

# Smooth Transition: Preparing for IFRS

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EXECUTIVE BRIEF

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# An Introduction to International Financial Reporting Standards

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International Financial Reporting Standards (IFRS) are the collection of reporting standards developed by the International Accounting Standards Board (IASB). The IASB is committed to developing “a single set of high quality, understandable and enforceable accounting standards to help participants in the world’s capital markets and other users make economic decisions.”

IFRS reporting is now required or permitted in nearly 100 countries, including the European Union and most of Asia Pacific. India, Japan, and Brazil plan to adopt or converge with IFRS over the next three years.

In the US, the Financial Accounting Standards Board (FASB) is working with the IASB to align US Generally Accepted Accounting Principles (GAAP) with IFRS reporting standards. The goal for both organizations is a single set of global standards for financial reporting of public companies listed anywhere in the world. The US Securities and Exchange Commission (SEC) has eliminated IFRS/US GAAP reconciliation requirements for foreign-owned filers, and published a preliminary timeline for US companies to adopt IFRS.

The SEC proposes that 2014 be the first year for US-registered companies to file their financial statements in an IFRS format. On this timetable, the current requirement for companies subject to SEC regulations in the US is to prepare opening balances plus the two most recent years of comparative statements, meaning that 2012 is the first year for which IFRS-formatted statements would need to be produced.

For companies that only operate in the US and have neither overseas subsidiaries nor a need to raise capital or debt in overseas markets, a more gradual approach to IFRS transition is under consideration. However, with multiple large economies and trading partners at various stages in the IFRS adoption process, domestic companies should begin to assess their business requirements over the next five years relative to IFRS deadlines. US firms should develop a timeline for internal adoption of IFRS accounting standards and the presentation of IFRS statements.

IFRS reporting encapsulates a principles-based framework, as opposed to the rules-based standards of US GAAP. Many US-based companies are comfortable with the financial certainty of a rules-based accounting system. Companies familiar with US GAAP should not be distracted by the debates about which system is inherently more or less complex or utilitarian. The fact remains that accounting standards conversion and dual reporting programs in the US are well underway. GAAP-based financial discipline must continue, as sound financial judgment and experience will be called upon to translate financial treatments in GAAP to their equivalents under IFRS.

Enterprise resource planning (ERP) technology will be a key enabler in the transition to IFRS, and for the financial consolidation and reporting process in particular. Companies should focus on the technology areas supporting IFRS transition: financial consolidation and reporting systems, the general ledger (GL), subledgers, and financial data entry systems. There are nearly 200 differences between IFRS and US GAAP accounting systems. However, most companies will find they will need to focus on somewhere between 10 and 40 differences in their own reporting requirements. These differences can be easily and cost-effectively compared, tested, and reconciled in a comprehensive ERP system. Epicor, a company dedicated to providing integrated enterprise software, offers one such ERP system. I will refer to the Epicor ERP system as an example for some of the points discussed in this document.

Early planning and adherence to best practices will provide a distinct advantage to all firms in the process of IFRS transition. Conversion benefits range from streamlined financial close, reconciliation, and reporting, to improved financial compliance in multiple markets. IFRS promotes the alignment of business objectives and financial reporting processes across a global enterprise. We'll turn now to the business and systems processes involved in a smooth transition to IFRS.

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# Effectively Managing the Transition to IFRS

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Although few in number, much has been made of the differences between the requirements of US GAAP-level reporting and IFRS, primarily focusing on the fact that the use of last-in-first-out (LIFO) inventory costing is precluded under **International Accounting Standard 2** (IAS 2). Companies that use the LIFO costing methodology under US GAAP may experience different operating results as well as altered cash flows under the IFRS regime.

In addition, IFRS reporting standards require inventory to be carried at the lower of cost and net realizable value (NRV), while under US GAAP, inventory is carried at the lower of cost and market-based valuation. Under IFRS, a larger number of financial instruments will qualify as derivatives. For instance, instruments such as option and forward agreements to buy unlisted equity investments are accounted for as derivatives under IFRS, but not under US GAAP.

