A BPM Partners White Paper

Key Steps to IFRS Readiness

How the right performance management solution can help you meet the coming deadline

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Executive Summary

A worldwide changeover to International Financial Reporting Standards (IFRS) from different accounting standards around the globe – including US Generally Accepted Accounting Principles (GAAP) – is well underway. Over 12,000 companies are estimated to have adopted IFRS, motivated not only by regulatory mandate, but also by globalization of business and the need for transparency and consistent reporting across multiple companies and countries.

IFRS is not merely a different way of reporting. It is, like GAAP, a performance measurement system unto itself. Conversion to IFRS will have an impact, direct or indirect, upon most business decisions. IFRS will probably become a near-universal standard for accounting and business reporting. For the strategically minded CFO, conversion to IFRS presents an opportunity to improve, unify, and standardize the finance organization, particularly its processes and software standards.

In 2005, the European Union approved IFRS in order to make financial statements by all public companies throughout Europe comparable and more transparent. In the USA, the SEC has proposed 2011 as the year for adoption of IFRS. The SEC does not necessarily believe IFRS will do a better job of protecting US investors, but the need for a globally uniform reporting standard becomes more obvious each year. In Canada, the Accounting Standards Board (AcSB) has proposed that public companies migrate from Canadian GAAP to IFRS over a transitional period, with full implementation required by the end of the 2011 fiscal year. Regardless of the timetable, everyone in business will need to know as much about IFRS as they know today about GAAP, and businesses will need to be fully ready for the significant changes that will accompany IFRS.

For the majority of companies adding IFRS, it will be necessary to modify, but not replace accounting applications. In many cases, companies will need to complement the existing general ledgers (GLs), and unify the data coming from them, with IFRS-friendly software applications for consolidation and other business performance management functions. It is fortuitous for performance management software companies that a "Y2K" like deadline is coming, and performance management can be a major part of meeting it. From this point on, selecting performance management and BI systems that conform to IFRS will be advantageous, if not an outright necessity. Finance professionals need to familiarize themselves with IFRS and with software systems that are designed with the transition and IFRS-GAAP interim period in mind. American and Canadian companies may find that some Europe-based software vendors offer an attractive mix of IFRS functionality with extensive implementation experience, due to Europe's head start with the new framework.

Introduction – Background

Several factors have led more than 12,000 companies in over one hundred countries to adopt IFRS:

- Pressure for stronger, more widely understood, and more enforceable financial governance;
- Globalization of business and finance and the resulting need for consistent reporting across international boundaries;
- Ability to improve transparency and management information;
- Designation as mandatory for listing in European markets after 2007;
- Regulators outside Europe who have been instituting IFRS;
- IFRS disclosure requirements which facilitate comparisons between companies in different countries for investors, lenders, and merger and acquisition (M&A) players

Regulatory bodies such as the European Union have mandated adoption of IFRS, and these decrees have been the most compelling force behind its implementation. The trend is worldwide; covering not just Europe but also Asia. For example, the *Financial Express* reported in August 2008 that India's blue-chip companies had begun to align their accounting standards to IFRS, three years ahead of the deadline for the switchover. Globally, many companies are moving forward with IFRS despite already being compliant with the US GAAP standards.

North American finance professionals need to understand the differences between IFRS and their local GAAP. This knowledge is crucial for a number of reasons; among them, to select new software systems that unify existing ledgers to comply with IFRS and support a transitional IFRS-GAAP stage.

In this document, we examine some key differentiators between IFRS and US GAAP and suggest steps for successful transition, including software selection. Because of ongoing convergence projects, the differences between IFRS and US GAAP are shrinking; nevertheless, many expect the usage of GAAP to eventually dwindle away.

Differences between IFRS and GAAP

While many finance executives initially assumed that US GAAP and IFRS would converge and become one, now it is clearer that US and Canadian GAAP are likely to be ousted by IFRS.

