Transparency in Financial Reporting
A concise comparison of IFRS and US GAAP

Ruth Ann McEwen
Sample
Transparency in Financial Reporting

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By Ruth Ann McEwen
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About the author

Ruth Ann McEwen is Associate Dean of Accreditation and Administration and Professor of Accounting for the Sawyer Business School at Suffolk University. She earned her Ph.D. in Industrial Management with a concentration in Accounting from the Georgia Institute of Technology and taught Financial Accounting at the Master’s and Doctoral levels for more than 20 years. She is the author or co-author of more than 40 refereed articles and proceedings focusing on the usefulness of accounting information. She has published in such premier journals as *The Accounting Review*, *Decision Sciences*, *Accounting Horizons*, *CPA Journal*, *International Journal of Accounting* and the *Journal of Business Ethics* and is the author of “Earnings Per Share” and co-author of “Asset Retirement Obligations” published by Tax Management, Inc. In 1998, she presented a series of research papers to a joint seminar of the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB) focusing on current financial reporting.

From 2005 until 2008, Ruth Ann McEwen served as a consultant to the FASB, authorized as a content expert to codify United States Generally Accepted Accounting Principles (US GAAP), which comprises authoritative guidance for US corporate financial reporting. She has received numerous scholarly, teaching and research awards.
Introduction

By January 1, 2012, all major economies will provide financial reports using International Financial Reporting Standards (IFRS) except for Argentina, Greenland, parts of Africa and the United States. While the US Securities and Exchange Commission (SEC) recently published a roadmap for transition from US GAAP to IFRS, the roadmap does not include an irrevocable transition date; instead, mandatory adoption will depend on accomplishing objectives represented by milestones. It is likely that these objectives will be met and transition will occur by 2016. This work will set out the key differences between IFRS and US GAAP from a practitioner's perspective, although financial analysts also will benefit from the material presented. The work identifies issues related to potential adoption of IFRS in the US and is aimed at intermediate to advanced practitioners and analysts.

IFRS differs in many respects from US GAAP, but no difference is as substantive as the IFRS view that all assets and liabilities can be revalued to fair value each reporting period, implicitly suggesting that only one value is “fair” and that managers are able to measure it. Unlike IFRS, US GAAP recognizes assets and liabilities at cost and, in most cases, revaluation reflects only decreases in value.

Balance sheet items are shown net of adjustments that keep assets from being overstated and liabilities from being understated. Alternately, assets and liabilities under IFRS are revalued each period to reflect both increases and decreases in value. Under both US GAAP and IFRS, decreases in value lead to unrealized losses that are recognized into current earnings or equity. Under IFRS and in fewer circumstances under US GAAP, increases in value lead to unrealized gains that may be
recognized into current earnings. Recognition of these unrealized (no transition has occurred) holding gains may seriously inflate measures of earnings and income.

IFRS, and in certain circumstances US GAAP, is viewed by some as providing useful information for investors and creditors because of the fair value requirement. Under either system, revaluation methods may be straightforward or extremely obscure. An example of a straightforward method would be revaluing a building at a price for similar buildings in a similar area in a functioning real estate market. But most revaluations are not straightforward.

More obscure methods employ pricing models based on unobservable inputs in markets that are not fully functioning. For example, consider the case of fair valuation of a contingent consideration acquired as part of a business combination. Recognition and periodic revaluation requires estimates of the cash flows associated with the contingency (usually based on a subjective probability distribution) and the choice of an appropriate discount rate reflecting the risk of the acquired entity. Depending on the nature of the consideration, active markets may not exist. Both IFRS and US GAAP require the consideration to be recognized at fair value and that its estimates and managerial judgments be disclosed. But even with extensive disclosure about cash flow estimates and risk analysis, additional disclosure does not guarantee greater transparency or enhanced usefulness of the financial information being presented.

The financial crisis which began in 2008 has been attributed to, among other things, a perceived lack of transparency in the financial markets. In general, transparency implies an ability to see the reported results of an entity’s financial activities clearly and to use these results in making investment decisions. At question is the belief that transparency in
financial reporting will lead to transparency in financial markets. Unfortunately, this link may be more subjective than most of us wish.

This book presents an analysis of reporting issues affecting transparency under IFRS, compared with US GAAP, and suggests areas of concern for preparers and users of financial reports. I also provide a technical analysis of major accounting issues raised by convergence, and indicate areas of interest during initial adoption of IFRS by US entities.
Part One

Transparency of Financial Reporting
In recent years, the transparency debate has largely focused on US GAAP and whether its proper application could offset Wall Street greed. Many believe that even with proper application, US accounting principles are too complex and prescriptive, and result in a system in which entities tend to follow form over substance while violating the underlying spirit of transparency. IFRS guidelines focus on broader principles and give entities more leeway to reflect those principles. Managers are provided with guidance that encourages reporting which reflects the true underlying substance of financial transactions. There is an expectation that convergence of US GAAP and IFRS will take the best practices of rules-based and principles-based accounting standards, resulting in the highest quality financial reporting possible. Under such a setting, transparency would be greatly enhanced.

