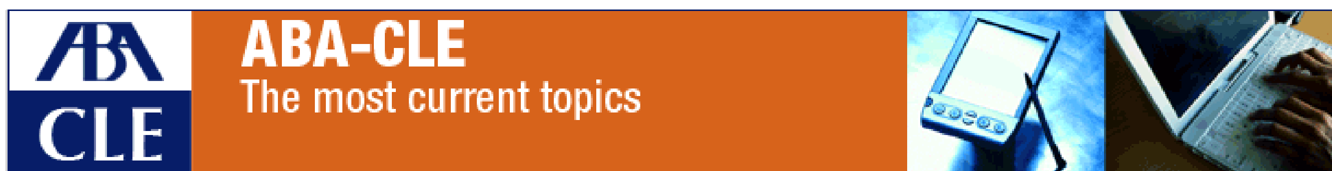

Avoiding Litigation as Businesses Transition from GAAP to IFRS

by Barry Jay Epstein, Ph.D., CPA and Elizabeth A. Kowalski, CPA, CFE

The move to International Financial Reporting Standards (IFRS) is accelerating. Today, about 120 nations have prescribed IFRS for publicly held and, to a lesser degree, private entity reporting. The U.S. Financial Accounting Standards Board (FASB) has committed to converge U.S. Generally Accepted Accounting Principles (GAAP) with IFRS—a process scheduled to be completed by mid-2011. In 2007, the U.S. Securities and Exchange Commission (SEC) eliminated the requirement for foreign private issuers to reconcile to U.S. GAAP if they report under IFRS, and a move is afoot to simply replace U.S. GAAP with IFRS. A decision is due within the next two years; if in the affirmative, all U.S. public companies could convert to IFRS beginning in 2015.

In mid-2009, the International Accounting Standards Board (IASB) issued an all-inclusive, simplified standard for optional use by many privately held entities. This will appeal to preparers, auditors, and users who have objected to the ever-increasing complexity of accounting standards, and may provide the impetus for the wider acceptance of IFRS. U.S. accountants may now opine on financial statements prepared in conformity with U.S. GAAP or under IFRS (including *IFRS for SMEs*).

There is much to celebrate with the coming of universal financial reporting standards, but there are also risks attendant to these changes. Attorneys can play a key role in advising clients on how to avoid or limit these transactional and litigation risks. The following are suggestions for anticipating difficulties in the adoption of IFRS and for interacting with entities already applying those standards.

Why the Move from GAAP to IFRS is Important for Attorneys

Although the ultimate promise of universal financial reporting standards is undeniably appealing, the road to its achievement will be filled with challenges and surprises. Some of those challenges will involve risks, including the risk of litigation. Inside (house) counsel, legal professionals with corporate practices, litigators, advisors to corporate boards, and others should be alert to these risks as they counsel their clients seeking to navigate, and benefit from, the coming changes in the financial reporting landscape.

Attorneys are in key positions to advise clients making business decisions that involve preparing, using, or understanding financial statements. Clients undertaking acquisitions or entering into joint venture arrangements, for example, increasingly will be doing so with counterparties that report under IFRS. Other clients will attempt to raise capital in overseas markets, many of which require or prefer registration filings on the basis of IFRS, necessitating conversion to, or supplementation with, IFRS-based financial statements. Yet other clients will choose to be early adopters of IFRS (or will be attracted to *IFRS for SMEs* as a strategy for simplification of the financial reporting process), running the real risk of encountering challenges to the efficacy of their conversion efforts.

Inappropriate IFRS conversion practices can lead to charges of securities fraud, other white collar crime, or assertions of breach of contract. Allegations could range from investor deception through accounting principles shopping, to manipulation of accounting standards applicable to earnout calculations or other contractual provisions.

Advising Corporate Clients on the Adoption of IFRS
Recommend that client entities begin training for all appropriate staff as soon as possible. All accounting policies and procedures should be reviewed to learn about the differences in new standards and update the organization's understanding and use of accounting standards. The transition to IFRS will impact many departments; for example, IT will face systems implementation issues, investor relations must communicate corporate performance to outsiders, employee benefits will need to understand how plan administration is affected, and human resources will need to address the impact on performance metrics.

Establish relationships with experts (e.g. consultants, university professors, international CPA firms). Accounting experts have been studying IFRS for 10 or more years and are available to assist. The International Accounting Section of the American Accounting Association, an organization of college professors, is one source for identifying local experts on IFRS. Attorneys should advise their clients to discuss implementation issues, as well as technical areas that will affect their respective organizations the most. For companies subject to Sarbanes-Oxley, the engagement of experts by the board audit committee could prove advisable to demonstrate a commitment to quality financial reporting, as well as for substantive purposes.

Document every judgment made. IFRS is a more principles-based system of financial reporting than U.S. GAAP, and accordingly calls for greater use of judgment than in the past. It's important that management and accounting staff document their understanding of the standards and how they are being met. Contemporaneous documentation may serve your clients well should challenges, including litigation, occur.

Encourage and document a healthy discourse between management and the external auditors. The best defense to an allegation of financial reporting fraud is often the openness of communications between the company and its auditors. In the event of such allegations, documented consultations with the independent auditors, coupled with other evidence from audit working papers, can refute the notion that management intended to conceal its practices, which counters a fraud assertion.

High-Risk Areas in Any Change in Accounting Standards
Any changes to reporting standards can engender disputes that may evolve into contractual or securities litigation. Notwithstanding the progress toward convergence, substantial differences between U.S. GAAP and IFRS still remain. A change from U.S. GAAP to IFRS would—in the near term—create a greater risk of misunderstandings, and of improper application of unfamiliar rules by preparers, and even by their auditors. In the authors' opinion, based on extensive experience with securities litigation, the expanded use of IFRS-based reporting will create expanded litigation risk.

