonial powers, particularly the United Kingdom, had been carried over).

Beginning in the mid 1990s, however, the IASC began to gain wider recognition. Thanks to a negotiated agreement with the International Organization of Securities Commissions (IOSCO) – the association of major nations' securities regulators – the IASC was encouraged to narrow available accounting alternatives and improve many already-extant IAS, with the expectation of endorsement for cross-border securities registrations. The IASC undertook several concentrated programmes to review and revise existing standards, eliminate some (not all) available alternative accounting treatments and add new standards to address evolving or complicated forms of economic transactions (eg those involving complex financial instruments). This ultimately led to IOSCO's qualified endorsement in 2000, although it had no power to require its membership (eg the US SEC) actually to act on its recommendation. Still, there was increased momentum towards universally accepted financial reporting standards.

The IASC's role as an accounting standard setter faced various challenges over the years. One of these was from the US private sector standard setter, the Financial Accounting Standards Board (FASB), which, as creator of the world's most detailed financial reporting standards, viewed the IASC's standards as inferior and as the end product of a less rigorous 'due process' than was the case in the United States. Some observers believed that the FASB harboured aspirations of becoming, at least, the de facto financial reporting standard setter for the world, but for several reasons – most notably issues of national pride and resentment against US domination of international financial reporting rules – this was never a real

possibility. Notwithstanding this fact, the FASB was able to press the SEC to insist on the need for improved standard-setting procedures by the IASC as a precondition for its ultimate acceptance of IFRS-based securities registrations in the United States. Ultimately, this culminated in the restructuring of the IASC into the IASB, with deliberative processes modelled on those of the FASB.

Once established, the IASB carried forward previously promulgated standards (IAS, plus interpretative guidance known as SICs), and commenced creation of new standards (IFRS) and additional interpretations (IFRICs). It also lobbied for recognition by the world's securities regulators. By the mid 2000s, over 100 nations either permitted or required IFRS compliance, most commonly by publicly-held companies, but in some instances for use by privately held entities as well. The IASB also negotiated several 'convergence' efforts (eg with US GAAP and with UK GAAP) with national standard setting bodies and, in a most significant achievement, succeeded in gaining endorsement by the European Commission, mandating that all EU-based publicly held companies file consolidated financial statements based on IFRS beginning in 2005, which now affects as many as 6,000 companies.

As a result of the foregoing developments, today IFRS-based financial reporting is widely utilised, and it is clear that near-universal use of IFRS by not only the developing nations (including China, India and Russia), but by the most highly economically developed ones also is merely a question of time. For example, Australia adopted its equivalents to IFRS standards in 2005, and Canada (whose national GAAP formerly mirrored US GAAP) has announced that it, too, would convert to IFRS in 2011. The United States and United Kingdom, both committed to 'converging' to IFRS, are among the few nations still, in theory, reluctant to concede the standard-setting role to the IASB.

The US reluctance, however, may abate due to important recent developments. The SEC – which formerly required foreign companies ('private issuers') registering securities in the United States and filing financial statements prepared under foreign

GAAP to reconcile net income and equity to corresponding amounts under US GAAP – has proposed waiving this requirement if the financial statements comply with IFRS (no similar waiver would apply to any other national GAAP), and this is almost certain to be formally enacted before the 2007 year-end. In a further, unexpected move – stimulated by demands of US publicly owned companies for equitable treatment – the SEC issued a 'concepts release' raising the prospect that even US companies could be permitted to use IFRS (that is, abandon US GAAP entirely).

If this ultimately is permitted (which remains an open question), the future role for US GAAP would be placed in serious doubt. Even if this does not quickly develop into a formal proposal, which is then enacted as a rule, the ongoing 'convergence' efforts between US GAAP and IFRS – which have already resulted in at least half a dozen major changes to US GAAP and to IFRS over the past few years – will continue, with all remaining material differences to be eliminated within about one more year. This may serve to make the distinctions between these two sets of standards more a matter of terminology than of substance.