1. Transparency and Financial Reporting Quality

Transparency may be viewed as a financial reporting quality indicator. While a single definition of financial reporting quality does not exist, markets have described a similar construct: earnings quality. Some view higher quality earnings as being more ‘persistent.’ Others suggest current earnings quality should be defined for shareholders who rely on financial reports to buy future earnings. All definitions seem to extend the idea that higher quality earnings are those that enable higher quality decisions about the future prospects for an entity. Market based

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1 Scott Richardson, “Earnings Quality and Short Sellers”, Accounting Horizons 17, Supplement (2003), pp. 49-61.


definitions of earnings quality relate higher quality to the ability of a firm to generate cash\(^4\) or to be useful in predicting the future, as summarized in the following quote published in the *CPA Journal* in 2005:

Earnings quality refers to the ability of reported earnings to reflect the company’s true earnings, as well as the usefulness of reported earnings to predict future earnings. Earnings quality also refers to the stability, persistence, and lack of variability in reported earnings.\(^5\)

High-quality earnings can be characterized as ‘repeatable, controllable and bankable.’\(^6\) In general, ‘taken as a whole, the quality of earnings can generally be summarized as the degree to which earnings are cash or non-cash, recurring or nonrecurring, and based on precise measurement or estimates that are subject to change.’\(^7\) Alternately, diminished earnings quality has been described as, ‘the extent to which net income reported on the income statement differs from true earnings.’\(^8\)

Note that some definitions seemingly conflict with others. Predictable earnings may be useful in predicting future earnings streams, but may not reflect the underlying volatility of an entity’s transactions. For example, entities with seasonal earnings patterns may be more difficult to predict, but the quality of earnings may be quite high. Persistent or recurring earnings as a determinant of earnings quality seems to be

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\(^4\) [www.ratefinancials.com](http://www.ratefinancials.com)


\(^6\) [www.investopedia.com/articles/02/103002.asp](http://www.investopedia.com/articles/02/103002.asp)

\(^7\) Deloitte & Touche, *Quality of Earnings*, 2002.

straightforward, but upon deeper examination, persistence implies the potential for smoothing, which is in conflict with the idea of having current earnings reflect an entity’s true earnings.

Under US GAAP, the underlying objective of financial reporting is to provide information that is useful to decision makers, primarily investors, in predicting the future earnings and cash flows of an entity. For financial statements to be useful to decision makers they must be transparent and of high quality – in other words, they must be representationally faithful.\(^9\) Higher quality financial reports exhibit a high degree of correspondence between what they measure and what they purport to measure.\(^10\) The AICPA notes that true earnings quality underlies the relation between the economic substance of a transaction, and our ability to reflect the transaction using accounting rules that require substantive judgment in a world of increasingly complex rules and transactions.\(^11\) Transparency represents the next layer of the financial reporting model. Transparent financial reports are clear, accurate reports that reflect the economic substance of transactions in a straightforward manner, even in times of great uncertainty.

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\(^10\) CON 2, ¶ 63.

\(^11\) http://fmcenter.aicpa.org/Resources/Traditional/Quality+of+Earnings+Case+Study+Collection.htm
2. Transparency of the Balance Sheet: Fair Valuation

A. Fair valuation under alternative market assumptions

Much of the current controversy regarding full adoption of IFRS for US GAAP entities rests on the relation between fair valuation and financial reporting transparency. International Accounting Standard No. 18 (IAS 18) defines fair value as, ‘the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.’\(^{12}\) FASB’s Codification\(^{13}\) Master Glossary provides two similar definitions, stating that fair value represents, ‘the amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale,’ and ‘the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.’ The first FASB definition was introduced as part of CON 7 and the second was provided in FAS 157. Note that these definitions imply active participants with available market prices.

But how are assets and liabilities valued if market prices are not available? FAS 107 identifies alternatives:

*Quoted market prices, if available, are the best evidence of the fair value of financial instruments. If quoted market prices are not available, management’s best estimate of fair value may be based on the quoted market price of a financial instrument with similar characteristics or on valuation techniques (for*

\(^{12}\) IAS 18, ¶ 7.