IFRS is often described as “principles-based” while GAAP is “rules-based.” In some areas, the “principles” approach of IFRS allows more latitude to the reporting company. Perhaps the most significant broad distinction between IFRS and US GAAP is that IFRS provides less overall detail. Several differences in the detail are allowed or required:

- When it comes to off-balance-sheet entities, IFRS is considerably tougher than US GAAP. In Europe, where IFRS has a significant head start, off-balance-sheet entities (prominent in the failure of tech firm Lernout & Hauspie) are as infamous as in the US (Enron).
- IFRS uses a single-step method for impairment write-downs rather than the two-step method used in US GAAP, making write-downs more likely.
- IFRS has a different probability threshold and measurement objective for contingencies.
- IFRS will “add” trillions of dollars to balance sheets by including values for such intangibles as brands and customer relationships. Depending on the source, it has also been reported that IFRS changeover already added more than $7 trillion. Whatever the number, the impact on many companies will be major.
- IFRS does not permit curing debt covenant violations after year-end.
- IFRS requires segment reporting; that is, breaking out the numbers on business or geographic segments that exceed threshold percentages of sales revenue.
- IFRS does not permit Last In First Out (LIFO) as an inventory costing method. This is potentially controversial in the United States; a LIFO Coalition has lobbied Congress to fight repeal of LIFO accounting and avoid a forced switch to FIFO.
- IFRS guidance on revenue recognition is less extensive than GAAP and contains relatively little industry-specific instruction.
- Revenue recognition can differ significantly, in particular within the software, oil and gas, banking and insurance businesses.

To illustrate the last two bullet points, US GAAP requires that a software maker can establish there is a signed contract before revenue from a customer can be recognized; under IFRS, if there is reasonable expectation of economic benefit from a customer relationship, revenue can be counted.

Importance of IFRS

To the Finance group and the CFO, IFRS is significant because it is considerably more than a reporting change. It is a performance measurement system that differs from GAAP in several respects. The differences impact affect fair valuations, capital allocation, leasing, segment reporting, revenue recognition, impairment reviews, deferred taxation, cash flows, dividend payments, disclosures, borrowing arrangements and banking covenants.

IFRS is not the only new accounting framework, of course; there is Basel II, for example, which is specific to banking organizations. Banks are particularly focused on aligning their different reporting standards within the overlap of Basel II and IFRS.

Besides mounting evidence that the SEC is going to require public companies to adopt it, there are these motivations for American companies:

- Non-US investors will become accustomed to IFRS and want to see US companies that report in GAAP through the IFRS lens.
- US companies are already making acquisitions of foreign companies that report using IFRS.
- For North American public companies, they must closely heed the SEC's statements regarding IFRS.
- In August 2008, the SEC agreed to propose a roadmap toward use of IFRS by domestic SEC registrants. At the same time, SEC Commissioner Elisse B. Walter said that a public corporation which voluntarily adopts IFRS early will probably be required to include, in its financial statements, a reconciliation from IFRS figures to US GAAP.
- The SEC may ultimately decide not to require or allow US issuers to use IFRS, or may delay the starting date. While those possibilities appear unlikely today, it implies strongly that US companies should be ready with software systems, especially in accounting and consolidation applications, that can function easily in both GAAP and IFRS at the same time.

Advantages of Adopting IFRS

For public companies in the US, the pros and cons are not likely to be part of their decision to adopt IFRS; the SEC will probably make that choice for them. However, it is important to gain knowledge as rapidly as possible of the details of IFRS, understand their benefits and drawbacks, and start preparing now. To aid comparison, we will look at the pluses and minuses, starting with the advantages of IFRS:

- Improved transparency. Investors, executives, and managers in different countries should be able to better understand a foreign company's or multinational's reports and statements.
- Uniformity across international boundaries.
- Better management information, with more visibility into foreign subsidiaries and more transparency via segment reporting.
- Improved communication among subsidiaries, as their accounting converges in IFRS.
- Possible cash management advantages1;
- Lowered costs of accounting services due to standardization; one example would be a shared financial services entity located in a low-tax jurisdiction that can meet the needs of all subsidiaries of a multinational because all will rely on a single accounting and taxation method under IFRS.