Thus, there is a high probability that financial reporting by both US-based and foreign companies will see further, fundamental changes over the rest of this decade. While the end of this process may be near-universal financial reporting requirements, the road towards that ultimate result will be strewn with hazards for entities engaging in a wide range of relationships and transactions, and for the attorneys that represent them. Major differences between, eg, US GAAP and IFRS still remain, and entities negotiating various arrangements (such as joint ventures or equity investments calling for profit sharing) with foreign companies may run afoul of these, risking later recriminations and even litigation or other disputes.

A number of strategies may assist companies, and counsel, in preventing costly and risky disagreements from later arising, but these must be invoked before, not after, transactions are finalised.

### **How does the quality of financial reporting differ across national boundaries?**

While, nominally, foreign companies will present financial statements under either IFRS or national GAAP (eg German GAAP, UK GAAP, Japanese GAAP), compliance with any of these will often be found to vary. Thus, it is not simply a matter of which standards reporting entities claim adherence to, it is also a function of interpretation and accuracy of application that determines the quality of financial reporting.

Many instances have been noted (some of which involved major cases of financial reporting fraud) where financial statements have been represented to conform to one (or more!) sets of GAAP requirements, but in fact departed from some of those. Since GAAP departures are often subtle and not obvious to those not expert in financial reporting matters, users typically would rely for decision-making purposes on financial statements that did not faithfully represent the financial position and/or results of operations, in at least some important specific regards.

Independent auditors' reports ('opinions') on the subject financial statements, of course, are supposed to provide comfort (typically defined as 'reasonable assurance') to the users of the financial statements that they are presented on the basis claimed, whether national GAAP or IFRS. Users of financial statements, who generally are not themselves accounting experts, rely on those opinions in most cases, and where such reliance is later found to have been misplaced, litigation is often the ultimate result.

Several factors affect the quality of financial reporting, and the wisdom of relying on the auditors' opinions on entities' financial statements. First, it must be recognised that not all audits are conducted under the same auditing standards, which vary from one jurisdiction to another. As with financial reporting standards, there are various national sets of auditing standards (often called generally accepted auditing standards, or GAAS), as well as a set of international standards on auditing (ISA) that have been promulgated by the

International Federation of Accountants (IFAC), another body having no authority to impose its rules on national standard setters or securities regulatory authorities. Auditing standards differ significantly from accounting principles, being more behaviourally-oriented in nature (eg regarding audit engagement performance, evidence gathering and judgments to be made), and thus tend to be less diverse than national GAAP have historically been, but there are still many divergent rules.

Second, the application of auditing standards can vary dramatically from one jurisdiction to another, and among different auditing firms, based on the quality control in effect. History has demonstrated, of course, that even the most esteemed of firms have experienced, from time to time, catastrophic audit failures, where materially false and misleading financial statements have been granted unqualified ('clean') opinions, to the detriment of those relying on those financial statements to make economic decisions. The variation in audit quality among firms is probably far greater than is the variation across jurisdictions, making the decision to rely on auditors' opinions more problematic, unfortunately. This ultimately places more responsibility on the users, and on their professional advisers (which may include accounting counsel as well as legal counsel).

Third, enforcement of accounting and auditing standards, particularly across national boundaries, is problematic. For example, if a foreign-based auditing firm opines on the financial statements of a foreign company, there will be a question of which, if any, regulatory body has oversight regarding the quality of that auditor's performance. While – should financial reporting failure later be determined to have occurred – private litigation will be available to the aggrieved party, this is a costly process (more so when foreign jurisdictions are involved) and is not a satisfactory alternative to having effective regulatory oversight.

Fourth, even adherence to a stated national GAAP or IFRS may not imply full compliance. Most notably, EU-based companies reporting under IFRS are not complying with the full set of standards promulgated by IASB and its

predecessor, IASC. The EU endorsement mechanism resulted in several 'carve-outs' of provisions of IFRS (in particular, with certain requirements pertaining to accounting for financial instruments), so that nominally IFRS compliant reporting by EU-based companies will not be consistent with IFRS financial statements prepared by, say, Australian or Japanese companies. This caveat presupposes a good faith effort to comply with promulgated rules – and experience suggests that not every reporting entity makes that level of effort, for a range of reasons.