The well-managed European experience with IFRS transition is encouraging. In their 2005 consolidated financials, all 7,000 of the European Union's listed corporations switched from their home-country GAAP to IFRS-based reporting. Each company had about four years to plan for this change. In order to inform their investors of

the upcoming conversion, most of these companies added a discussion to their 2003 filings on how IFRS would affect their future statements, followed by a report quantifying their forecast of the impact of the expected changes. European companies ended their local GAAP reports in their 2005 financial statements.

IFRS reporting already affects a large number of US multinational companies through statutory or other reporting requirements in their foreign subsidiaries. Apart from the SEC's role in guiding the formal domestic transition process, it is only a matter of time before IFRS reporting has a major impact on the remaining US companies. Financial consolidation and reporting for IFRS is an important and entirely manageable task for public companies.

IFRS transition should not be viewed as "another" huge business process reengineering program (as many business consultants have suggested), and it should not drain time and money from already tight budgets. Instead, with efficient planning, companies should focus on embedding IFRS requirements into their GL and subledger systems while gaining the benefits of simplified charts of account and improved reporting structures, and remove the headache of manual adjustments to financial

consolidation and reporting. This approach will reduce the scope of updates to primary systems so that the focus is on consolidation rules and IFRS reporting formats.

Many US organizations will choose a phased standards-embedding process to convert their systems from US GAAP to IFRS. One of the keys to a smooth conversion is coordinating the transition to IFRS with the technology roadmap, planned systems deployments, and scheduled upgrades (e.g., IFRS components should be included when performing upgrades to the financial systems). IT coordination will help limit the time, budget, and human resources necessary for this transition.

Companies across Europe, Asia, and Australia have learned that, as with any project, effective planning and management allows enough time and resources for a smooth transition process, with critical tasks not being rushed, and progress not being hindered due to unforeseen gaps. This lowers the risk of errors and redundancies as well as the need to outsource more work than necessary.

Given the amount of time necessary to train staff on IFRS and adapt to changes in financial reporting practices, the time has come for US-based companies to start planning for IFRS transition. Early action (including the creation of an internal project team to assess the financial processes and systems required) allows companies to benefit from cost reduction during each phase, and to better control the scope of the implementation.

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# Forming the IFRS Transition Team

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Companies may elect to approach their IFRS transition as part of a portfolio of strategic business objectives that include process and performance improvements, but this is not a prerequisite for successful conversion. The myriad failures of business technology projects involving regulatory changes and standards adoption provide object lessons in the dangers of “scope creep.”

**Successful IFRS transition project management involves a number of preferred practices:**

- keeping IFRS conversion objectives clear, and related tasks succinctly defined
- limiting the size of the project team and distributing responsibilities by skill and requirement
- determining, agreeing to, and adhering to a project plan with time-bound, step-wise phases
- including contingencies and alternatives for each task to ensure completion and progress
- reviewing progress at agreed milestones
- testing and simulating results prior to the implementation of subsequent phases
- reassessing and making necessary changes with a post-implementation review

The first step for IFRS transition involves taking an inventory of financial procedures and systems, and the people responsible for them. Representatives from finance, treasury, tax, audit, compensation, and the IT staff that support their systems will form the core IFRS project team. Where necessary, a deficit of internal staff in key functional areas should be remedied, whether temporarily or permanently. A critical function of this team will be to evaluate and report on progress and issues to senior management.

Team members that have previously worked together on financial compliance programs (including the US Sarbanes-Oxley Act [SOX]) and related system installations/upgrades will provide valuable insights into financial projects undertaken in recent corporate history, documented strengths and weaknesses, and the best practices emerging from each effort. This will help prevent errors and ensure that the IFRS project does not spiral into a multiyear, resource-challenged program. It is important to recall that avoiding costly gaps or redundancies in similar circumstances was one of the long-term objectives of recent financial compliance programs.

