

## THE IMPACT OF THE ADOPTION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS ON THE LEGAL PROFESSION

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I. INTRODUCTION

REQUIESCAT

Tread lightly, she is near  
Under the snow,  
Speak gently, she can hear  
The daisies grow.

All her bright golden hair  
Tarnished with rust,  
She that was young and fair  
Fallen to dust.

Lily-like, white as snow,  
She hardly knew  
She was a woman, so  
Sweetly she grew.

Coffin-board, heavy stone,  
Lie on her breast,  
I vex my heart alone,  
She is at rest.

Peace, peace, she cannot hear  
Lyre or sonnet,  
All my life's buried here,  
Heap earth upon it.<sup>1</sup>

The poem *Requiescat*, written by Oscar Wilde, is—as its name implies—a “prayer for the repose of a dead person.”<sup>2</sup> Like

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1. OSCAR WILDE, *Requiescat*, in THE COMPLETE WORKS OF OSCAR WILDE 724, 724 (J.B. Foreman ed., HarperCollins Publishers, Inc. 1989) (1966).

the woman depicted in the poem, the method of accounting currently in use in the United States (“U.S.”) may soon be lying under a “coffin-board” and “tarnished with rust.”<sup>3</sup> In its place will be the method of accounting used by most other countries in the world.<sup>4</sup> The death of its current accounting method and the birth of a new method in the U.S. will, obviously, affect the accounting profession in a multitude of ways, including tax reporting, inventory accounting procedures, and perhaps revenue recognition policies.<sup>5</sup> In addition, it will send ripples through the legal profession.<sup>6</sup> It will, in particular, compel the legal profession to reassess its current practices and adjust them accordingly.<sup>7</sup>

This article explores the impact the adoption of International Financial Reporting Standards (“IFRS”) will likely have on the legal profession. First, however, it provides a necessary informational backdrop to the legal issue.

## II. THE DEFINITION AND NEED FOR ACCOUNTING STANDARDS

The first order of business entails a discussion of the definition and purpose of accounting. Accounting has been described as “the art of recording, classifying, and summarizing . . . transactions and events . . . and interpreting

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2. See *id.*; MERRIAM WEBSTER'S COLLEGIATE DICTIONARY 1058 (11d ed. 2003) (defining “requiescat” as a Latin noun meaning a “prayer for the repose of a dead person”).

3. WILDE, *supra* note 1, at 724; cf. Alistair M. Nevius, *How Will IFRS Affect Tax Practicioners?*, J. ACCT., June 2008, <http://www.journalofaccountancy.com/Issues/2008/Jun/HowWillIFRSAffectTaxPracticioners> (describing the effect the transition to International Financial Reporting Standards from U.S. Generally Accepted Accounting Principles will have on methods of current financial reporting); see also Sarah Johnson, *Slow Death for GAAP: Cox*, CFO.COM, Jan. 10, 2008, <http://www.cfo.com/article.cfm/10517917?f=related> (arguing that although the transition to IFRS is coming, it may not come as quick as some anticipate).

4. See Sarah Johnson, *Accountants Now Taking the Shift to IFRS More Seriously*, CFO.COM, Dec. 4, 2008, <http://cfo.com/article.cfm/12734796?f=search>.

5. See, e.g., Steve Meisel, *Mapping the Change: IFRS Implementation Guide*, in 40TH ANNUAL INSTITUTE ON SECURITIES REGULATION 2008 610 (PLI Corp. L. & Prac., Course Handbook Series No. 1705, 2008) [hereinafter *Mapping the Change*].

6. See Stuart H. Deming, *International Financial Reporting Standards: Their Importance to U.S. Business and Legal Practice*, 84 MICH. BAR J. 14, 17 (2005); see also L. Gordon Crovitz, *Closing the Information GAAP*, WALL ST. J., Sept. 8, 2008, available at [http://online.wsj.com/article/SB122083366235408621.html?mod=hpp\\_us\\_inside\\_today](http://online.wsj.com/article/SB122083366235408621.html?mod=hpp_us_inside_today); cf. David M. Katz, *How LIFO Could Stall Global Accounting*, CFO.COM, Dec. 3, 2007, [http://www.cfo.com/article.cfm/10239047/c\\_2984368](http://www.cfo.com/article.cfm/10239047/c_2984368).

7. See Deming, *supra* note 6, at 17; see also Crovitz, *supra* note 6; cf. Katz, *supra* note 6.

the results thereof.”<sup>8</sup> That is, it is a way of accumulating and communicating “information essential to an understanding of the activities of an enterprise, whether large or small, corporate or non-corporate, profit or non-profit, public or private.”<sup>9</sup> The information provided by practitioners of accounting is useful in making business and economic decisions.<sup>10</sup>

The two types of users of accounting information are internal users and external users.<sup>11</sup> As their names imply, internal users are internal to the firm (i.e. managers), and external users are external to the firm.<sup>12</sup> “External users include owners, lenders, suppliers, potential investors, potential creditors, employees, customers, stockbrokers, financial analysts, taxing authorities, regulatory authorities, trade associations, and teachers.”<sup>13</sup> Internal users and external users seek different types of accounting information.<sup>14</sup> Internal users seek accounting information they can use to decide issues such as: (1) were the objectives of the firm met? (i.e. sales goals), (2) were budgets complied with?, (3) which goods were sold at a profit and which were not?, etc.<sup>15</sup> Conversely, external users seek accounting information that they can use to decide whether they should supply goods to a particular company, purchase stock in a firm, or loan money to a firm.<sup>16</sup> To meet the different needs of internal and external users, two segments of accounting have arisen: financial accounting and managerial accounting.<sup>17</sup> Financial accounting serves the informational needs of the external users; whereas, managerial accounting serves the informational needs of internal users.<sup>18</sup>

8. GARY L. SCHUGART, JAMES J. BENJAMIN, ARTHUR J. FRANCA & JEFFREY W. STRAWSER, *SURVEY OF FINANCIAL ACCOUNTING* 1-1 (Thomas R. Noland ed., Thomson Custom Publishing 2003).