[1] According to a Deloitte Consulting LLP document published in 2008, Technology Implications of IFRS Adoption for US Companies, "Dividends that can be paid from subsidiaries are based on local financial statements. A change from local GAAP to IFRS can have significant effects on cash dividends, facilitating a consistent standard across countries that can help improve cash flow planning."

Disadvantages of Adopting IFRS

Implementing IFRS is no simple task. It is much more than a reporting change. The challenges of IFRS vary with company size and complexity, and by country. The national accounting standards in some countries, like the example of India mentioned above, are rather closely aligned with IFRS, so the switchover will be relatively easy. In general, businesses need to be aware of the following burdens of conversion to IFRS:

- Systems will need to be modified to accommodate new charts of accounts. There will likely be a period for US companies of tracking and reporting in both GAAP and IFRS, while also clarifying the variances between the two methods.
- There will be changes to tax, technology, and valuation and these will vary from country to country.
- IFRS has complex rules governing what constitutes debt and equity.
- Under IFRS, all derivatives must be recorded on the balance sheet at fair value. This can bring considerable added volatility to income statements.
- IFRS treats employee compensation and stock options differently, which could trigger major company policy shifts. There will be a strong need for software to support IFRS consolidation while unifying existing GLs and reporting under GAAP and IFRS simultaneously. This is also an opportunity for organizational improvement.

As of September, 2008, the SEC was insistent that a pathway back to US GAAP be in place for US companies opting for early adoption of IFRS. The decision will probably stick, but it’s not yet final.

Steps to Prepare for Transition

Accounting firms such as Price Waterhouse Coopers have estimated that most companies will require two to five years for full conversion to IFRS. Larger, more complicated companies usually face a longer conversion process. Certain industries, including oil and gas, forestry, insurance and banking, and software marketers face additional requirements that can make the process more demanding.

It should be helpful to plan for the following steps before a conversion to IFRS:

1. Assess the numbers impact on the company; IFRS may bring changes of unexpected magnitude to key reporting numbers. A major part of assessing the numbers: state, local and national tax issues. For US companies, it is possible that taxation will first migrate to a new, revised version of FAS 109 and then, second, conversion to IAS 12.

2. Review human resource implications such as compensation and benefits, particularly stock options.

3. Identify what changes to processes and workflow may be necessary. For example, will IFRS require segregation of duties controls, splitting up certain employee tasks, in your company?

4. Evaluate current systems, processes and protocols; identify what data are missing that IFRS requires and what changes are needed in ledgers. Likely changes include changes to charts of accounts. Assess whether current accounting software can accommodate these changes, and run both GAAP and IFRS concurrently.

5. Determine whether accounting software and other legacy systems must be replaced; or if modifying them and unifying their data with an IFRS-compliant “umbrella” application for consolidation, reporting, budgeting, and governance compliance will fulfill the demands of the conversion.

6. Start as soon as possible to iron out the transition obstacles, and to realize the benefits of an umbrella performance management solution earlier.

Performance Management Software To Ease the Transition to IFRS

Some companies deploy a set of packaged performance management applications to address their IFRS needs. The consolidation and multi-dimensional (OLAP) analysis capabilities of these packaged solutions are crucial in IFRS compliance. Other companies, including many in Europe, have chosen a single, unified performance management solution to reduce implementation and integration demands, bringing some measure of simplicity in a complex situation.

IFRS has a heavy impact upon consolidation, intercompany reconciliation, and reporting. This is coincidentally where performance management applications can be most useful. To avoid a substantial increase in complexity, we recommend that the transition to IFRS be handled with deployment of one unified performance management solution. This transitional period, when companies probably will report in multiple standards, is not the ideal time to install disparate applications in different subsidiaries and divisions of a large enterprise.

Fortunately, the features of a strong unified performance management application map neatly to IFRS. First, reporting in multiple standards *and comparing the differences correctly* is very difficult unless one application yields all the reports. The unified performance management application reuses the same base data, offers consolidation logic and alternate roll-ups for each standard, and can output reconciliation reports to track the differences between GAAP and IFRS results, for example.

