

Differences and Similarities Between IFRS and GAAP on Inventory, Revenue Recognition and Consolidated Financial Statements

S. Sam Sedki
St. Mary's University

Abby Smith
St. Mary's University

Aissa Strickland
St. Mary's University

As globalization progresses and international economic dependency increases, the need for a global accounting system becomes more apparent. American companies will inevitably have to adopt international accounting standards if they wish to enter or remain in their respective international markets. The idea of obtaining an international convergence of accounting standard first arose in the late 1950s in response to economic integration and increases in international trade. As of today, over one hundred (100) countries either require or permit the use of International Financial Reporting Standards (IFRSs)

INTRODUCTION

The International Accounting Standards Committee was formed in 1973 and was the first international standards-setting entity. It became International Accounting Standards Board (IASB) in 2001. This paper will highlight the similarities and difference in IFRS and Generally Accepted Accounting Principles (GAAP) as they pertain to accounting for inventory, revenue recognition, and consolidated financial statements and to provide an accurate depiction of what issues future convergence will need to address. The three accounting areas may well be considered to be core accounting areas and may affect most U.S. companies' financial position. Therefore, anticipated adoption of IFRS will be most problematic in these areas.

INVENTORY

Accounting for inventory is intended to accurately reflect the cost expended by an entity. Accounting for inventory should also provide investors a basis with what to determine expected profit. IFRS aimed to provide guidance on "the amount of cost to be recognized as an asset and carried forward until the related revenues are recognized." International Accounting Standards (IAS 2-1). "Similarly, GAAP requires companies to record inventories at cost when first recognized. Accounting Standards Codification" (ASC 330). The integration of IFRS by companies currently using GAAP will not be seamless as IFRS and

GAAP significantly differ in some areas. “Switching to IFRS wouldn’t only require coordinating money regulatory authorities, such as the Public Company Accounting Oversight Board, the Internal Revenue Service, and the Securities and Exchange Commission (SEC) but it would also put pressure on changes to company information systems, internal controls, and tax planning, (Krishnan, 2012).

IFRS prohibits the use of the Last-in-First-out (LIFO) method to account for inventory, while LIFO has been long accepted under GAAP IAS 2 & ASC 330. This will have the biggest impact on American companies financial statements particularly on their reported tax obligations. The IRS requires companies using LIFO for tax purposes to have to use LIFO for income measurement in financial accounting as well IRC Sec. 472(c). Usually companies using LIFO have lower tax expenses and lower financial income. Operating results and cash flows might be significantly different for American companies currently using LIFO and wish to incorporate IFRS. Requiring American companies to switch from LIFO to First-in-First-out (FIFO) in a short and abrupt amount of time can have detrimental effects life of these companies and volatility of the economy. Because removing LIFO as an available inventory method to be used will have such a dramatic impact on companies and the economy, therefore, the adoption of IFRS should: 1) be an stated as a requirement as early as possible to allow companies to adjust their financial plans, 2) the adoption should be conducted in increments and, for example, include set requirements for year 1, year 3, and year 5 so that the economic impact of the adoption does not fully impact the year of adoption, and 3) prohibit companies from reversing previously written down inventory as required by IFRS.

Currently, subsequent measurement of inventory under GAAP is recorded at the lower of cost or market and market is defined as current replacement cost, which is limited to net realizable value. Subsequent measurement of inventory under IFRS is measured at the lower of cost or net realizable value. Under GAAP companies are prohibited from reversing the write-down and increasing the new cost basis. However, under IFRS, reversals up to the amount of that was previously written down is not only allowed but is required when surrounding economic circumstances clearly indicate the net realizable value of the inventory has increased. This mandatory recovery of previously written down inventory is based on subjective criteria and will inevitably subject companies to earnings volatility and also has the potential for abuse. Companies’ profit and gross profit percentages will be subject to the changes in economic circumstance. This requirement is contrary to accounting’s qualitative characteristic, predictive value. An abrupt adoption of IFRS may result in economic volatility, GAAP should gradually eliminate the use of LIFO from being used while IFRS should remove its requirement for reversing previously written down inventory upon change of circumstance.

REVENUE RECOGNITION

GAAP provides extensive guidance and encompasses a wide variety of industry-specific scenarios. GAAP has been criticized as being over complex and, therefore, not providing effective guidance (Munter, 2011). There are over 200 specialized and/or industry-specific revenue recognition requirements under U.S. GAAP (www.fasb.org). IFRS, on the other hand, has two revenue standards and four interpretations and has been criticized for not providing enough guidance (Munter, 2011) the two IFRS standards encompass transactions in one of four broad categories: sale of goods, rendering of services, others’ use of an entity’s assets, and construction contracts.

IFRS and GAAP both contain revenue recognition criteria aimed at determining when earnings should be recorded and how to realize assets through the earning process. Under IFRS revenue is defined as “the gross inflows of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increase in equity other than increases relating to contributions from equity participants.” (IAS 18). GAAP states revenue represents actual or expected cash inflows that have occurred or will result from the entity’s ongoing operations. Both GAAP and IFRS require revenue to be realizable and earned before it is recognized. However, GAAP and IFRS differ as to when these criteria are met.

Recognition of revenue from sales of goods most likely occurs more often than recognition of revenue from any other source. Although IFRS and GAAP consider revenue should be realizable and

earned before it is recognized, the differences in their criteria for determining whether revenue should be recognized from sales of goods evidences a differing goal. Public companies relying on GAAP recognize revenue from sales of good when delivery has occurred, ownership has been transferred, and there is persuasive evidence of a fee arrangement that is fixed or determinable, and collectability is reasonably assured (Staff Accounting Bulletins, SAB Topic 13). However, under IFRS revenue is recognized when significant risks and rewards of ownership have been transferred to the buyer, the seller does not retain managerial involvement or control over goods sold, the amount of revenue can be measured reliability, the flow of economic benefits to seller is probable, and related costs can be reliably measured (IAS 18.14).