9. *Id.* at 1-1; *see also* George Mundstock, *The Trouble With FASB*, 28 N.C. J. INT'L L. & COM. REG. 813, 814-15 (2003).

10. SCHUGART ET AL., *supra* note 8, at 1-1; *see also* Financial Accounting, <http://www.quickmba.com/accounting/fin/> (last visited Jan. 6, 2010); Lawrence A. Cunningham, *The SEC's Global Accounting Vision: A Realistic Appraisal of a Quixotic Quest*, 87 N.C. L. REV. 1, 27 (2008).

11. SCHUGART ET AL., *supra* note 8, at 1-3.

12. *Id.* at 1-3.

13. *Id.* at 1-4.

14. *See id.* at 1-4 to 1-5; *see also* DONALD E. KIESO, JERRY J. WEYGANDT & TERRY D. WARFIELD, *INTERMEDIATE ACCOUNTING* 5-6 (Christopher DeJohn et al. eds., John Wiley & Sons, Inc., 12th ed. 2007) (1965).

15. SCHUGART ET AL., *supra* note 8, at 1-5.

16. *Id.* at 1-4.

17. *Id.* at 1-3.

18. *Id.* at 1-3 to 1-4; *see also* William E. Nelson, *Contract Litigation and the Elite Bar in New York City, 1960-1980*, 39 EMORY L.J. 413, 433-434 (1990); JAMES JIAMBALVO, *MANAGERIAL ACCOUNTING* 1 (Jay O'Callaghan et al. eds., John Wiley & Sons, Inc. 2004).

Because internal users are internal to the firm, they can easily access any and all information required to make decisions.<sup>19</sup> However, external users are not so privileged.<sup>20</sup> They make decisions solely upon information the firm communicates to the public.<sup>21</sup> To ensure that accounting information disseminated to the public is free from bias and useful in decision making, standards governing the recordation of transactions and the preparation of financial statements have been promulgated.<sup>22</sup>

### III. ACCOUNTING STANDARDS CURRENTLY IN USE

Until recently, the principles and rules governing accounting differed across country borders.<sup>23</sup> However, there has been a movement in which most countries have adopted IFRS.<sup>24</sup> In fact, over one hundred countries currently mandate the use of IFRS (or permit its use).<sup>25</sup> Further, that number will likely rise to more than 150 in the near future.<sup>26</sup>

The United States is not one of the countries that have adopted IFRS.<sup>27</sup> In the United States, the standards, rules and conventions that govern financial accounting are called Generally Accepted Accounting Principles (“GAAP”).<sup>28</sup> U.S. GAAP was developed by the Financial Accounting Standards Board (“FASB”), the Securities and Exchange Commission (“SEC”), the American Institute of Certified Public Accountants (“AICPA”), and the Government Accounting Standards Board (“GASB”).<sup>29</sup> Although U.S. GAAP was developed by many bodies, the FASB

19. SCHUGART ET AL., *supra* note 8, at 1-5.

20. *See id.* at 1-4.

21. *See id.*

22. *See* KIESO ET AL., *supra* note 14, at 3-5; *see also* Claudia P. Spencer, *Understanding GAAP, GAAS, and the Accounting Cycle*, in *BASICS OF ACCOUNTING FOR LAWYERS* 2008 23, 25 (PLI Corp. L. & Prac., Course Handbook Series No. 23, 2008).

23. SCHUGART ET AL., *supra* note 8, at 1-17.

24. *See* Crovitz, *supra* note 6; *see also* DELOITTE, *INTERNATIONAL FINANCIAL REPORTING STANDARDS FOR U.S. COMPANIES 1* (2008), [http://www.deloitte.com/dtt/cda/doc/content/us\\_tax\\_ifrsandtaximplications\\_082208.pdf](http://www.deloitte.com/dtt/cda/doc/content/us_tax_ifrsandtaximplications_082208.pdf) [hereinafter *IFRS FOR U.S. COMPANIES*].

25. Kathleen L. Casey, *SEC Commissioner Casey Addresses Global Financial Reporting Convergence Conference*, *US FED. NEWS*, Sept. 28, 2007, *available at* 2007 WLNR 19326309; *see also* CHRISTINE NEWELL & JAY KALIS, *IFRS IS COMING, WHAT DOES THIS MEAN FOR TAX?* 1 (2008) <http://www.taxgovernanceinstitute.com/documents/TGI/12302008111955Tax%20Implications%20of%20IFRS%20Conversion.pdf>.

26. Casey, *supra* note 25.

27. *See* Crovitz, *supra* note 6.

28. Spencer, *supra* note 22, at 25; *see also* KIESO ET AL., *supra* note 14, at 1323; SCHUGART ET AL., *supra* note 8, at 1-11.

29. *See* KIESO ET AL., *supra* note 14, at 6; *see also* Spencer, *supra* note 22, at 25-26.

and the SEC are the most important.<sup>30</sup> Among other things, the FASB promulgates the Statements of Financial Accounting Standards (“SFAS”), which establish GAAP.<sup>31</sup> The SEC mainly serves to enforce the use of the standards by companies and to oversee the other bodies.<sup>32</sup> The components of the two guidelines parallel each other:

The standard-setting structure internationally is now very similar to the standard-setting structure in the United States. That is, the structure is comprised of two main bodies: The International Accounting Standards Committee Foundation (IASCF) provides oversight. The International Accounting Standards Board (IASB) develops the standards, which are referred to as IFRS.<sup>33</sup>

IFRS and its competitor, GAAP, are the two main methods of accounting that are currently in use.<sup>34</sup>