Finally, the quality of financial reporting is heavily influenced by the quality of corporate governance within the reporting entities. As has been widely observed in the financial reporting frauds experienced in the late 1990s and early 2000s, the 'tone at the top' of business and other types of entities informs organisational values down to the lowest levels, and this heavily influences the behaviour of those responsible for financial reporting. In those cultures and companies having stronger commitments to the principles of good governance, financial reporting is more likely to be accurate, honest and transparent, whatever set of accounting principles are being subscribed to.

Thus, while broad generalisations about quality of reporting across national boundaries would not be valid, it is nonetheless true that variations among reporting entities have been and will continue to be experienced, and this is exacerbated by having different financial reporting (GAAP) regimes and different auditing practices apply. Those embarking on commercial relationships or major transactions with entities whose financial statements are presented in accordance with foreign GAAP (or IFRS), and whose financial reports are certified by auditors employing foreign GAAS (or ISA), should therefore make the effort to both understand those alternative financial reporting and auditing regimes, and to verify that they have been complied with, before going forward with the proposed transactions.

### **What transactions may be affected by differences in accounting and auditing standards?**

Virtually any material commercial arrangement or transaction – where the initial decision to invest in, or associate with, another enterprise is based on its audited financial statements – risks being the victim of financial misrepresentations. For example, even a simple decision to extend credit to a new customer, if based on financial statements, could become a matter of contention if it is later discovered that the counter-party was not as solvent or profitable as had been stated. Barring financial reporting fraud, this might relate to the application of foreign financial reporting standards that were not understood by the US-based entity. While these differences have been substantially reduced over recent years (particularly as the US GAAP–IFRS convergence projects have borne fruit), a number of differences still remain to be resolved, making it a matter of importance that contracting parties have an up-to-date understanding of the remaining financial reporting distinctions.

Business acquisitions and dispositions are the most obvious types of transactions where disputes should be anticipated. In many such cases, transaction prices are based on ‘book values’ represented as having been computed in accordance with GAAP, and often a post-closing audit is prescribed as a means of calculating the final transaction price. Even if a particular GAAP is clearly defined (eg US GAAP), there are many areas where judgments are applied (eg inventory costing and reserves; useful lives for depreciable assets; pension accruals) in the normal course of events. These often become matters of contention after transactions are entered into, and many of these disputes evolve into protracted and costly litigation, which can only be more difficult when international transactions are involved. The more precisely these accounting issues are addressed (eg even to the extent of explicitly defining GAAP practices such as useful lives, inventory costing methods), the less likely will be such disputes. Alternatively, consistency with recent prior practices can be stipulated.

Where a post-closing audit is called for, GAAS matters should be defined contractually. If the post-closing audit is to be conducted in accordance with

US auditing standards, this should be stated; if ISA is to be used, that should be made explicit. Identification of an independent auditing firm (ie neither the buyer’s nor the seller’s regular outside accounting firm) is typically a wise move, also. If the transaction involves an earn-out arrangement (common in business acquisitions), having an independent audit of the earn-out computations is recommended.

Accounting for business combinations (relevant to acquisitions of business units such as subsidiaries) varies across national GAAP and IFRS, particularly as to the allocation of the purchase price to specific assets and liabilities, including goodwill (the excess cost over identifiable net assets, typically encountered in such transactions), since such allocations will often have an effect on subsequent period earnings, on which earn-out payments will be calculated. For example, under certain national GAAP goodwill will be amortised, reducing periodic earnings in a prescribed pattern, whereas under other GAAP no such amortisation will be permitted. Where amortisation of goodwill is proscribed (as is now the case under US GAAP), periodic testing for impairment may be demanded, and any impairment so determined will be reflected as a charge against earnings. It will obviously benefit the buyer, if subject to an earn-out payment requirement under the contract, to discover the need for an impairment charge – which could easily mitigate or completely eliminate the pay-out obligation. It is therefore vital (from the seller’s perspective) that this be carefully circumscribed in the buy-sell agreement, if later disputes are to be avoided. Understanding alternative GAAP treatments is a necessary condition to such an undertaking.