IFRS has taken a more liberal approach in determining when to recognize revenue from sale of goods. On the hand, GAAP approach better embodies the qualitative characteristic of reliability and relevance by requiring contingencies to occur before revenue can be recognized. The criteria set out in GAAP better ensures representational faithfulness and predictive value in financial statements reflecting revenue from sales of goods. Multiple-deliverable arrangements are accounted for differently under IFRS and GAAP. There are two common revenue recognition issues pertaining to multiple-deliverable arrangements: 1) determining when to separate transactions with multiple-deliverables and 2) determining the appropriate accounting methods to allocate revenue into the separated components (Cleavland, 2013). GAAP requires the selling price to be the basis for allocation consideration to the different components of the transaction. GAAP requires vendor-specific objective evidence of fair value in determining as estimate of the selling price. If that is not available, third-party evidence may be used. If neither of those items is available, a best estimate of selling price may be used and prohibits the use of the residual method to allocate consideration. However, IFRS continues to permit companies to elect use of the residual method.

Another difference between IFRS and GAAP is the accounting of customer loyalty programs. Accounting for customer loyalty programs will most likely have different results under IFRS and GAAP and therefore be another issue that needs to be addressed before completely adopting IFRS. IFRS requires and GAAP allows customer loyalty programs to be accounted for as multiple-element arrangements. GAAP, however, also permits companies to use the incremental cost model, which, unlike the multiple-element arrangement model, results in less revenue being deferred. Companies using GAAP wish to convert to IFRS or expand their business to an international market, will have to reconcile their reported income to reflect a deferral, otherwise, this can ultimately affect the viability of a company and its ability to compete fairly on an international level.

Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are collaborating and attempting to clarify principles for recognizing revenue and to develop a common revenue standard aimed to: “1) remove inconsistencies and weaknesses in existing revenue requirements, 2) provide a more robust framework for addressing revenue issues, 3) improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets, 4) provide more useful information to users of financial statements through improved disclosure requirements, and 5) simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer” (FASB). FASB and IASB have proposed respective amendments, but most of their difference still remains.

Overall the adoption of IFRS will result in change in revenue recognition for most American companies. This will have a dramatic impact on their earnings and their viability. These changes will ultimately impact the national economy. Therefore, implementation should occur in increments to allow companies to revise or adjust if necessary their future financial plans.

CONSOLIDATED FINANCIAL STATEMENTS

Both IFRS and GAAP determine whether or not entities should report consolidated by assessing the amount of control one entity has in another (ASC 323 & IAS 28). However, IFS and GAAP differ in their definition of control. GAAP determines control by focusing on who control financial interests of the company by analyzing voting rights. Potential voting rights are excluded from the GAAP analysis but

included in IFRS. IFRS focuses on the ability for a company to govern the financial and operating policies of an entity to obtain a benefit. While IFRS analysis may factor in voting rights, it is not the exclusive factor.

Special purpose entities are also accounted for differently with IFRS and with GAAP. GAAP requires a reporting entity that is the primary beneficiary of a variable interest entity (VIE) to consolidate with the variable interest entity (ASC 810). For a reporting entity to be considered a primary beneficiary they must possess “the obligation to absorb losses of the VIE or possess the right to receive benefits from the VIE that could potentially be significant to the VIE.” ASC 810-10-25-38A(b). However, under IFRS entities that are created to achieve a specific objective are consolidated with a parent entity when an analysis of the relationship between the parent company and the entity created for a specific objective indicates the parent company has control (SIC-12).

Preparation of consolidated financial statements differs under IFRS and GAAP. Under GAAP the parent company and the subsidiary company are allowed to have different year-ends up to three months apart. GAAP requires significant events occurring between the reporting dates to be disclosed in the financial statements. Under IFRS the subsidiaries prepare for consolidation purposes additional financial statements to reflect activity in the same period as the parent entity. Subsidiaries must prepare these additional financial statements unless it impractical to do so or the difference between year-ends is less than three months and the subsidiaries financial statements reflect significant transactions or occurrences.

CONCLUSION

It is apparent from the comparison of GAAP and IFRS on these three topics that GAAP aims to provide definitive answers to potential questions while IFRS intends to create a principle based framework. Despite GAAP’s attempt to provide specific guidance on issues, GAAP will never be fool proof. The success of GAAP is directly dependent on its application and its ability to adjust to an evolving global economy. We believe that as globalization progresses we will see more and more instances of GAAP failing to evolve, failing to adjust to new accounting scenarios and failing to timely address accounting problems.

REFERENCES

- Baker, Christensen, Cottrell, *Advanced Financial Accounting*, 2012.
<http://www.eisneramper.com/Revenue-Recognition-0610.aspx#sthash.KIsLVWjj.dpuf>
- Cleavland, Richard “Revenue Recognition (Topic 605) Multiple-Deliverable Revenue Arrangements A consensus of the FASB Emerging Issues Task Force.” 2013.
- Krishnan, Sudha. “Inventory Valuation Under IFRS and GAAP” *Strategic Finance*. March 2012: 51-61.
- Munter, Paul. “Accounting Standard-Setting: Convergence Drives More Change.” *Financial Executive*. January/February 2011: 22-25.
- www.fasb.org