#### IV. THE NEED FOR A SINGLE, GLOBALLY ACCEPTED ACCOUNTING STANDARD

“We have witnessed an incredible transformation in the speed and scale of communications among companies and individuals across borders. As communication barriers continue to drop, companies and individuals in different countries and markets are becoming comfortable buying and selling goods and services from one another.”<sup>35</sup> Because the marketplace is increasingly global, the existence of two different accounting systems is problematic for both global companies and investors.<sup>36</sup> International companies must prepare financial statements in

30. See Spencer, *supra* note 22, at 25-26.

31. See KIESO ET AL., *supra* note 14, at 9; see also GRANT THORNTON, COMPARISON BETWEEN U.S. GAAP AND INTERNATIONAL FINANCIAL REPORTING STANDARDS 6 (2008), [http://www.grantthornton.com/staticfiles/GTCom/files/GT%20Thinking/IFRS\\_Resource\\_Center/Grant\\_Thornton\\_U%20S%20GAAP\\_v\\_IFRS\\_Comparison.pdf](http://www.grantthornton.com/staticfiles/GTCom/files/GT%20Thinking/IFRS_Resource_Center/Grant_Thornton_U%20S%20GAAP_v_IFRS_Comparison.pdf).

32. See KIESO ET AL., *supra* note 14, at 6-7.

33. KIESO ET AL., *supra* note 14, at 1325; see also International Financial Reporting Standards (IFRS), <http://www.investopedia.com/terms/i/ifrs.asp> (last visited Jan. 6, 2010).

34. KIESO ET AL., *supra* note 14, at 16; see also Roel C. Campos, Comm’r, U.S. Sec. & Exch. Comm’n, Remarks at the SEC Open Meeting: IFRS / U.S. GAAP Reconciliation (June 20, 2007), available at <http://sec.gov/news/speech/2007/spch062007rcc-3.htm>.

35. KIESO ET AL., *supra* note 14, at 1322; see also The Global Marketplace, [http://www.consumerpsychologist.com/intl\\_Global\\_Marketplace.html](http://www.consumerpsychologist.com/intl_Global_Marketplace.html) (last visited Jan. 16, 2009).

36. See John Morgan, *SEC Prepares to Close the GAAP: Companies Brace for New International Reporting Standards*, MONEY MGMT. EXECUTIVE, Aug. 4, 2008, available at 2008 WLNR 14516748.

accordance with the accounting standards promulgated in each country in which they operate.<sup>37</sup> The need to prepare multiple sets of financial statements is costly and administratively burdensome.<sup>38</sup> Investors are also burdened by the existence of different accounting standards.<sup>39</sup> Because companies in different countries use different standards to prepare their financial statements, the investor cannot readily compare the financial statements of companies based in different countries.<sup>40</sup> “A single set of accounting rules would mean more effective global disclosure and transparency. It would reduce costs for multinationals that must now prepare multiple books. It would also make U.S. exchanges more competitive for listings by eliminating accounting differences.”<sup>41</sup>

#### V. WHICH STANDARD WILL PREVAIL? – THE MOVE TOWARD IFRS

The foregoing is evidence that a globally accepted accounting standard is needed.<sup>42</sup> “There was once hope that the one global set of standards would be the U.S. generally accepted accounting principles . . . . But, following enactment of the Sarbanes-Oxley Act, to which foreign companies responded with distaste,” the European Union mandated the use of IFRS.<sup>43</sup> This catalyst prompted more than just the countries in the European Union to begin requiring IFRS.<sup>44</sup> Many other countries have increasingly begun to adopt IFRS.<sup>45</sup> Because the majority of the rest of the

37. See Casey, *supra* note 25.

38. *Id.*

39. See *id.*

40. Casey, *supra* note 25; see also Crovitz, *supra* note 6 (“[I]t [is] hard to compare an energy company based in Texas with one based in Amsterdam, a bank in New York with one in London, or a biotech firm in Boston with one in Singapore.”).

41. Crovitz, *supra* note 6; see also *Testimony Concerning Globally Accepted Accounting Standards: Before the Subcomm. on Securities, Insurance, and Investment of the U.S. Sen. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 2-3 (2007) (statements of Conrad W. Hewitt, Chief Accountant & John W. White, Director, Division of Corporate Finance, Sec. & Exch. Comm’n), available at <http://sec.gov/news/testimony/2007/ts102407cwh-jww.htm> [hereinafter *Testimony Concerning Globally Accepted Accounting Standards*].

42. Morgan, *supra* note 36; see also Edward W. Trott, *The Road to a Single Set of Stable, High Quality Accounting Standards Used Globally*, in AUDIT COMMITTEE WORKSHOP 2008 205, 209 (PLI Corp. L. & Prac., Course Handbook Series No. 1682, 2008); *Testimony Concerning Globally Accepted Accounting Standards*, *supra* note 41.

43. Lauren Gardner, *Move from GAAP to IFRS Could Spell Big Changes for Companies Using LIFO*, 4 ACCT. POL’Y & PRAC. RPT. 803, 804 (2008), available at 4 APPR 803 (BNA Tax and Accounting Center).

44. *Id.*

45. Christopher Cox, Chairman, Sec. & Exch. Comm’n, Proposing a Roadmap Toward IFRS (Aug. 27, 2008), available at <http://www.sec.gov/news/speech/2008/>

world is using IFRS, it is only a matter of time before the U.S. will jump on the bandwagon and adopt IFRS.<sup>46</sup> A study of the recent history of the activities of the SEC is illustrative of the inevitability of the adoption of IFRS by the U.S.<sup>47</sup>

Before 2007, the SEC required that foreign private issuers reconcile their financial statements from their local accounting standards to U.S. GAAP before listing securities on a U.S. exchange.<sup>48</sup> Because this requirement imposed substantial additional costs to foreign private issuers, they were less inclined to invest in the U.S. capital markets.<sup>49</sup> To make the U.S. capital markets more attractive, the SEC eliminated the requirement that foreign private issuers reconcile their financial statements from IFRS to GAAP.<sup>50</sup> Thus, the U.S. became one additional country permitting, under some circumstances, the use of IFRS.<sup>51</sup> This step was a big one on the road toward the adoption of IFRS in the U.S.<sup>52</sup>

American companies are disadvantaged by the recent SEC decision to eliminate the reconciliation requirement.<sup>53</sup> These companies will have to prepare and file their financial statements with the SEC in accordance with U.S. GAAP, whereas foreign private issuers may prepare and file their

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sph082708cc\_ifrs.htm (“Today, all of Europe and nearly 100 countries around the world require or permit the use of IFRS, and many more are on the verge of doing so.”).