Even payment obligations under seemingly mundane arrangements may suffer unless GAAP differences are understood and addressed in contractual commitments. For example, a long-term supply arrangement may provide the vendor (say, the foreign company) with a promised return over its actual production costs, determined ‘in accordance with GAAP’. Under some, but not all, GAAP standards, those production costs may include allocations of various overhead categories, including idle plant

costs, and various inventory costing schemes (LIFO, FIFO, et al) may or may not be allowed. Unless the contracting parties fully appreciate the GAAP differences, these matters may be ignored, and later disputes may arise. Again, counsel can assist if provided with detailed GAAP comparisons in advance, so that useful contractual provisions (such as prescribing cost elements that may be assigned to inventory, regardless of national GAAP practices) can be negotiated.

Some arrangements may call for compensation to be made such that the counter-party (say, a vendor) will enjoy a defined ‘return on investment’ over a defined time horizon. This may be encountered, inter alia, where the vendor has to make capital investments (such as new machinery) in order to provide the promised product deliveries to the customer. A number of accounting determinations will affect the determination of the investment, and hence the achievement of the defined return thereon. For example, under IFRS (until very recent revisions) it was acceptable either to expense interest incurred during the construction period of long-lived assets, or to add these costs to the carrying amount of the investment; US GAAP demands capitalisation of construction period interest when certain conditions are met. Unless this distinction was appreciated, later disputes over the computation of the return on investment could easily have arisen. This complication would be in addition to those arising over the choice of depreciation methods (straight-line, accelerated, etc) and useful lives. If these variables were prescribed in the contractual arrangement, such disputes would be obviated.

### **What are the tax implications of adopting IFRS for financial reporting?**

In most European jurisdictions (in contrast to the situation in the United States), the accounting principles that must be applied in the presentation of financial statements is dictated by law, publication of financial statements is required and income taxes are imposed based on the earnings reported in such ‘statutory’ financial statements. Adopting IFRS may inadvertently affect or interfere with a reporting entity’s tax position in those nations where taxes

are determined with reference to the entity's statutory (ie separate company, non-consolidated) financial statements. Thus, to the extent that IFRS are applied in the preparation of financial statements heretofore prepared in accordance with some other basis of accounting (such as national GAAP), doing this may result in major changes to the tax treatment of financial statement items and affect the entity's effective tax rate, the determination of deferred taxes, or the tax treatment of, inter alia, intangible assets or derivative financial instruments. It may also encourage or increase the pressure on management to manage their effective tax rates more proactively.

In many countries, currently, IFRS is mandated only for consolidated financial statements, while taxes are imposed based on statutory financial statements, which are generally still required to comply with local GAAP. In many Continental European countries (all of which belong to the European Union with the exception of Switzerland and Norway), there is a close link between accounting and taxation rules in order to avoid any significant tax effects of timing differences. Since the adoption of IFRS is only (with rare exceptions) required for consolidated financial statements, there is a distinction between individual financial statements (prepared under statute and used in calculating income tax) and consolidated financial statements (prepared under IFRS and not used for tax reporting). IFRS-based consolidated financial statements will, with rare exceptions, need to provide inter-period tax allocation, since the resultant differences will almost certainly be in the nature of timing differences – that is, the question is when, not if, items taxable or deductible for financial reporting purposes will become taxable or deductible for tax reporting purposes, or vice versa.

When and if it is proposed that separate entity (ie statutory, nonconsolidated) financial statements become mandatorily (or optionally) IFRS-based, taxing authorities are likely to raise concerns or objections. To the extent that IFRS would require differential treatment of revenues or expenses than is the current rule under statutory requirements, the impact on tax collections would be closely examined. To the extent that IFRS permits reporting

entities to choose among acceptable measurement methods, management could well be motivated to 'manage' taxable income, a practice that might not be welcomed.

