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Premier Issue

# Closing the GAAP

Prepare now for international accounting standards

For years, participants in the international capital markets have been pushing for a single set of high-quality, globally accepted accounting standards. It's finally happening, as International Financial Reporting Standards (IFRS), issued by the London-based International Accounting Standards Board (IASB), grows in popularity. In fact, there's little disagreement that IFRS will gain global acceptance. The only questions now are when and how it will happen.

## Tower of Babel no more

The proliferation of different accounting standards has made it difficult for investors to draw meaningful comparisons among cross-border investments. Often, key financial information is lost in translation. If certain assets are reported at fair value in one country and at historical cost in another, for example, otherwise similar companies may look very different on paper.

A universal accounting language, however, can make international investments, including cross-border acquisitions, much easier to evaluate. Other benefits of universal standards include:

- ▶ Improved financial reporting,
- ▶ Greater financial statement comparability,
- ▶ Stronger internal controls,
- ▶ Less complexity for financial statement preparers and users,
- ▶ Lower capital-raising costs, and
- ▶ Better cash-flow management.

The initial transition to IFRS may be costly. But a single set of standards ultimately will lower accounting costs — particularly for multinational corporations now forced to keep multiple sets of books to comply with divergent local reporting requirements.

## Momentum builds

IFRS is currently either required or permitted in some form in more than 100 countries. Late last year, the SEC adopted new rules that recognize the role IFRS now plays on the global accounting stage.



The rules permit foreign private issuers to file financial statements prepared in accordance with IFRS — without reconciliation to U.S. Generally Accepted Accounting Principles (GAAP). The SEC also recently issued for public comment a “concept release” on allowing U.S. issuers to prepare their financial statements in accordance with IFRS.

Meanwhile, U.S. and foreign accounting rulemakers are working to accelerate the transition to IFRS. The IASB and the Financial Accounting Standards Board (FASB) formalized a commitment to converge IFRS and GAAP in the 2002 Norwalk agreement. In a 2006 Memorandum of Understanding, the boards reaffirmed their “shared objective of developing high-quality, common accounting standards for use in the world’s capital markets.”

In August 2008, the SEC announced that it was considering a timetable for gradually switching public companies to IFRS over several years, beginning as early as 2010. At press time, however, the agency had taken no further action and its plans remained uncertain.

## Making the transition

In keeping with its objectives, FASB has issued several statements that align U.S. GAAP more closely with IFRS, including Statement of Financial Accounting Standards (SFAS) No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, and, most recently, SFAS No. 141R, *Business Combinations*, which eliminates many of the differences between U.S. and international treatment of mergers and acquisitions.

At press time, the two standard-setters were expected to release an updated Memorandum of Understanding outlining their plans for making the transition.

According to the IASB, the memorandum will call for the resolution of major differences between U.S. GAAP and IFRS by 2011 and mandatory adoption of IFRS in the United States by 2013. FASB and its parent organization, the Financial Accounting Foundation, also plan to host a public forum to discuss drawing a blueprint for moving U.S. companies to IFRS.

## Breaking the language barrier

There's nearly universal agreement that global accounting standards are a worthy goal. To reach that goal, however, rulemakers and companies must contend with:

**IFRS shortcomings.** For IFRS to work as the global accounting language, some critical improvements are needed, including elimination of "carve-outs" — local versions of IFRS that deviate from the IASB version.

**IASB independence.** The international financial community agrees that a single standard-setting body is needed, and even FASB acknowledges that the IASB will likely fill this role. But the IASB first will need to strengthen its position as global standard-setter and ensure its independence. The board, for example, will need an adequate, sustainable source of funding in place of the voluntary, private-sector donations on which it currently relies.

**Transition costs.** Organizations adopting IFRS will have to invest time, money and effort into retooling their information systems, implementing new internal controls, training their accounting staffs and modifying

policies and procedures. The transition will also affect tax planning, cash management, corporate governance, legal compliance and other activities.