46. See Nevius, *supra* note 3.

47. See Gardner, *supra* note 43; see also Chester Abell, *International Financial Reporting Standards: Tax Must be Involved*, 120 TAX NOTES 1057, 1057 (2008).

48. See Press Release, International Accounting Standards Board, The IASB Welcomes SEC Vote to Remove Reconciliation Requirement (Nov. 15, 2007), available at [http://www.iasb.org/NR/rdonlyres/7990D56A-15A84811A5F3D42EA73520B2/0/SEC\\_vote\\_to\\_remove\\_reconciliation\\_requirement.pdf](http://www.iasb.org/NR/rdonlyres/7990D56A-15A84811A5F3D42EA73520B2/0/SEC_vote_to_remove_reconciliation_requirement.pdf). A foreign private issuer is a foreign company that lists its securities in the U.S. Foreign Private Issuers, [http://content.lawyerlinks.com/sec/securities\\_law/foreign\\_issuers/foreign\\_private\\_issuers.htm?q=foreign+private+issuer](http://content.lawyerlinks.com/sec/securities_law/foreign_issuers/foreign_private_issuers.htm?q=foreign+private+issuer) (last visited Jan. 6, 2009). In addition, the majority of the foreign company’s shareholders and officers must not be living in the U.S. *Id.*

49. Carlos R. Albarracín, J. Allen Miller & Eric J. Rothman, Foreign Private Issuers Preparing Financial Statements in Accordance with IFRS are No Longer Required to Reconcile to U.S. GAAP (Apr. 17, 2008), <http://www.chadbourne.com/clientalerts/2008/fpifinancial/>.

50. *Id.*; see also Press Release, U.S. Securities and Exchange Commission, SEC Takes Action to Improve Consistency of Disclosure to U.S. Investors in Foreign Companies (Nov. 15, 2007), available at <http://www.sec.gov/news/press/2007/2007-235.htm>.

51. *Id.*

52. See Albarracín et al., *supra* note 49.

53. Sarah Johnson, *Auditor: Convergence Could Spur Revenue Wreck*, CFO.COM, Aug. 29, 2007, <http://www.cfo.com/article.cfm/9721751?f=search> [hereinafter *Convergence*].

financial statements in accordance with IFRS.<sup>54</sup> This creates a disadvantage in that “a company using IFRS can record revenue sooner than a company using GAAP can for a very similar transaction . . . .”<sup>55</sup> Since revenue/earnings are often an indicator of success, the company using IFRS will look better than the company using GAAP “[e]ven though both companies could have the same product and similar financial health.”<sup>56</sup>

The only way to eliminate the disadvantage American companies face is to eliminate the existence of two separate and different standards.<sup>57</sup> Since most of the world has adopted IFRS (including the U.S.—albeit for foreign private issuers only) and not GAAP, it seems as if the U.S. will have to jump on the bandwagon and adopt IFRS as well.<sup>58</sup> Recognizing all of the foregoing, “[the SEC] issued a request for comment on whether or not U.S.-listed companies should be able to use IFRS instead of U.S. GAAP.”<sup>59</sup> This act was an additional step on the road toward the adoption of IFRS.<sup>60</sup>

The SEC recently took a big step toward the adoption of IFRS.<sup>61</sup> On August 27, 2008, the SEC proposed to adopt IFRS if a series of milestones were met.<sup>62</sup> The improvement of the quality of IFRS and the creation of an independent funding source for the International Accounting Standards Committee

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54. *See id.*; Guy P. Lander & G. Christina Gray-Trefry, SEC Eliminates U.S. GAAP Reconciliation Requirement for Foreign Private Issuers that Adopt International Financial Reporting Standards (Feb. 7, 2008), <http://www.clm.com/publication.cfm/ID/165>.

55. *Convergence, supra* note 53; *see also IFRS Revs Up DaimlerChrysler's Earnings*, CFO MAG. FOR SENIOR FIN. EXECUTIVES, Apr. 27, 2007, available at 2007 WLNR 8401076 (“DaimlerChrysler finds that shifting from U.S. GAAP to IFRS, as required by the European Union, revved up the carmaker’s earnings.”).

56. *Convergence, supra* note 53.

57. *See id.*

58. *See* NEWELL & KALIS, *supra* note 25, at 1. “IFRS is the accounting standard currently used in many parts of the world. Over 100 countries currently require or permit IFRS or a variation of IFRS. Many other countries . . . are planning to require or permit IFRS, or are working on convergence with IFRS. As a result, IFRS seems to be the most likely approach to achieving a single set of high quality, globally accepted accounting standards.” *Id.*

59. Abell, *supra* note 47, at 1057; *see also* John W. White, Dir. Div. of Corporate Fin., Sec. & Exch. Comm’n, Speech by SEC Staff: IFRS and U.S. Companies: A Look Ahead (June 5, 2008), available at <http://www.sec.gov/news/speech/2008/spch060508jww.htm> (responding to the request that the SEC investigate allowing U.S.-listed companies to use IFRS).

60. *See* Casey, *supra* note 25.

61. *See* Steven Marcy, *SEC Offers Potential Path for Adoption of International Accounting Standards*, 4 ACCT. POL’Y & PRAC. RPT. 770, 771 (2008), available at 4 APPR 770 (BNA Tax and Accounting Center) [hereinafter *SEC Offers Potential Path*].