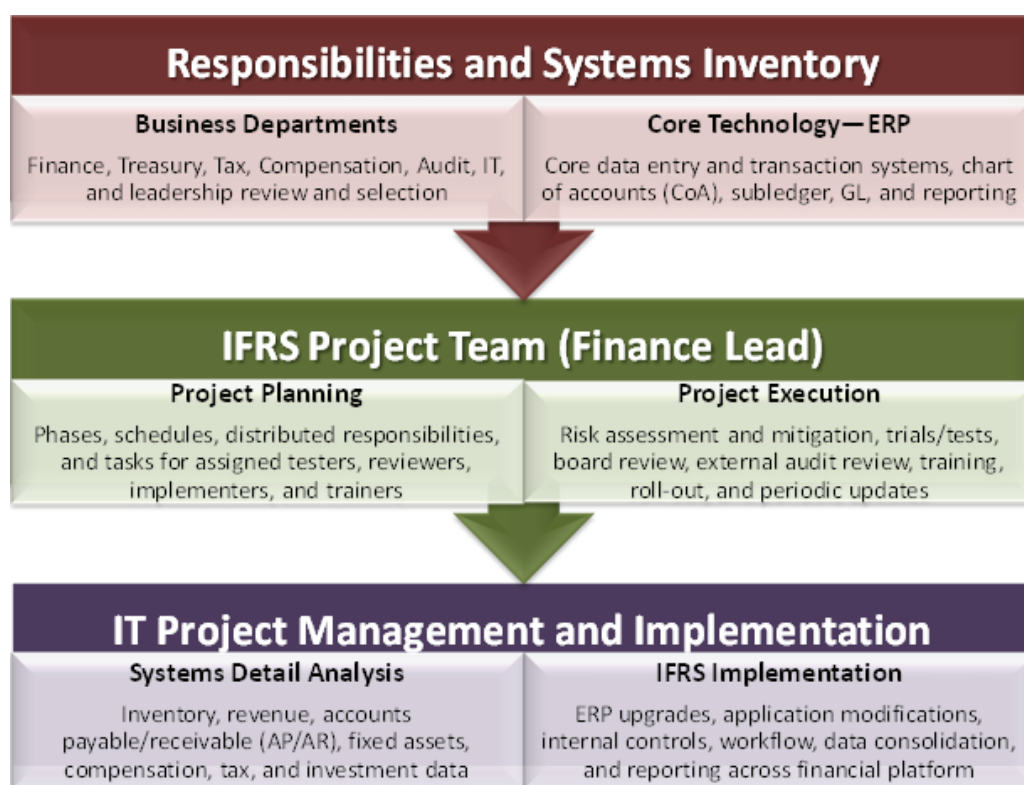
IFRS project leadership should include a senior director of finance, including the vice-presidential level, to ensure team cohesion and progress. The project leader will also oversee the review of potential risks to internal financial controls and gather input from team members on ways to mitigate or eliminate any potential control violations that

may emerge. Moreover, the leader will play the central role in assessing project risks and advising senior management on the expected operational impact of the transition.

The inevitable transition testing phases will require additional staff from the core team departments, as well as internal auditors who will inform and review the dual accounting reconciliations. Also required, on a part-time basis: ERP and applications specialists to help with initial field setups, sample data entry comparisons, systems changes, and test reports. A group of internal test users in finance (outside the project team) should be trained prior to the rollout of new accounting procedures. Testers will evaluate alternate data entry methods, rollups and reconciliation procedures, bugs, and breaks, as well as any ERP platform applications that have been modified.

It will be necessary to work with external auditors to evaluate the IFRS project test results. The IFRS transition must consistently focus on accounting treatment tests, dual reporting validation, and reliable system capture and reporting of the test results. The goal is to present consistently accurate IFRS-compliant balances in the appropriate format for the company.