Next, the performance management application will need mature Intercompany consolidation features, with auto-eliminations, for example. Consolidation is critical to IFRS, and some performance management features that are valuable here include the ability to define and capture enough detail in the base data to satisfy every reporting mandate, and roll it up according to unique consolidation logic for each standard. The consolidation functionality must yield a “Total Company IFRS” entity and a “Total Company US GAAP” entity, for example.

IFRS calls for the multi-dimensional analytics built into most performance management systems today via OLAP technology. Segment reporting, such as by product or geography, is a straightforward breakout with a multi-dimensional data engine. Adding to the IFRS challenge, both the Balance Sheet and the Income Statement must be viewable by category: operating income, investing, and financing. This tends to be cumbersome and difficult to do without the typical performance management architecture of an OLAP engine driving a reporting system.

What to Look For in an IFRS / Performance Management Vendor

With Europe's head start in IFRS, North American companies may find that European-based software vendors offer an attractive combination of IFRS consulting experience and mature software functionality for operating simultaneously in multiple frameworks for accounting, reporting, and governance.

Direct, hands-on experience with IFRS changeover is essential. Even when taking the most practical and elegant approach of a unified single performance management solution to create an IFRS umbrella over existing systems and the entire enterprise, the implementation team needs to be aware of the fine points of IFRS, as well as the impact on procedures and division of responsibilities among employees.

The software vendor should be able to demonstrate a comprehensive approach to IFRS, and it is important the software be able to support other reporting standards that are mandatory for a company.

How Companies Have Converted to IFRS

Following are three case studies of companies successfully transitioning to IFRS, using Europe-based software vendors and implementation consultants. The first is financial services giant Unicredit.

Financial Services Example: Unicredit

Unicredit is one of the largest banking and financial services groups in the world, and the second largest in Europe. It serves 35 million customers from more than 10,000 branches in over 20 countries. Its assets total well over $1 trillion. Unicredit needed a structured method to manage all its statutory consolidation processes. Looking to get strategic benefit from the conversion, Unicredit also wanted to restructure its entire accounts planning process.

Unicredit chose a unified performance management / consolidation application that allows it to fulfill IFRS/IAS requirements via a single group consolidation that satisfies the needs of its local country subsidiaries. Implemented in 2005, this system delivers separate, consolidated financial statements for each of four sub-holding companies.

Company-wide, Unicredit operates about 600 sets of corporate accounts, and of these roughly 160 are consolidated. More than 350 contributors are mapped onto the system. Web access with an Excel-based interface aids in the collection of contributors' data.

With this application, which allows multidimensional analysis of performance data, Unicredit can meet the IFRS segment reporting requirements, and handle IAS14 deferred taxes, revenue recognition changes, and better understand its banking risks.

Media Example: Mediaset

Mediaset, part of the Fininvest Group, offers analog and digital television and multimedia services. Mediaset employs 5,800 people and generated €3,750 million revenue in 2006. Mediaset was already running Oracle databases in 2005 when it started its IFRS initiative. After evaluating its options, Mediaset chose a unified performance management system from a European vendor that emphasizes consolidation, reporting, analysis, and meeting IFRS requirements. Among its requirements: the ability to produce segment reports and conduct impairment tests on its cash-generating units.

Mediaset

A Performance Management Solution to meet IFRS needs

As described in *DM Review*, February 2008, Italo-Hispanic commercial TV broadcaster Mediaset, one of the world's largest media companies, achieved IFRS compliance using a unified performance management system from a Europe-headquartered software company.

In 2005, Mediaset faced the challenge of complying with International Financial Reporting Standards (IFRS) / International Accounting Standards (IAS). In addition to producing segment reports and conducting impairment tests on its cash generating units, full audit-ability would be needed. Mediaset decided on an extensive business performance management (BPM) approach. It set the following functional requirements: IFRS-compliant management accounting; activity-based costing (ABC) modeling; budgeting; management financial reporting at company level; financial planning and reporting at Mediaset Group level. It also demanded a common model for data analysis be shared by both the statutory and management systems.

Mediaset chose a single unified system that addressed these needs, and that included built -in functionality for cash flow planning and cost allocation, while supporting multiplatform technology.