**Education.** Knowledge about IFRS in the U.S. is limited. Work is required to revamp accounting education and training, auditing standards, and even the CPA exam.

**Differences between IFRS and U.S. GAAP.** Some significant differences remain in the areas of revenue recognition, lease accounting and financial statement presentation. One of the biggest roadblocks is inventory accounting. For tax reasons, many U.S. companies use the last in, first out (LIFO) method when accounting for inventories. But LIFO is prohibited under IFRS. Unless the federal tax code is changed, many U.S. companies that switch to IFRS will find themselves with an enormous tax liability.

**Principles-based standards.** IFRS will require U.S. companies to accept a principles-based approach instead of U.S. GAAP's rules-based standards. (See "Principles-based standards: Substance over form" on page 6 for more on the difference.)

## Learning a new language

There are still plenty of issues to work through before the goal of an international accounting language is realized, but it seems certain that the day will come. To ensure a smooth transition, begin preparing now by familiarizing yourself with IFRS, evaluating its potential impact on your organization and developing an implementation plan. ■

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# Your audit committee's changing role

Just in the last few years, the role of the audit committee has changed dramatically. Traditionally, committees have overseen the financial reporting process — advising management and external auditors and reporting to the board of directors.

But in the wake of this decade's corporate scandals, audit committees have assumed a more proactive role, even substantial authority. It's critical, therefore, to ensure that your company's board has a competent, independent audit committee that's knowledgeable about changing accounting rules and aware of its significant responsibilities.

## Declaration of independence

The Sarbanes-Oxley Act of 2002 (SOX) fundamentally changed the audit committee's role in public companies. Today, this committee — rather than management or the full board of directors — is directly responsible for appointing, compensating and overseeing external auditors. It also pre-approves most audit and nonaudit services provided by outside accountants.

Your company's auditors must keep the audit committee apprised of all critical accounting policies and practices. And auditors must report all material



*Value Measurements*, to provide companies with guidance on measuring fair value.

SFAS 157 establishes a fair value hierarchy that emphasizes market-based valuation methods. Highest priority is given to “Level 1” inputs — quoted prices in active markets for *identical* assets or liabilities. If that information is unavailable, value is to be based, if possible, on Level 2 inputs. These include quoted prices in active markets for *similar* assets or liabilities or other “observable” inputs. Level 3, or “unobservable,” inputs — which include the company’s own data — are assigned lowest priority.

alternative accounting treatments of financial information within Generally Accepted Accounting Principles (GAAP) that have been discussed with management, as well as other material written communications between the audit firm and management.

SOX requires audit committee members to be “independent,” meaning they shouldn’t be part of company management or otherwise “affiliated” with the company. And they must not receive extra compensation for serving on the committee. In addition, at least one member of the committee must be a “financial expert.” The SEC and stock exchanges also have rules regarding the responsibilities, makeup and independence of audit committees.

## All’s fair in financial reporting

Your audit committee is responsible for the integrity of your company’s financial statements, so it’s important for members to understand ongoing changes in accounting standards. This responsibility is particularly critical when it comes to fair value reporting, which can have an impact on earnings and demands significant judgment by management.

In the past, companies reported assets and liabilities at their historical cost. One advantage of this approach is that values aren’t subject to market whims and fluctuations. Over time, however, they become less relevant to investors.

In response, the Financial Accounting Standards Board (FASB) has been incorporating fair value principles into previously issued financial reporting rules to enhance relevance and transparency. FASB has also issued a separate standard, Statement of Financial Accounting Standards (SFAS) No. 157, *Fair*

SFAS 157 also imposes enhanced disclosure requirements. These focus on the types of inputs used to measure fair value, recurring fair value measurements based on significant unobservable (Level 3) inputs, and the impact of fair value measurements on the company’s earnings or changes in net assets. What’s more, the SEC recently issued a list of suggested disclosures to help investors decipher filings that incorporate the new fair value standard.