62. *Id.*

Foundation are among the several milestones set.<sup>63</sup> In the year 2011, the SEC plans on assessing progress of achievement of the milestones and then, based upon such assessment, deciding whether to adopt IFRS.<sup>64</sup> If adopted, the transition will occur in phases.<sup>65</sup> That is, there will be staggering effective dates.<sup>66</sup> Under the proposal, the SEC envisions “large companies moving to IFRS in 2014, followed by medium-sized ones the following year, and finally smaller companies in 2016.”<sup>67</sup> Although the switch to IFRS has not been set in stone and is only a mere possibility, many believe that it is inevitable.<sup>68</sup> In fact, many big companies that operate in many countries, like GE and Microsoft, have begun to prepare for the switch.<sup>69</sup> The question is not if, but when.<sup>70</sup>

Although the U.S. has not adopted IFRS yet, there have been ongoing convergence efforts since 2002.<sup>71</sup> In October of 2002, the FASB and the IASB issued the Norwalk Agreement, a memorandum of understanding, in which both standard-setting bodies agreed to work toward a convergence of their respective standards.<sup>72</sup> That is, the FASB and the IASB have agreed to use

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63. *Id.*; see also *SEC Road Map for Transition to IFRS Available*, J. ACCT., Nov. 16, 2008, <http://www.journalofaccountancy.com/Web/RoadMapforTransitiontoIFRSAvailable.htm>.

64. *SEC Road Map for Transition to IFRS Available*, *supra* note 63.

65. Denise Lugo & Stephen Bouvier, *FASB to Issue Invitation to Comment on IASB Income Tax Standard*, ACCT. FOR INCOME TAXES MONITOR, Sept. 12, 2008; see also Yvette Essen, *Securities and Exchange Commission Unveils Road Map to Adopt IFRS*, TELEGRAPH, Aug. 28, 2008, <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/2795401/Securities-and-Exchange-Commission-unveils-road-map-to-adopt-IFRS.html>.

66. Essen, *supra* note 65.

67. *Id.*; see also H. Stephen Meisel, *10 Minutes on Transitioning to IFRS*, in 40TH ANNUAL INST. ON SEC. REGULATION 2008 581 (PLI Corp. L. & Prac., Course Handbook Series No. 14864, 2008) [hereinafter *Transitioning to IFRS*].

68. *SEC Offers Potential Path*, *supra* note 61, at 3; see also *Transitioning to IFRS*, *supra* note 67, at 581.

69. See *What an XBRL Mandate Means to You*, DELOITTE AUDIT COMMITTEE BRIEF (Deloitte Dev. LLC, New York, N.Y.), May 2008, at 2, available at <http://www.iasplus.com/usa/0805auditcommitteebrief.pdf>. On the other hand, many smaller companies are unfamiliar with the standards and thus less prepared for the switch. See Casey, *supra* note 25. (“A recent survey by Duke University and CFO Magazine found . . . a relatively low degree of familiarity with IFRS by U.S. companies. This is not surprising, but it validates . . . [a] key concern[], which is the need to step up IFRS training for our preparers and auditors.”).

70. Gardner, *supra* note 43.

71. See Memorandum of Understanding between the Financial Accounting Standards Board and the International Accounting Standards Board 1 (Oct. 29, 2002), <http://www.fasb.org/news/memorandum.pdf>.

72. Financial Accounting Standards Board, *Convergence with the International Accounting Standards Board (IASB)*, [http://www.fasb.org/intl/convergence\\_iasb.shtml](http://www.fasb.org/intl/convergence_iasb.shtml) (last visited Jan. 6, 2010); Robert K. Larson & Donna L. Street, *The Roadmap to Global*

their best efforts to make their existing financial reporting standards compatible.<sup>73</sup>

They further agreed that, where one system has a better approach than the other, both systems would adopt the better principle without having to conform all of the detailed rules. And instead of trying to eliminate differences between two standards where both are in need of significant improvement, FASB and the IASB agreed to develop a new and better common standard. To my mind, this approach to the creation of high quality standards and the good faith of the FASB and IASB should allay concerns about the predominance of one accounting system or approach over another. It is in everyone's interest that any global standard be the superior standard and that we avoid U.S. GAAP or IFRS biases that would impede this worthy goal.<sup>74</sup>

The convergence effort undergone by the FASB and IASB may soon be abandoned.<sup>75</sup> When the SEC accepts IFRS as its generally accepted accounting principle, there will no longer be a need to continue the convergence efforts.<sup>76</sup> However, the convergence efforts will continue until that point in time.<sup>77</sup> The continued convergence of the standards is necessary in that the challenges of adopting a new standard will lessen as the differences between the two standards lessen.<sup>78</sup>

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*Accounting Convergence: Europe Introduces 'Speed Bumps'*, CPA J., Oct. 2006, at 36, 36, available at <http://www.nysscpa.org/cpapjournal/2006/1006/essentials/p36.htm>.

73. Casey, *supra* note 25.

74. *Id.*

75. See AICPA, IFRS PRIMER FOR AUDIT COMMITTEES (June 2009) [http://media.cpa2biz.com/Publication/IFRS/1939-347\\_ifrs-audit\\_comm\\_news.pdf](http://media.cpa2biz.com/Publication/IFRS/1939-347_ifrs-audit_comm_news.pdf).

76. See *id.*

77. See IFRS FOR U.S. COMPANIES, *supra* note 24 (The move to IFRS will probably occur in two stages—convergence and then adoption).

78. See Mohan R. Lavi, *The Transition to IFRS*, BUS. LINE, Jan. 3, 2008, at 2, available at 2008 WLNR 94067. Today, there are a lot of differences between IFRS and GAAP; however, after convergence efforts and at the time of the adoption of IFRS, there may be only about three to four major differences. Dean Schuckman et al., *IFRS: The right move toward convergence*, PRICEWATERHOUSECOOPERS, Jan. 2008, [http://www.pwc.com/extweb/pwcpublications.nsf/docid/D306B0B48A4248F785257426006D7AAE/\\$file/ifrs\\_right\\_move\\_tax.pdf](http://www.pwc.com/extweb/pwcpublications.nsf/docid/D306B0B48A4248F785257426006D7AAE/$file/ifrs_right_move_tax.pdf).