Currently, each of the 27 Member States of the European Union has the option of extending the application of IFRS to unlisted companies and to individual company financial reporting. The extension of the IAS Regulation, requiring European companies listed in an EU or EEA securities market to prepare their consolidated financial statements in accordance with IFRS, to individual financial statements (statutory accounts) in Continental European countries, is not expected in the near future because these statements are used to determine taxable income.

For instance, the United Kingdom is moving towards a position where companies will be able to elect to prepare their individual financial statements under IFRS. This will automatically affect the taxable income calculation for companies so electing. Whether taxable income can be controlled or lowered through new IFRS accounting methods, or similarly, if a particular industry that will have a different profile under IFRS vs UK GAAP, should they elect IFRS, depends on how the tax authority will address items that have not been within the realm of financial reporting previously.

The foregoing is not intended to convey an expectation that IFRS-based reporting would always yield tax advantages, even if this were to become permissible for tax reporting purposes. There are circumstances where using national GAAP may be advantageous. It can, for example, be seen that in Switzerland, under existing laws, Swiss GAAP is very conservative and allows a company to establish 'prudent' reserves for tax purposes as long as they are established for reporting under Swiss GAAP. Many Swiss companies will establish these reserves since they are relatively unconcerned what Swiss GAAP net income is, and are only interested in the reporting GAAP of the parent company (ie on a consolidated basis, applying IFRS). It is conceivable that a similar phenomenon could occur with the adoption of IFRS

reporting requirements for individual financial statements.

In order for companies to identify the tax effects of implementing IFRS or of incorporating IFRS accounting principles into national GAAP, the first step should be to identify the impact on the financial statements of IFRS-based reporting, both at the transition date and for future periods. Next, it will be necessary to establish whether or not there are specific tax rules applicable to particular transactions, especially on transition to the IFRS framework. Where the tax treatment of a transaction differs from its accounting treatment, the practical difficulty of identifying those transactions for tax computational purposes will remain.

Some fundamental differences may exist between IFRS and national accounting rules, and these may require the tax authority to give consideration to the manner in which these might be dealt with for tax purposes. These significant accounting differences may include:

- the increased use of fair value measurements, particularly for financial instruments;
- more capitalisation of deferred costs that may have been expensed previously, eg development costs;
- more recognition of specific types of intangibles;
- the treatment of actuarial differences on defined benefit pension schemes;
- bifurcating certain bonds into debt and equity components for accounting purposes;
- acceleration or deferral of income due to new income recognition rules; and
- new accounting disclosures.

IFRS requirements for consolidated financial reporting raise other concerns. One of the greatest of these pertains to the calculation and explanation of deferred taxes on consolidated statements. In many continental European countries, for instance, there has not been a tradition of accounting for deferred taxes. In Belgium, where statutory accounts are the basis for the income tax return, temporary differences between income in the statutory accounts and taxable income are mostly limited to items such as excess depreciation

and taxed provisions (eg estimated liabilities), giving rise to deferred tax assets. The prudence principle, which is a basic accounting assumption under Belgian GAAP, does not encourage companies to record deferred tax assets in their consolidated financial statements, although it is allowed. Consequently, recognition of deferred taxes has been one of the major adjustments to the IFRS financial statements at the time of adoption of IFRS-based reporting.

Financial reporting under IFRS involves a conceptual change in accounting for income tax, which requires a balance sheet method to calculate deferred taxes, and companies may struggle with its complexity. Additionally, implementing IFRS may have a significant impact on the recognition of deferred taxes as well as on the effective tax rate of companies and their reported tax balances, increasing pressures on management to manage their effective tax rates more proactively.

The FASB is conducting a joint project with the IASB to eliminate differences in approach in recognising deferred taxes (eg addressing remaining ‘exceptions’ to full inter-period allocation; measuring deferred tax assets; and the requirement for ‘backwards tracing’ to shareholders’ equity for certain temporary differences). The IASB has agreed to converge with the US GAAP standard, SFAS No 109, on several items, but intends to hold its ground on others.