## Explain losses with solid disclosures

Given the recent credit crisis and volatile market conditions, fair value reporting can have a particularly significant impact on your company’s earnings. In some cases, fair value reporting results in losses — at least on paper — that may alarm shareholders and prospective investors.

It’s incumbent on the audit committee to ease investor concerns by ensuring that the company’s financial statements are backed by solid disclosures that explain the impact of short-term market fluctuations. If your company anticipates and communicates short-term liquidity risks and provides evidence that values will be materially different over the long term, it can better cushion the blow for external stakeholders.

## A matter of priorities

Your audit committee’s responsibilities are increasingly important — particularly in these uncertain economic times. Make sure committee members understand how important their job is and that they give top priority to financial statement disclosures. ■

# The foreign language of fraud

*U.S. companies are especially vulnerable in China*

If your company has Chinese operations or plans to start doing business in China, you face many challenges — not the least of which is fraud. Language and cultural barriers, geographic distance, and rudimentary government regulations mean that Western companies often fall victim to both familiar schemes and variations they never encountered at home.

## Recognize the signs

Most of the basic types of fraud experienced in China are the same as those found anywhere, as are the tools to fight them. U.S. companies, however, may need to recalibrate their tools to fight local variations of occupational fraud.



Lack of government oversight, for example, makes it easy for employees to set up companies that compete with their foreign-owned employer — often using that company's technology and other resources. Or employees may use their employer's assets to secure loans for themselves, which is easy to do when local authorities rarely have the resources to verify assets pledged as collateral.

Supply-related schemes, such as billing foreign investors for more than the cost of goods and services, or falsifying production records and selling foreign employers' products off the books, are also common. When books and records are thousands of miles away, in an unfamiliar language and a country where accounting standards are still evolving, it can be difficult to know whether discrepancies are a result of sloppy bookkeeping or outright fraud.

## Have a policy — and implement it

Although Western companies rate fraud as a significant risk in China, they don't appear to be taking steps to minimize the risk, according to a 2006 Ernst & Young survey. Even in markets where fraud is known to be common practice, only 32% of staff are trained to recognize the difference between facilitation fees and corrupt payments, the survey found. What's more, 25% of employees receive no training in how to implement antifraud policies — even when policies exist and are communicated.

In many companies, there are significant discrepancies between the antifraud policies U.S.-based management believes are in place and the reality as practiced by local operators. Chinese managers who are compensated based on their ability to minimize costs may be tempted to hide irregularities in hours worked or workplace conditions, as well as in suspect financial dealings.

## Know your partners

One solution is to proceed cautiously into the Chinese market. Before you set up shop, consult financial and legal experts knowledgeable about Chinese regulations and culture to assess the feasibility of — and risk involved in — your plans.

Once you've set up Chinese operations, avoid relying too heavily on local managers. Keep at least one expatriate manager on site to monitor day-to-day activities.

## Trust, but verify

Chinese law requires foreign enterprises to partner with Chinese nationals. It's imperative, therefore, that you investigate potential business partners thoroughly before embarking on a joint venture that, if unsuccessful, could put your company at serious financial peril.

Even if a partner appears perfect, verify its reputation and the information it has provided with trade associations such as the U.S.-China Business Council and with The Foreign Commercial Service, which has offices in U.S. consulates. Also consider enlisting the help of a Chinese consulting firm that specializes in due diligence.

*Lack of government oversight makes it easy for employees to set up companies that compete with their foreign-owned employer.*

And enlist the help of independent auditors to regularly review the books rather than rely exclusively on the trustworthiness and knowledge of internal accounting personnel.

Finally, make sure your internal controls and antifraud policies are being implemented and enforced. Because

poor management-employee communication and insufficient training can hamstring even the most effective program, both need to be an ongoing part of every antifraud undertaking.