Attorneys can usefully reinforce five key areas in their ongoing counsel of corporate clients.

Consider the impact of changes on performance metrics (e.g. bonus plans). Arrangements for compensation based on a financial statement caption—such as EBITDA—may need adjusting for the possible impact of IFRS. At minimum, affected employees need to be made aware of the changes and given assurances regarding the impact on their compensation. Failure to do so could result in breach of employment contract and other claims.

Anticipate the impact of changes on debt covenants. Compliance with various affirmative and negative covenants (e.g. EBITDA, debt service coverage ratio) may be affected by new measurement or classification rules under IFRS. Lenders should be educated before changes take effect, and in some cases, amendments (e.g. to "freeze" GAAP for covenant calculation purposes) may be negotiated, to ameliorate the impact of changes to IFRS.

Weigh the tax accounting implications. IFRS doesn't permit the use of LIFO inventory costing, and U.S. tax regulations require that any LIFO reserve be absorbed into taxable income, when changing from LIFO. Investors will find most companies that formerly used LIFO reporting higher earnings and larger inventories, but also reduced cash flows (due to higher taxes owed on inflated earnings and on the loss of the LIFO reserve), all of which has the potential to confuse and disappoint investors. Communication ahead of the change will be needed to avoid potential investor suits.

Consider how the implications of fair value reporting rules, including recognition of impairments and recoveries, differ under IFRS. Already a controversial and complex issue, the application of fair value measurements under IFRS differs from U.S. GAAP. Also, unlike under U.S. GAAP, in many instances, previously recognized impairments are reversed under IFRS when values increase, making this a likely area for confusion.

Be aware of the effects on M&A earnout agreements. Many business acquisitions involve earnout arrangements, giving sellers additional compensation based on future performance. This area has long been rife with disputes, because buyers often could alter accounting procedures to depress the amounts (EBITDA, net income, etc.) upon which earnout obligations were to be computed. A change to IFRS will exacerbate the risk of disputes, which in some cases might be avoided by amending agreements (e.g. to "freeze" GAAP for measurement purposes, whereby accounting principles employed at the inception of the relationship are preserved, for measurement purposes, throughout the term of the agreement).

An Advisory Checklist for Transactional Attorneys

IASB's stated goal is to develop a single set of high-quality, global accounting standards that can be uniformly utilized by financial statement issuers in all countries at some time in the future. However, even before that time, your clients may wish to enter into transactions with entities that report under full IFRS or one of the several localized versions of IFRS.

Before engaging in transactions with entities employing non-U.S. GAAP, clients should be advised to take certain precautionary steps. The following specific actions can be considered a "checklist" of defensive steps for 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 public accountants (or the equivalent under various foreign regulatory regimes), should be deemed more reliable than unaudited (e.g. reviewed, compiled, or assembled) financial statements.

2. Closely read the financial statements, including the footnotes, and auditors' reports to ascertain which set of financial reporting standards have ostensibly been utilized for their preparation. For example, the financial statements may purport to be in conformity with IFRS, or with various national standards, such as U.K. 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, because this is virtually impossible to achieve. Note if and when the entity has recently adopted a new set of financial reporting standards, and if it has, pay particular attention to any adjustments made in the conversion process. Also, 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, adoption 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 haven’t always been firmly grounded in verifiable values.

3. If the proposed counter-party prepared its financial statements in accordance with any set of standards other than U.S. GAAP, obtain a comprehensive comparison of the foreign standards with U.S. GAAP. Several of the major international CPA firms offer, via their websites, complimentary guides comparing specific foreign GAAP to either U.S. GAAP or IFRS, and various comparison tables can be found in other publications, such as *Wiley IFRS 2010.* Identify the areas of potential discrepancies that are pertinent to the entity being reviewed and consider how these might distort decision making.

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 (e.g. EBITDA, return on investment), and then use those computed criteria to assist in the investing or other decision-making process. Common indicators are those pertaining to cash flows or profitability, those implying a range of transaction values (e.g. multiples of revenues or operating earnings), and those addressing operating characteristics (e.g. operating expense ratios). It’s critical that, if any such indicators are to be constructed and utilized, the bases for the financial statement captions upon which these indexes are to be calculated be fully understood, and that, e.g. GAAP-IFRS differences not be disguised and then incorporated within misleading indicators.

5. If the differences in accounting principles are more than trivial, consider engaging an accounting expert to recast the target entity’s financial statements onto a U.S. 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-U.S. GAAP financial reporting might have on the key information elements (e.g. working capital and other solvency indicators) being used as a basis for decisions. Thanks to the Internet, finding qualified help should rarely be difficult—in fact, even simply “Googling” terms such as “international accounting expert” reveals the existence of many such consulting experts.

6. If the recast financial statements should affect the client’s decision making (e.g. the amount to be paid for an acquisition or invested in a joint venture), obtain an agreement from the proposed counter-party as to the propriety of any adjustments made. It’s not unlikely that the counter-party will lack a detailed (or even any) understanding of U.S. GAAP, and may therefore not be capable of agreeing with the proposed adjustments to bring its financial statements into conformity with these standards. 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 convert the U.S.-based entity’s (the client’s) financial statements into foreign GAAP (most likely IFRS). The objective of either exercise is to facilitate an “apples-to-apples” comparison, and it’s actually less important which set of standards is used to accomplish this goal. However, there will be more effort required to educate the U.S. 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. Doing so should obviate the basis for any later claims regarding misrepresentations (e.g. the counterparty's assertion as to its net current assets at the transaction date). It's 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 the other; the consulting accountants' work must be ratified by the contracting parties or against the attorneys who advised the process.

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