The board of directors and internal audit committee are the ultimate decision makers regarding project effectiveness. The audit committee will review and approve the IFRS financial statements and determine how disclosures will be handled under this framework. These internal focal points reinforce the value of working in an integrated and flexible ERP environment, where necessary modifications, re-testing, and controls are consistently managed across all operations.



**Figure 1.** An overview of the IFRS project development and execution process. The IFRS implementation phase is a subset of the overall project execution process and runs in parallel. The ERP system is at the core of the IFRS transition process at the systems and data level.

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# The Critical Role of IFRS Project Team Members

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The finance, audit, and IT contingents of the IFRS transition team will make specific contributions to the project's success. The finance team will focus on the specific rules in US GAAP that require alternative treatment in IFRS. In this respect, the fixed assets area is one accounting domain that will have a proportionately large impact on the integrity of IFRS reporting. For example, under US GAAP, when a company purchases a building, it capitalizes the total cost and depreciates it over the life of the building. Under IFRS, the company will allocate total costs to applicable asset components (the building superstructure, the roof, windows, external doors, etc). The company will capitalize the components and depreciate each of them over their useful lives. The finance and accounting members of the transition team have the primary responsibility to review and test the validity of such treatments throughout the process.

A close relationship with the IT contingent of the team will be critical to IFRS project success. For instance, to account for fixed assets under IFRS, companies will be required to track and allocate real estate costs, modify or replace fixed asset values to support the different depreciable life categories, and evaluate post-acquisition costs for capitalization or expense. Related system changes may

involve modifying data capture fields and accounting formulas; mapping changes to reporting modules, the chart of accounts, and reporting templates; and making modifications to report documentation. An inherently adaptable and comprehensive ERP system will allow the IT team to make the necessary changes, test them in a non-production mode, and introduce final modifications in a secure production environment.

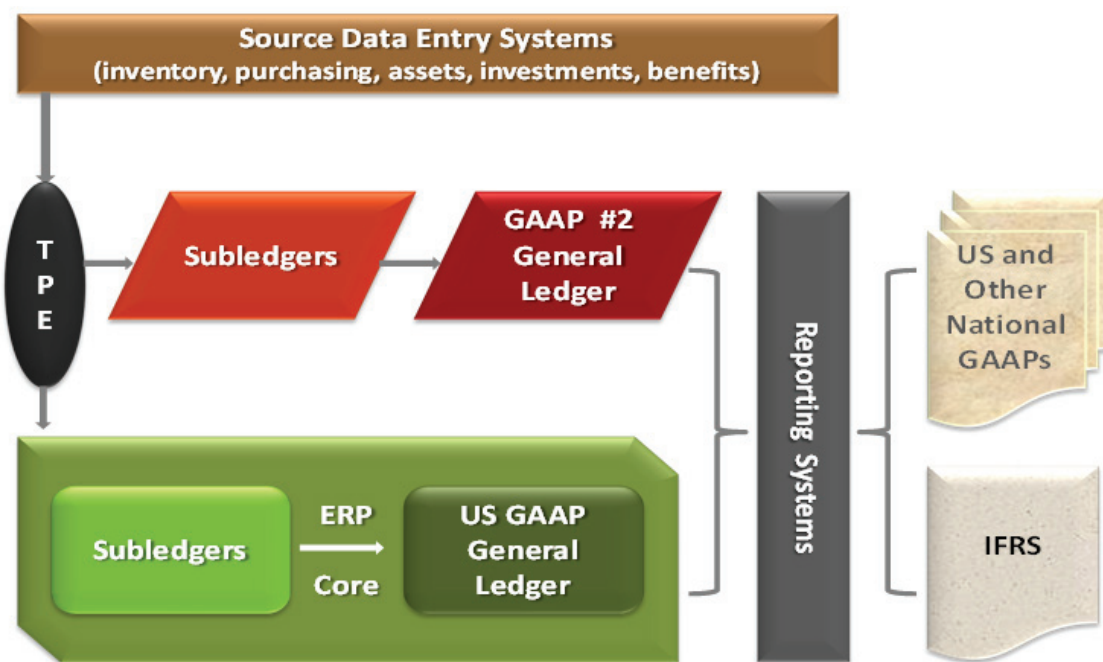
Determining and executing a detailed timeline for analysis of core and supporting financial systems is the primary responsibility of the IT team, which will directly assess the necessary changes and updates in accounting, tax, and financial reporting systems. With input and review from the tax, audit, and reporting specialists, IT will reconcile the key set of 10 to 40 accounting and disclosure differences in the affected systems. Fair-value requirements, inventory valuation, revenue recognition, asset component accounting, share-based payments, and asset impairment data should be flagged for at least the previous two years of information, and reviewed in the context of IFRS treatments as recommended by the finance members of the team.