Mediaset now uses this system for statutory consolidation to comply with IFRS/IAS regulations. It provides Mediaset with a common shared language for performance measurement across its businesses, and allows it to perform forward-looking assessments. The application allows the processing of data from different sources while generating full data traceability. Mediaset's planning and controlling department uses the same system to process management data using a variety of accounting allocations, consolidated statistical data and aggregation for reporting.

Mediaset had success with its choice of a system that unifies several performance management processes and operates from a single database, and which offers comprehensive auditing through data and process traceability, a double-entry accounting system and drill down to the lowest level. The system delivers a quarterly balance sheet, income statements and cash flow statements as well as management and statutory consolidation.

Manufacturing Example: Artemide Group

This lighting manufacturer based in Milan, Italy faced a more specific problem: implementing the conversion to IFRS to meet the requirements of a stock exchange listing. This multinational enterprise with operations in over 40 cities, and 24 subsidiaries, needed a web-based consolidation system as part of the transition. For Artemide, a unified performance management solution helped meet the requirements of its Italian stock market IPO, and brought other familiar performance management benefits such as faster closings.

Artemide

Global European company seeks IFRS solution for IPO

Artemide Group, a European leader in indoor and outdoor lighting fixtures, is based in Milan and operates through 24 subsidiaries. Its distribution network includes 47 single-brand showrooms located in major cities, with production sites in Italy, France, Hungary and the U.S.

Although they are connected through intercompany flows, many of Artemide's subsidiaries draw up their financial statements in local currency. Initially, the project's goal was to enable preparation of consolidated financial statements in compliance with Directive IV. The new solution was to replace all the data from Excel files, revise all figures in the 2004-2006 chart of accounts according to the statutory accounting standards, and enable preparation of supporting notes to the local Italian financial statements. Artemide also planned to conduct an IPO, which would require adoption of IFRS by the parent company and drawing up the consolidated accounts.

The Group sought an IFRS-compliant software solution to enable:

- Management of consolidation variations
- Automated processing of the typical accounting entries
- Diagnostic control
- Drawing up Supporting Notes to the Financial Statements
- Managing progress reports on the consolidation process
- Consolidation processes based on multiple accounting principles (IAS/IFRS, local GAAP, for example)
- Web-based dashboard for intercompany reconciliation
- Drill-down to individual consolidation adjustment items

Results

Artemide implemented a unified performance management software solution to manage consolidation in a demanding environment. This system delivers consolidated data for both statutory financial statements and reporting purposes, is based on an accounting logic, and can provide the data necessary to draw up the Supporting Notes required under IFRS. All these elements have made it easier for the Group to comply with stock exchange requirements. Accounts closing and report production cycles have been significantly shortened.

Conclusion

Largely due to regulatory mandate, Europe is several years ahead of the US in adopting and running on IFRS. Now it is time for American companies to start the transition.

The SEC favors early adoption by US public companies to help investors acclimate to evaluating US companies with IFRS. However, the SEC insists on a way back to GAAP for early adopters if the agency changes its mind by 2011. Despite this uncertainty, the timeline for IFRS adoption does not permit a wait-and-see stance. Moreover, the advantages of addressing IFRS as soon as possible with a unified performance management system are significant.

US companies should start now preparing their existing general ledgers for IFRS, and be ready with new performance management-oriented software systems that function easily in both GAAP and IFRS simultaneously. There will be a widespread need for IFRS-compliant applications to handle consolidation and unify a range of performance management functions including multidimensional analysis, budgeting, and planning.

Companies need to select new performance management software systems that support all the regulatory frameworks required for their industry: SOX, IFRS, Basel II, Solvency II, GAAP and relevant country-specific standards. Investors likely will tend to punish companies that lack a consistent, coordinated approach to risk and disclosure.

The migration from one accounting standard to the next will be challenging. A unified performance management solution, not a set of separate applications, is the best and most straightforward approach to bring consistency and transparency to companies already managing multiple GLs and data sources. European-based software vendors are likely to offer an attractive combination of IFRS consulting experience and mature software functionality for operating simultaneously in multiple frameworks for accounting, reporting, and governance.