By Todd Neely

Accounting Changes Ahead

Implementation of the International Financial Reporting Standards will have an impact on supply management — here's how.

Accounting is the language in which business is conducted. Each country has historically had its own dialect, with its own unique slang, quirks and idioms. But as the world shrinks and globalization expands, having multiple accounting systems is confusing and inefficient. To overcome these challenges, accounting is undergoing a massive worldwide evolution.

International Financial Reporting Standards (IFRS) is the new global accounting system being implemented worldwide. Approximately 114 nations have already adopted IFRS. All European countries started adoption in 2005, while other countries are changing soon: Canada in 2011, Mexico in 2012 and Japan in 2014. As a result, IFRS has been implemented in more than 12,000 companies, including many subsidiaries of U.S. global enterprises.

Difference Between IFRS and GAAP

Prior to the shift toward IFRS, companies relied upon U.S. Generally Accepted Accounting Principles (GAAP) in their accounting structure. GAAP is a set of detailed rules and guidance on how financial information is to be reported. However, IFRS is a philosophy on reporting financial information to give the best understanding of the company's financial situation. To put this in perspective, consider an organization with an expensive made-to-order part in inventory. While critical to a machine in maintaining production, the original part has yet to show signs of wear. Thus, what is the value of the part in inventory? Under GAAP, the made-to-order part is valued at the acquisition price. However, under IFRS, the part is valued at the current market price — but how is that determined?

This will be management's responsibility. The market price could be the scrap value of the metal and electronics in the part or the replacement cost of having another part fabricated or some other value. The "why" management made a decision and ensuring that the decision is consistently applied is as important under IFRS as the value reported. Thus, IFRS is being implemented to provide more transparency and a better understanding of a company's true financial situation.

For U.S. publicly traded companies, implementing IFRS is no longer a matter of "if" but of "when." On November 14, 2008, the Securities and Exchange Commission (SEC) issued a roadmap proposing transition for adoption of IFRS by U.S. public companies.

The Road to Implementation

The implementation of IFRS will require accounting and financial reporting to undergo an unprecedented change.

IFRS has been implemented in more than 12,000 companies, including many subsidiaries of U.S. global enterprises.

Changing to an IFRS accounting philosophy will require colleges to add courses. Also, in 2012, the CPA exam will begin testing on IFRS. Most accountants and managers will need to be re-educated to understand the decisions they are required to make under IFRS.

IFRS may already be impacting your work through business dealings with international suppliers and customers or when working with your company's international subsidiaries already using IFRS. The impact of IFRS will become greater as more countries require IFRS and as U.S. companies start IFRS implementation.

Additionally, many GAAP rules have been changed to begin the convergence of GAAP with IFRS. By the time the last U.S. public company implements IFRS in 2020, the differences will be small between GAAP and IFRS.

The SEC's roadmap applies only to publicly traded companies. U.S. companies that are subsidiaries of foreign corporations can petition to switch early. After meeting SEC guidelines, the first U.S. companies can implement IFRS on January 1, 2014. Privately held companies, charities or other such entities are not included in the roadmap. The eventual adoption of IFRS by small businesses and not-for-profit organizations is likely to be market-driven.

To switch in 2014, a company must have one or more years in which it kept two sets of books, GAAP and IFRS. That means by 2012 all IFRS decisions have been made and the IT systems installed. To meet the 2014 deadline, companies need to start the implementation process by 2010.

The impact of implementing IFRS goes far beyond accounting and financial reporting. Accounting is the language of business, and implementing IFRS changes the language. Supply chain, tax policy, mergers and acquisitions, budgeting, employee compensation structures and intercompany arrangements are just some of the areas that will be affected.

Supply Management Impacts

Four major changes IFRS has on supply chain management are LIFO, inventory valuation, long-term contracts and management responsibility.

Last in, first out (LIFO). The change to LIFO is easy to understand. IFRS does not permit inventory to be valued using the LIFO method. If you are valuing inventory using LIFO, implementing IFRS will require switching from LIFO to another method. The switch can have large tax consequences and should be thoroughly investigated to minimize taxes.

Inventory valuation. Under GAAP, inventory is valued once. As long as the inventory sits on the shelf, it reflects the historical prices paid. Under IFRS, inventory is valued at current market price. For many inventory items, the number of turns is high, resulting in current market price being equal to historical price paid. But for other items, significant changes between the price paid and current market price will require repeated revaluation to report the inventory's true value.

Long-term contracts. Under GAAP, possession and ownership are not the same. Under lease or consignment agreements, you can have possession but do not own the inventory. The inventory would not have to be included in the reporting of your financial statements. Under IFRS, when you take possession, you take responsibility. When you are responsible for an item, it is to be reported on the financial statements.

Management responsibility. The responsibility of management in making decisions on how financial data is collected and reported is much greater under IFRS. GAAP has rules and guidelines for most situations. The trick is to determine which rule or guideline applies to the situation you are investigating. Once the rule is found, apply it. Under IFRS, there are fewer rules or guidelines. You are responsible to do what is best to report the true financial condition of the situation. Whatever your decision, you will be responsible to consistently perform the same action repeatedly. If you change — you have to report why.

The change to IFRS will be a large undertaking. The SEC estimates that for early adopters the average U.S. company will incur costs of between 0.125 percent to 0.13 percent of revenue. The complete overhaul of accounting and financial reporting will make the change similar in scope to the Y2K and Sarbanes-Oxley projects. IT will be heavily involved to support the change, as it is likely that other system projects will need to be delayed due to a resource constraint.

Don't be complacent. Because the CFO will lead the project, it is easy to assume the implementation of IFRS is only an accounting project. But accounting and financial reporting impact everything. The bottom line is supply management professionals need to get involved early and stay involved. **ISM**

This article provides general information on accounting issues. For a specific problem, please ask your internal or external auditors.

Todd Neely is president of NanoImproved in Chicago, assisting international utilities and life-science companies, as well as a college instructor of supply chain and international management courses. For more information, send an e-mail to **author@ism.ws**.