The IT team will design and implement templates for internal data-gathering on identified fields and entries in the ledger and subledger systems. Potential “information gaps” during the conversion process are IT-level risk factors that will be identified at this stage. The involvement of financial systems professionals who can identify related IT system needs (and any dovetailing with requirements for planned ERP upgrades) is strongly recommended.

The extended IT team must be involved in the build, implement, and rollout phase of the IFRS conversion project. During this phase, IT members confirm an itemized understanding of all new data requirements. They work with members of the internal IT organization to configure the financial and reporting applications that are subject to conversion requirements. IT reviews and tests all changes to data, application setups, internal controls, and related workflow and reporting process templates. IT can

also update an outdated chart of accounts design and consolidate disparate global ledgers into an IFRS-friendly format.

At the appropriate point in the final phases of the project, a cutover will be required from the local GL to an IFRS GL. Prior to cutover, the IT team maps documented changes, and links data entry sources to the IFRS GL without the need for individual IFRS-related adjustments. Internal tax reporting systems, processes, and controls will already have been designed to meet financial statement reporting requirements under US GAAP. IT therefore focuses on testing (and then maintaining) tax data and internal control consistency in the new dual reporting environment. Systems and procedures maintained for compliance with SOX and other industry-based reporting requirements should also be leveraged for the new reporting regime.



**Figure 2.** IFRS requirements are embedded in the supporting core financial systems (GL and subledgers) integrated with the ERP platform. The need to make adjusting entries to prepare IFRS financial statements will be reduced as a consolidated chart of accounts develops. The need to adjust entries for US GAAP financial statements and local tax or regulatory reporting remains as IFRS reporting becomes the standardized reporting format. Note: TPE = transaction posting engines.

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# The Inherent Advantage of ERP for IFRS Transition

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According to Ernst & Young, “ERP packages are sufficiently flexible to support all the main accounting standards, including US GAAP and IFRS.” **The business value of the ERP system will actually expand in its new role of supporting the ongoing need for multiple reporting in US GAAP, remaining national GAAP systems, and IFRS.** Accounting standards, along with tax and other regulatory and financial reporting requirements will, of course, continue to evolve. Adaptable ERP systems that are capable of tracking and embedding changes during this evolution will greatly minimize the need for incremental application changes.

IFRS transition will be an exceedingly lengthy process if consolidation and reporting systems are adjusted manually. During the IT project phases, each IFRS requirement can be embedded into the GL and subsystems. Updates in and support from the ERP system (with additional changes to the GL and subsystems) will support all IFRS disclosure fields and reporting.

IFRS reporting standards highlight the fact that companies will need to maintain—and, in some cases, strengthen—internal controls over financial reporting. Gone are the days of large volumes of manual adjustments using desktop tools that created enormous financial compliance and data control issues. A clear benefit of converting to IFRS is the opportunity to centralize and streamline financial reporting functions throughout the organization with

a single set of accounting policies managed in the ERP system. With ERP, companies can automatically leverage embedded application risk mitigation tools to maintain controls and apply policies to keep information security on track during the transition process.