## VI. THE CHALLENGES FACED BY THE LEGAL PROFESSION

When the U.S. adopts IFRS, the differences that still exist between the two accounting methods will greatly impact the financial accounting world.<sup>79</sup> In addition, its impact will radiate into the legal profession.<sup>80</sup> Lawyers must understand and appreciate the differences between the two accounting systems as well as the impact those differences may have on the legal profession.<sup>81</sup>

A. *The Legal Profession May Have to Codify a New Defense for Accountants*

One of the principle differences between U.S. GAAP and IFRS is that IFRS is more principles-based, whereas U.S. GAAP is more rules-based.<sup>82</sup> More specifically, GAAP tries to prescribe rules to guide accountants in all possible situations.<sup>83</sup> That is, it tries to anticipate all contingencies and to set rules to guide the accountant in accounting for each of them.<sup>84</sup> Therefore, GAAP, as a rules-based form of accounting, is very detailed and consists of many rules and standards.<sup>85</sup> On the other hand, IFRS does not provide much guidance to accountants.<sup>86</sup> IFRS “provides a conceptual basis for accountants to follow instead of a list of detailed rules.”<sup>87</sup> It requires accountants to consider the specific

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79. See Remi Forgeas, *Audit and Assurance Partner, Mazars, Is IFRS that Different from U.S. GAAP?*, AICPA, Dec. 15, 2008, [http://www.cpa2biz.com/Content/media/PRODUCER\\_CONTENT/Newsletters/Articles\\_2008/CPA/Dec/USGaap.jsp](http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2008/CPA/Dec/USGaap.jsp).

80. Deloitte: The Language of Business is Changing: Do You Speak IFRS? (Apr. 15, 2009), [http://www.deloitte.com/view/en\\_US/us/article/70a555baf1001210VgnVCM100000ba42f00aRCRD.htm](http://www.deloitte.com/view/en_US/us/article/70a555baf1001210VgnVCM100000ba42f00aRCRD.htm).

81. Carrie Huff & Bruce Newsome, SEC Issues Proposed Roadmap For International Financial Reporting Standards (IFRS): What In-House Counsel Should Know Now (Nov. 20, 2008), <http://www.haynesboone.com/sec-issues-proposed-roadmap-for-international-financial-reporting-standards-ifs-what-in-house-counsel-should-know-now-11-20-2008/>.

82. IAS Plus: Comparisons of IFRSs and US GAAP, <http://www.cs.trinity.edu/~rjensen/Calgary/CD/JensenPowerPoint/IAS%20Plus%20%20Comparison%20of%20IFRS%20and%20US%20GAAP.htm> (last visited Jan. 7, 2010).

83. Rebecca Toppe Shortridge & Mark Myring, *Defining Principles-Based Accounting Standards*, CPA J., Aug. 1, 2004, <http://www.nyssecpa.org/cpajournal/2004/804/essentials/p34.htm>.

84. *Id.*

85. *Id.*; see also Crovitz, *supra* note 6 (“GAAP rules fill a nine-inch, three-volume set of pronouncements plus interpretive information.”).

86. Lee A. Sheppard, *News Analysis: IFRS and Accounting Method Changes*, TAX NOTES, Dec. 1, 2008, at 995, available at 2008 TNT 232-5.

87. Shortridge & Myring, *supra* note 83. “In contrast [to GAAP’s rule book], IFRS is a slim two-inch book.” Crovitz, *supra* note 6.

circumstances of each transaction and exercise their professional judgment in determining how to account for it.<sup>88</sup>

One of the many reasons why GAAP consists of so many rules is because of the “pressures of the U.S. legal system.”<sup>89</sup> The United States is a very litigious forum, more so than in other countries.<sup>90</sup> In fear of lawsuits, U.S. companies prefer to have specific accounting rules that govern every possible situation.<sup>91</sup> In this way, when they are sued and called into court, they have a defense.<sup>92</sup> The companies merely have to prove they followed the applicable accounting rule and, therefore, are not liable.<sup>93</sup>

Because IFRS does not prescribe rules that accountants can follow but, instead, requires accountants to exercise their professional judgment, the accountants no longer can rely on the defense that they followed the pertinent rules.<sup>94</sup> The law must begin to recognize “well-reasoned professional judgments” as a defense “for company boards and accountants who try to do the right thing[] if they fully disclose why they thought that [the] particular accounting treatment made sense. The law will have to adjust to accept more ambiguity in accounting.”<sup>95</sup>

#### B. *Lawyers Need to Exercise Care When Drafting Contracts Tied to Financial Statements of an Entity*

Another reason why the differences between the two accounting methods is important to lawyers is because the terms of legal instruments often refer to and are dependent on the information in financial statements.<sup>96</sup> When the method of accounting for the transactions recorded in the financial statements changes, the information in the statements may change as well.<sup>97</sup> In effect, the terms of the contract tied to the

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88. Ted Kamman, Christopher M. Kelly & Richard M. Kosnik, SEC Proposes Adoption of IFRS Financial Reporting for U.S. Issuers (Jan. 2009), [http://www.jonesday.com/pubs/pubs\\_detail.aspx?pubID=S5787](http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S5787).

89. Crovitz, *supra* note 6.

90. Lawrence Richter Quinn, *International Reporting Standards Gain Global Recognition*, INVESTOPEDIA.COM, <http://www.investopedia.com/articles/financialcareers/08/international-accounting-standards.asp?viewall=1> (last visited Jan. 7, 2010).

91. *Id.*

92. *Id.*

93. *Id.*

94. *See* Crovitz, *supra* note 6.