### Remember your priorities

In the wake of recent food contamination scandals and the international scrutiny involved in hosting the 2008 Summer Olympic Games, the Chinese government is actively working to clean up fraud. But it's likely to take some time. So even if you're eager to take advantage of new, and seemingly limitless, opportunities in China, approach them with caution — and a fraud prevention plan. ■

## Principles-based standards: Substance over form

As U.S. companies gear up to comply with International Financial Reporting Standards (IFRS), both the SEC and Financial Accounting Standards Board (FASB) are recognizing the need to move toward principles-based standards. These standards address many of the shortcomings of the traditional *rules*-based and *principles-only* approaches.

Rules-based standards, in theory, minimize confusion and the need to apply professional judgment in financial reporting. But because these standards provide a multitude of exceptions and numeric thresholds, they typically increase complexity and lead to divergent accounting treatments for similar transactions. Critics of this approach contend that it invites abuses because companies focus on mere technical compliance rather than on the values underlying the rules.

Principles-only approaches, on the other hand, entail loosely defined guidance with limited implementation directives. Such ambiguity requires executives and accountants to exercise significant judgment without providing advice on how to frame it. As a result, these standards can reduce comparability and cause disagreements between companies and auditors.

Principles-based standards represent a middle ground, addressing the shortfalls of rules-based and principles-only standards by:

- ▶ Clearly stating underlying accounting objectives,
- ▶ Minimizing exceptions,
- ▶ Providing sufficient detail and structure to ensure that companies can apply rules consistently, and
- ▶ Avoiding the use of percentage tests.

Principles-based standards give companies more flexibility to report their financial results. At the same time, they hold management responsible for capturing each transaction's economic substance "as defined specifically and framed by the substantive objectives built into each pertinent standard," according to the SEC.

U.S. Generally Accepted Accounting Principles (GAAP) contain primarily rules-based standards. But principles-based standards are favored by IFRS, and U.S. companies will be required to comply with them eventually. (See "Closing the GAAP" on page 2.)

No single set of rules is likely to eliminate the need for accounting professionals to make occasional judgment calls. A principles-based system, however, remedies several of the ills of other standards and minimizes opportunities for companies to meet a standard's technical requirements while evading its underlying intent.



# How to avoid reporting missteps

Under the Sarbanes-Oxley Act, you're required to report errors or omissions found by an auditor as a material misstatement or weakness unless you can prove you would have found them yourself with your current internal financial reporting controls. Naturally, you aren't trying to make mistakes or omit required information. So take steps to prevent these things from inadvertently happening by adopting a relatively simple practice: balance account reconciliation.

## Segregating by risk

There's one way to be confident that an audit won't identify a serious misstatement — reconcile every balance sheet account and understand the risk of misstatements in each. Depending on your company's size, type and industry, monthly reconciliations may be difficult. Consider starting with a risk assessment that asks which accounts are most likely to result in financial reporting misstatements.

Higher-balance accounts that see many complex, high-dollar transactions typically are at greatest risk of being misstated by a *material* amount. You may want to reconcile these accounts more than once a month to reduce the work required to adjust them. This will also help ensure that you can make all adjustments before the reporting deadline. In addition, regularly reconcile any other accounts that could be misstated by a *significant* amount up to a material amount.

What about simpler, lower-balance accounts that you've determined carry no reasonable risk of significant or material misstatements? Continue to perform timely reconciliations before your postclosing adjustment review.

## Covering all your bases

You also want to check with your bank, because different institutions have different reconciliation requirements. Most require you to reconcile zero-balance accounts, for example, but some also require that you reconcile profit and loss or off-balance-sheet accounts.

Additionally, some financial institutions require specific reconciliation procedures for certain types of accounts. For example, suspense accounts — often



defined as clearing accounts where unidentified items are temporarily posted — may have specialized reconciliation procedures.

Regardless of which accounts you reconcile or what procedures you use, your company and its financial advisors should periodically review your reconciliation processes to be sure they're in place and functioning as intended.

## Reactive to proactive

Balance account reconciliation transforms the reconciliation process from a reactive one into a proactive mistake detector. Consider putting this effective internal control in place to prevent serious financial reporting mistakes and their long-term repercussions. ■