### **What specific steps can I take to protect my client’s interests in international commercial transactions?**

The standard prescription that ‘an ounce of prevention is worth a pound of cure’ applies to commercial transactions in general, and to those involving foreign GAAP and GAAS even more so. Given the fact that financial reporting requirements are in the midst of the process of ‘convergence’, and that many important differences remain to be addressed, it would undoubtedly be valuable to make use of tables or checklists highlighting GAAP–IFRS (or other national GAAP) discrepancies to be used in making business and contractual decisions. These would be of particular value to any negotiations involving joint investments

or profit-sharing arrangements, including earnout agreements associated with sales of operations to foreign entities, where the selling party (say, the US company) will be compensated based on future earnings of the operations sold to a foreign company that will thereafter report under different accounting standards.

Appropriately armed with detailed guidance on the pertinent differences between the financial reporting standards by sellers and buyers, the attorneys can construct a contractual provision that will best serve the client’s interests. One alternative is to include a ‘frozen GAAP’ provision – meaning that, for the life of the contractual arrangement (eg over the three-year earnout term) the operating results of the transferred division must continue to be measured (for contractual purposes, at least) under the GAAP that had been employed by the selling entity. Should this not be feasible, the knowledgeable seller can instead demand terms that will compensate it appropriately under the buyer’s GAAP (eg by applying a different profit sharing percentage).

The following specific actions can be considered as a ‘checklist’ of defensive steps to be taken in advising or assisting clients contemplating major transactions with foreign entities, ranging from joint ventures and acquisitions to firm supply agreements.

(1) *Obtain several years’ financial statements of the intended counter-party enterprise.* Five years’ financial statements should be considered a minimum, to avoid being misled by a recent, unsustainable interlude of exceptional performance. Audited financial statements, certified by a reputable firm of certified public accountants (or the equivalent under various foreign regimes), should be deemed far more reliable than unaudited financial statements (eg reviewed, compiled or assembled financials). If the auditors are unfamiliar, it would be advisable to ask the client’s regular independent accounting firm to make inquiries through its international network to learn about the foreign firm’s reputation.

(2) *Closely read the financial statements and auditors’ reports to ascertain which set of financial reporting standards have ostensibly been utilised for the preparation thereof.* For example, the financial statements may purport to be in conformity with IFRS, or with various national GAAP such as UK GAAP. Be wary of any representation (in either auditors’ reports or financial statement footnotes) suggesting that the financial statements simultaneously conform to more than one set of reporting standards (eg IFRS and UK GAAP), since this is virtually impossible to achieve if the financials fully apply one of the comprehensive sets of GAAP. Also, note if and when the entity has recently adopted a new set of financial reporting standards, and if so pay particular attention to any adjustments made in the conversion process. It is not uncommonly observed that the occasions of major transactions (such as business combinations) or events (the adoption of new accounting principles) have been used to perpetrate financial reporting schemes, such as provision of ‘cookie jar’ reserves. In particular, adoptions of IFRS has been found to have encouraged a number of entities to embrace restatements of long-lived assets to revalued (fair value) amounts, which have not always been firmly grounded in verifiable values. (Note that IFRS has a particular, rather detailed standard directing how first time reporting under IFRS must be accomplished.)

(3) *If the proposed counter-party enterprise prepared its financial statements in accordance with any set of standards other than US GAAP, obtain a comprehensive comparison of the foreign standards with US GAAP.* Several of the major international CPA firms offer, via their websites, complimentary guides comparing specific foreign GAAP to either US GAAP or IFRS, and various comparison tables also can be found in other publications, such as *Wiley IFRS 2007*. Identify the

areas of potential discrepancies that are pertinent to the entity being reviewed. For example, if the target entity has significant self-construction of long-lived assets, be aware that IFRS permitted (until very recent change in rules) immediate expensing of construction period financing costs, whereas US GAAP requires that interest be added to the asset cost and subsequently amortised over its useful life. Another example: LIFO inventory costing is popular in the United States and typically depresses earnings and reported inventory values, but under IFRS the use of LIFO is now prohibited, so earnings may appear higher than would otherwise be the case. Yet another: IFRS permits revaluations of long-lived assets (ie write-ups for inflation) whereas US GAAP mandates historical cost accounting, meaning that US GAAP-based balance sheets might be more conservatively reported than IFRS-based ones, assuming the reporting entity elects that option.