\(^{13}\) Note that subsequent sections of this book will discuss FASB’s Codification project and the terminology which will be required to reference authoritative guidance after July 1, 2009.
example, the present value of estimated future cash flows using a discount rate commensurate with the risks involved, option pricing models or matrix pricing models).

FAS 157 identifies three valuation techniques that are to be consistently applied in estimating fair value:

1. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities;

2. The income approach uses valuation techniques (including present value techniques, option-pricing models such as the Black-Scholes-Merton formula, and the multi-period excess earnings method which reflects a discounted cash flow method used to estimate the fair value of certain intangible assets) to convert future amounts, for example, cash flows or earnings, to a single present discounted amount;

3. The cost approach which is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost).

B. Hierarchy of inputs

In addition, FAS 157 establishes a revised hierarchy of inputs to be used in determining fair value estimates. Comparable to FAS 107, the hierarchy gives the highest priority to observable market inputs and the lowest priority to unobservable market inputs as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date;
• Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly;

• Level 3 inputs are unobservable inputs for the asset or liability, (e.g. inputs derived through extrapolation or interpolation that cannot be corroborated by observable market data).

Level 1 inputs transparently reflect fair value. Fair valuation of either financial or non-financial assets based on recent sales for identical assets in functioning markets conveys the underlying true value of the assets and reflects the substance of fair valuation as promulgated by IFRS. The same can be said for non-financial or financial liabilities using Level 1 inputs: such comparisons communicate the underlying outflow required to settle the liability and they fairly reflect the intent of periodic revaluation.

Level 2 inputs include:

(a) quoted prices for similar assets or liabilities in active markets;

(b) quoted prices for identical or similar assets or liabilities in markets that are not active;

(c) inputs other than quoted prices that are observable for the asset or liability (e.g. interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates);

(d) inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs). Level 2 inputs are more problematic. Use of “similar” prices invariably leads to subjectivity in determining exactly which prices are similar to the asset or liability being revalued. While current US GAAP requires extensive subjectivity,
Level 2 estimation exacerbates what is already a well documented problem in US financial reporting: understatement of risk and manipulation of earnings.

Level 3 inputs should be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability. However, FAS 157’s emphasis that the fair value objective in Level 3 continues to be an exit price from the perspective of a market participant may diminish transparency and certainly increases the complexity of the financial statements.

Under the guidance of FAS 157, entities must estimate these inputs not from an internal perspective, but from the view of an external party who would exchange for the asset, or assume the liability, at a fair price reflecting appropriate risk levels. The guidance provided by FAS 157 seems to suggest that external markets could or would price the risk of an asset retirement obligation in 2010 to decommission a nuclear power plant in 2030 and that an external party would be willing to assume the risk.

FAS 157 uses the term ‘inputs’ to refer broadly to the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk. It indicates that valuation techniques should maximize the use of observable inputs (Levels 1 and 2) and minimize the use of unobservable inputs (Level 3). Observable inputs are those that reflect assumptions market participants would use in pricing the asset or liability developed, based on market data obtained from sources independent of the reporting entity. Unobservable inputs are inputs that reflect the reporting entity’s own assumptions about the assumptions (emphasis added) market participants would use in pricing the asset or liability developed based on the best information available.
in the circumstances.\textsuperscript{14} Valuation under the Level 3 provisions of FAS 157 is based not on entity-specific estimates, but on estimates of what external parties would estimate. This uncertainty seems counterintuitive and is likely to diminish transparency.

C. Hierarchy of inputs: example

For example, assume that an entity must value an asset or liability using Level 3 inputs in a mathematical model. If a model such as present value is used, the entity must estimate:

(a) future cash flows,

(b) the variability in timing and amount of cash flows under differing circumstances and the likelihood of those circumstances,

(c) the price that marketplace participants demand for bearing the uncertainty inherent in those cash flows, and

(d) the time value of money.

In determining these components, value is defined by the assumptions about estimated cash flows that the external parties would make. Level 3 inputs, then, require extensive estimates based on externally-based estimates.

Consider valuation for contingent consideration under US GAAP and IFRS (FAS 141R and IFRS 3R). In certain settings, both require initial recognition at acquisition of the consideration at fair value and both require remeasurement at each reporting date until the contingency is resolved. Under US GAAP, fair value must reflect markets while IFRS entities may use entity-specific estimates. Thus, if Smith Company enters into a purchase agreement in which an earn-out clause will net

\textsuperscript{14} FAS 157, paragraph 21.
Brown Company a $5 million payment and 5% of net sales for Product A contingent upon successfully defending a patent, then, at the acquisition date, Smith Company must estimate the fair value of the contingent liability. The fair value of the contingency is based on estimates of the likelihood that the defence will be successful and estimates of the cash flows from future sales of Product A.