Managing a new multiple-reporting system is clearly not a temporary condition. As GAAP accounting is converted and IFRS reporting gradually becomes the foundation of financial data management, various local tax and regulatory reporting requirements will benefit from the consolidated data rollups. The common data repository in ERP allows for apples-to-apples comparison of trial balances during and after the transition. Testing and sampling of simulated reporting and synchronized financial statements directly benefits from a single, authoritative system of record.

Anticipated re-testing and re-evaluation of conversion integrity in subsequent quarters is a standard operating task in ERP systems. Epicor has the added capability to monitor data conversion and control processes during the fiscal quarter and for any period after the quarter is closed. Unforeseen changes in accounting formulas or entry treatments, as well as scheduled changes in IFRS reporting parameters, can be quickly updated and re-embedded in Epicor.

Another notable feature is Epicor’s ability to hold both GAAP- and IFRS-compliant GLs concurrently, which is of particular interest during the transitional phase.

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# Conclusion: Reaping the Business Benefits of IFRS Transition

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The business benefits of IFRS become apparent early in the planning process and throughout the transition project. Below is a summary of some of the major benefits to the organization.

**A. Financial process management and control is improved with automation.** IFRS transition offers a classic opportunity to exploit the benefits of ERP. The inherent value of consolidated transaction management and reporting systems becomes clear in a financial data conversion process. The ledger and subledger systems (where core data resides and feeds the GAAP-based GL) are the sources of the data conversion process. In the same way that ERP efficiently consolidates large volumes of financial and operational data for management visibility and reporting, companies can leverage the ERP system to consolidate multi-GAAP reporting for IFRS conversion.

**B. Financial information management is improved with a streamlined global chart of accounts.** Comprehensive financial data management that includes financial controls, transparent reporting, and audit and security management is embedded in ERP systems like Epicor. A globally standardized accounting regimen will reduce the time and resources required to provide manual conversions still seen today. Combined with the consolidated financial resources of ERP, a globally streamlined chart of accounts under IFRS

allows a chief financial officer (CFO) sitting in Ohio to get current financial updates from subsidiary operations across the globe at any time of day.

**C. Teams work together to efficiently achieve a common objective.** Internal best practices developed over many years of project and program management are immediately valuable to the IFRS transition project. Costs escalate, time and again, when companies extensively outsource these competencies or abdicate internal program management functions to external consultants. Project cost-reduction in the IFRS transition process depends upon solid planning and efficient project management.

**D. Previous investments in internal skills are leveraged.** The combination of IT, finance, and internal audit skills and experience determine the ease and efficiency of the IFRS transition project. The knowledge gained by project team members from similar work in areas such as SOX compliance is invaluable to the IFRS transition. IFRS transition is an opportunity to leverage the thousands of hours of skills development and program management that have been invested in related programs.

E. **The organization participates in the twenty-first-century global economy.** As major markets across the globe begin to standardize financial reporting on IFRS, international transparency in financial performance will improve. The ability to instantly assess and translate value from one operation to another will smooth the flow of payments. Financial services will become more efficient with reduced latency in financial information management. The fact is that local tax reporting and process monitoring and reporting for a host of regulations will continue. The ability to maintain consistent compliance and single-source reporting for both IFRS and the variety of other external requirements is a critical advantage of advanced ERP systems.

Given the business objectives and resources involved, companies seeking the most efficient and lowest-cost path to IFRS are turning to ERP systems like Epicor. Indeed, companies that see the importance of getting a handle on IFRS requirements before the deadlines for conversion are now taking steps to implement an effective methodology with the right tools to help them smooth the transition process. Proactive companies will have the advantage in controlling costs, managing the scope of implementation, and ensuring the smoothest possible transition to IFRS.

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