- (4) *Consider how the differences in financial reporting practices might have an impact on the proposed transaction or commercial relationship.* Users of financial statements commonly select certain data contained therein to construct one or more indicators, and then use those computed criteria to assist in the decision-making process. Common indicators are those pertaining to cash flows or profitability, those implying a range of transaction values (eg multiples), and those addressing operating characteristics (eg expense ratios). It is obviously critical that, if any such indicators are to be constructed and utilised, the bases for the financial statement captions from which these indexes are to be calculated must be fully understood, and that, eg, GAAP-IFRS differences not be hidden within faulty indicators.
- (5) *If the differences in accounting principles are more than trivial, consider engaging an accounting expert (eg consultants, university professors, international CPA firms) to recast the target entity's*

*financial statements into US GAAP basis. With the sudden awareness of the growing relevance of IFRS (and the diminishing importance of other national GAAP), many firms are gearing up to develop in-house expertise, and more universities are teaching international accounting courses.* It should therefore be possible to obtain the services of a qualified adviser who can explain the impact that non-US GAAP financial reporting might have on the key information elements (eg working capital and other solvency indicators) being used to base client decisions on. Thanks to the internet, finding qualified help should rarely be difficult – in fact, even ‘Googling’ terms such as ‘international accounting expert’ reveals the existence of many score such consulting experts.

- (6) *If the recast financial statements seemingly should affect the client's decision making (eg the amount to be paid for an acquisition, or invested in a joint venture), obtain agreement from the proposed counter-party as to the propriety of any adjustments made.* It is not unlikely that the counter-party will lack a detailed (or even any) understanding of US GAAP, and therefore may not be capable of agreeing with the proposed adjustments to bring its financial statements into conformity with US GAAP. However, unless the prospective business partners reach an understanding, later disputes become much more probable. An alternative approach in such situations would be to have qualified assistance to convert the US entity's (the client's) financial statements into foreign GAAP (most likely, into IFRS). The objective is to facilitate an ‘apples-to-apples’ comparison, and it is actually less important which set of standards is used to accomplish this. However, there will be more effort required to educate the US client if its financial statements are to be recast, probably further underscoring the need for qualified assistance from accounting experts.

- (7) *Consider the foregoing in developing proposed representations and warranties to be incorporated into the contractual agreement.* For example, if the foreign counter-party's financial statements were recast, its formal acknowledgment of the propriety of the revisions should be obtained and set forth in the agreement, so that ownership of the restatement is assumed by the counter-party, which would affect the basis for any later claims regarding misrepresentations made (eg the counterparty's assertion as to its net current assets at the transaction date). It is important that no opportunity be left for either party to direct responsibility to the consulting accountants who ‘translated’ from one set of financial reporting standards to another, whose work must be ratified by the contracting parties.

In addition to the foregoing precautions, specific provisions can be negotiated into the transaction so that disagreements over the application of differential GAAP can be economically and efficiently resolved. In some instances, accounting experts have been identified and granted final authority over GAAP application issues, to avert costly litigation, or, at minimum, it is contractually agreed that such disputes will be directed to experts having defined credentials for resolution.

In summary, the parties entering into international commercial transactions and relationships, and their legal advisers, should endeavour to be fully informed about GAAP (and GAAS, where relevant) differences, and to evaluate carefully the impact those differences may have on the economics of the events. In the more complex of these situations, thought should be given to engaging appropriate experts to assist. To minimise later disputes, specific GAAP treatments should be set forth in the agreements whenever later disputes can reasonably be anticipated. While convergence clearly looms on the horizon, there remain many pitfalls on the path to that bright future.