95. *Id.*

96. Deming, *supra* note 6, at 17.

97. *See* Susan B. Hughes & James F. Sander, *A U.S. Manager's Guide to Differences between IFRS and U.S. GAAP: With the Greater Likelihood that You Will Face Situations that Require an Understanding of the Differences Between U.S. GAAP and IFRS, the Odds Increase that You Will Also Have to be Able to Estimate the Impact of These Differences*,

financial statements may be affected.<sup>98</sup> Therefore, “[s]pecial care must be exercised [by attorneys] in the drafting of legal instruments that are tied to the financial statements of a[n entity].”<sup>99</sup>

### 1. Financing Agreements/Debt Agreements

A common type of legal instrument which contains terms that are inextricably tied to a company’s financial statements is a financing agreement.<sup>100</sup>

#### a. How Can a Financing Agreement be Tied to an Entities’ Financial Statements?

A financing agreement often contains loan covenants.<sup>101</sup> A common loan covenant requires that the borrower maintain its debt-to-equity ratio at or below a certain level.<sup>102</sup> As its name implies, the debt-to-equity ratio is calculated by dividing total liabilities by stockholders’ equity.<sup>103</sup> The value of a company’s total liabilities and stockholders’ equity are derived from the borrower company’s financial statements.<sup>104</sup> Therefore, the loan covenant, a term of the financing agreement, is tied to the financial statements of the borrower company.<sup>105</sup>

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MGMT. ACCT. Q., June 22, 2007, available at <http://www.allbusiness.com/professional-services/accounting-tax-auditing/11731265-1.html>.

98. See Deming, *supra* note 6, at 17.

99. *Id.*

100. See *id.* (a borrower/company enters into a financing agreement when it wants to borrow funds); see also Loan Agreement Definition, <http://www.businessdictionary.com/definition/loan-agreement.html> (last visited Jan. 6, 2010) [hereinafter Definition of Financing Agreement]. The financing agreement is an instrument that evidences the borrower’s promise to repay the loan, and it specifies “how the loan will be repaid and over what period.” See *id.*

101. Definition of Financing Agreement, *supra* note 100. A loan covenant is “[a] condition that the borrower must comply [with] . . . . If the borrower does not act in accordance with the covenants, the loan can be considered in default and the lender has the right to demand payment (usually in full).” Loan Covenants Explanation and Definitions, <http://www.loanuniverse.com/covenant.html> (last visited Jan. 6, 2010).

102. *Id.*

103. Debt/Equity Ratio, <http://www.investopedia.com/terms/d/debtequityratio.asp> (last visited Jan. 6, 2010). Stockholders’ equity is equal to total assets less total liabilities. Stockholders’ Equity Definition, [http://www.investorwords.com/4737/stockholders\\_equity.html](http://www.investorwords.com/4737/stockholders_equity.html) (last visited Jan. 6, 2010).

104. See Loan Covenants Explanation and Definitions, *supra* note 101; see also Financial Statements, <http://accountinginfo.com/study/fs/fs-comp-101.htm> (last visited Jan. 6, 2010).

105. *Id.*

b. The Effect of a Change in Accounting Principle on the Financing Agreement

U.S. GAAP and IFRS account for a number of transactions differently.<sup>106</sup> A number of the differences in accounting affect the balances of total liabilities and equity on the balance sheet.<sup>107</sup> Therefore, the ratio of total liabilities to equity will change with a change in accounting principle.<sup>108</sup> Because the borrower entity may be found to have defaulted on the loan if its debt-to-equity ratio rises above a certain level, the effect of the change in accounting principle on the debt-to-equity ratio must be closely monitored.<sup>109</sup>

To illustrate the foregoing, consider the following. The method of accounting for convertible debt instruments will be different with a change in accounting method.<sup>110</sup> Currently, under U.S. GAAP, convertible debt instruments are to be wholly classified as liabilities except when warrants are detachable.<sup>111</sup> However, under IFRS, “IAS 32 . . . requires convertible debt instruments to be split in[to] their liability and equity

106. Teresa Iannaconi, *SEC Seeks Input on Allowing Domestic Companies to use IFRS*, in CORPORATE GOVERNANCE 2008: COUNSELING YOUR CLIENTS FOR THE 2008 PROXY SEASON 139, 145 (PLI Corp. L. & Prac., Course Handbook Series No. 14494, 2008), available at 1652 PLI/Corp 139 (Westlaw); see also Donald T. Nicolaisen, Chief Accountant, Sec. & Exch. Comm’n, Remarks Before the 2004 AICPA National Conference on Current SEC and PCAOB Developments, in THE SEC SPEAKS IN 2005 11, 22 (PLI Corp. L. & Prac., Course Handbook Series No. 1474, 2005).

107. Lawrence M. Gill, *IFRS: Coming to America*, J. ACCT., June 2007, <http://www.journalofaccountancy.com/Issues/2007/Jun/IfrsComingToAmerica.htm>. A balance sheet is a “financial statement that lists the assets, liabilities and equity of a company at a specific point in time.” Term Definition: Balance Sheet, <http://www.entrepreneur.com/encyclopedia/term/82186.html> (last visited Jan. 6, 2010).

108. See Deming, *supra* note 6, at 17.

109. See *id.* (“Where the debt-to-equity ratio governs the default provisions of a finance agreement, the net result of a change to IFRS from US GAAP is that a lender’s risk is enhanced and the borrower’s risk of default is reduced.”).