Under FAS 157, Smith should maximize the use of observable inputs when possible. In the current setting, estimating the liability requires Smith to estimate a subjective probability distribution for each of a series of questions addressing the likelihood of defending the patent and estimates of future cash flows. For example, Smith might estimate: (1) the probability of defending the patent, (2) market sales once the patent issue has been resolved, (3) the probability that Product A will become technologically obsolete, and (4) the probability that future patent actions may reduce sales.

Smith must then use these probability weighted estimates in estimating future cash flows associated with Product A. Brown Company risks are included in the expected value of the cash flows. Since the earn-out will occur over several years, Smith must discount the expected cash flows by a risk adjusted discount rate. One choice for this rate might be the industry weighted average cost of capital. The liability would be the probability weighted cash flows (expected values) discounted at an industry cost of capital. Smith would need to remeasure the contingent liability at each reporting date.
D. Entity-specific estimates

CON 7 offers justification for using entity-specific estimates. Entities might expect to realize or pay cash flows that differ from those expected by external parties if:

(a) the entity’s managers might intend different use or settlement than that anticipated by others;

(b) the entity’s managers may prefer to accept risk of a liability (like a product warranty) and manage it internally, rather than transferring that liability to another party;

(c) the entity might hold special preferences, like tax or zoning variances, not available to others;

(d) the entity might hold information, trade secrets, or processes that allow it to realize (or avoid paying) cash flows that differ from others’ expectations;

(e) the entity might be able to realize or pay amounts through use of internal resources.

US GAAP does not allow entity-specific measurement. US entities rely extensively on mathematical models, some of which are extremely complex with subjective estimates that can introduce extreme volatility. Take, for example, the Black-Scholes model for estimating the value of employee share based payments.\(^{15}\) Under the Black-Scholes model, estimates are required for the risk-free rate and the expected volatility of common stock. These estimates are considered to remain constant over the option’s term (not necessarily the case) and assumptions inherent in initial estimates can substantively affect the expense

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associated with the options, thus affecting income. For example, a Black-Scholes valuation of call options with an exercise price of $20 per share, a stock price at the date of the grant of $20 per share, an expected life of the option of 5 years, and no dividends would be $6.07 if the initial estimates of the risk-free rate and volatility are 6.5% and 15%, respectively. If the initial estimates are 5.0% and 10%, respectively, the valuation is reduced to $4.67, a reduction of 23% in employee compensation expense. Note that the Black-Scholes model requires assumptions that options are freely traded and that the option life is relatively short term. Neither of these assumptions is true for employee share-based payments, but the model is considered to be robust to violations of its assumptions.

IFRS does allow entity-specific estimates and requires extensive disclosure about cash flows and other fair value estimates, especially when entity-specific measures have been used. Entities may well publish the assumptions underlying their estimates in the notes to the financial statements. However, predicting volatility in markets that are not fully functioning is an uncertain task. Thus, fair valuation even with extensive disclosure may not enhance usefulness or meet the objectives of transparency. And since remeasurement gains and losses are recognized directly into income, slight changes in estimates hold the potential to affect earnings. Current accounting research suggests that valuation based on standards that are unstructured or less transparent, such as Level 3 unobservable inputs, provides a setting where managers are likely to manipulate earnings. In applying that technique an entity’s assumptions should be realistic; however, US GAAP guidance allows considerable latitude in estimating Level 3 unobservable inputs.

Such discretion calls into question the effects of fair valuation inherent in the asset/liability approach on transparency and quality of financial reporting. McInnes and Cataldo (2007) offer a particularly stinging criticism of the asset/liability approach. They state:

Many otherwise well informed accounting and finance professionals seem unaware of the radical impact that fair value would have on our financial reporting system. According to the fair value vision, the entire framework of transaction-based accrual accounting would be replaced by a system that measures every asset and liability at an estimate of its current “fair value.” Traditional concepts of revenue, expense, and matching have no place in this vision. What we currently understand as “net income” would be redefined as the change in book equity – that is, the difference between the estimated fair values of assets and liabilities, adjusted for primary capital flows. This system of comprehensive fair value accounting is known as the asset-liability approach.\(^\text{17}\)

Noting that historic cost may be of greater use than fair value in predicting future cash flows, especially with the advent of more principles-based IFRS, McInnes and Cataldo (2007) reiterate the assertions of numerous critics of fair value accounting:

The adoption of full fair value accounting for all assets and liabilities and convergence with IFRS will present challenges for preparers and users alike, perhaps with little benefit, and with the nontrivial possibility of great harm.

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