110. Deming, *supra* note 6, at 17; see also PRICEWATERHOUSECOOPERS, IFRS AND US GAAP: SIMILARITIES AND DIFFERENCES 111 (2008), [http://www.pwc.com/extweb/pwpublications.nsf/docid/598E9D7EDF5239A0852574AB00659431/\\$File/IFRS\\_USGAAP\\_Sep08.pdf](http://www.pwc.com/extweb/pwpublications.nsf/docid/598E9D7EDF5239A0852574AB00659431/$File/IFRS_USGAAP_Sep08.pdf) [hereinafter IFRS AND US GAAP]. A convertible debt is a liability that may be satisfied by issuance of the debtor’s stock. See Asheesh Advani, *Raising Money Using Convertible Debt*, ENTREPRENEUR.COM, May 15, 2006, <http://www.entrepreneur.com/money/financing/startupfinancingcolumnistasheeshadvani/article159520.html>. However, if a covenant within the debt instrument is violated, the loan may become due and payable in cash. See Stephen Taub, *Saks May Default on Convertible Debt*, CFO.COM, June 17, 2005, <http://www.cfo.com/article.cfm/4096722?f=search>.

111. Deming, *supra* note 6, at 17. A detachable warrant is “[a] derivative that is attached to a security and gives the holder the right to purchase an underlying security at a specific price within a certain time frame. A detachable warrant is often combined with various forms of debt offerings and can be removed by the holder and sold in the secondary market separately.” Detachable Warrant, [http://www.investopedia.com/terms/d/detachable\\_warrant.asp](http://www.investopedia.com/terms/d/detachable_warrant.asp) (last visited Jan. 6, 2010).

components at the time of issuance.”<sup>112</sup> Therefore, under U.S. GAAP, the liabilities (debt) of a company with convertible debt generally will be higher than the liabilities would be under IFRS.<sup>113</sup> In addition, the equity of the company will be higher under IFRS.<sup>114</sup> As a result, for companies with convertible debt, the debt-to-equity ratio under U.S. GAAP will be higher than the debt-to-equity ratio under IFRS.<sup>115</sup> If a borrower’s financing agreement states that default will occur if the debt-to-equity ratio exceeds a particular threshold, then the borrower is more likely to default if he uses U.S. GAAP (as opposed to IFRS) to prepare his financial statements.<sup>116</sup> Therefore, in the event that the borrower’s default is tied to the debt-to-equity ratio, “the net result of a change to IFRS from [U.S.] GAAP is that a lender’s risk is enhanced and the borrower’s risk of default is reduced.”<sup>117</sup>

While the liabilities of a company with convertible debt will usually be higher under U.S. GAAP than IFRS, the use of U.S. GAAP does not always produce a greater amount of liabilities.<sup>118</sup> When accounting for contingent liabilities, the use of U.S. GAAP may result in lesser liabilities.<sup>119</sup> U.S. GAAP requires that all contractual liabilities be recognized.<sup>120</sup> However, it only allows recognition of non-contractual, contingent liabilities if they are probable and reasonably estimable.<sup>121</sup> On the other hand, IFRS requires that all contingent liabilities (contractual and non-contractual) be recognized if they can be reliably measured regardless of whether they are probable.<sup>122</sup> IFRS’s less stringent requirements governing recognition may result in greater liabilities.<sup>123</sup>

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112. Deming, *supra* note 6, at 17; *see also* IFRS AND US GAAP, *supra* note 110, at 111.

113. *See* Deming, *supra* note 6, at 17.

114. *See id.*

115. *See id.*

116. Deming, *supra* note 6, at 17.

117. *Id.*

118. *See* IFRS AND US GAAP, *supra* note 110, at 11.

119. *See id.*

120. *See id.* at 154.

121. *See id.*

122. *See id.*

123. *See id.*

## 2. Compensation Agreements

### a. How Compensation Agreements Can Be Tied to Financial Statements

Often times, a company bases its employee's compensation on its financial performance.<sup>124</sup> For example, "a senior officer's bonuses or benefits may be based on ordinary income before taxes."<sup>125</sup> Because ordinary income before taxes is derived from the company's financial statements, the compensation agreement is tied to the financial statements.<sup>126</sup>

### b. The Effect of a Change in Accounting Principle on the Compensation Agreement

IFRS permits a company to recognize revenue earlier than U.S. GAAP in certain situations.<sup>127</sup> The following examples illustrate two transactions in which IFRS permits the earlier recognition of revenue (as compared to U.S. GAAP). First, when a company receives a fee for a service before actually performing the service, IFRS permits the company to recognize the "up-front" fee as revenue as soon as the company performs that service.<sup>128</sup> However, U.S. GAAP requires that the up-front fee be deferred.<sup>129</sup> It is to be recognized as revenue ratably over the period in which the customer relationship arising from the transaction is expected to exist.<sup>130</sup> For example, when a gym charges its members an initial joining fee, IFRS would permit the gym to recognize the fee as revenue as soon as the gym admitted the member.<sup>131</sup> However, U.S. GAAP would require the fee to be

124. IFRS AND US GAAP, *supra* note 110, at 154; *see also* Huff & Newsome, *supra* note 81. The financial performance of a company is determined by analyzing its financial statements. *See* U.S. Securities and Exchange Commission, *Beginners' Guide to Financial Statements* (Feb. 5, 2007), <http://sec.gov/investor/pubs/begfinstmtguide.htm> [hereinafter *Beginners' Guide to Financial Statements*].

125. Deming, *supra* note 6, at 17. Ordinary income before income taxes is found in the income statement, one of four financial statements. *Beginners' Guide to Financial Statements*, *supra* note 124.

126. *Beginners' Guide to Financial Statements*, *supra* note 124; Deming, *supra* note 6, at 17.

127. *Convergence*, *supra* note 53.

128. Steven Marcy, *Planning for Change to IFRS*, in ACCOUNTING POLICY & PRACTICE SPECIAL REPORT \*14 (2008), available at 4 APPR 770 (BNA Tax and Accounting Center) [hereinafter *Planning for Change*].

129. *Id.*

130. *Id.*

131. DELOITTE, IFRS IN TOURISM, HOSPITALITY AND LEISURE: MORE THAN JUST ACCOUNTING, 11 (2008), <http://www.iasplus.com/dttdpubs/0810ifrstourism.pdf> [hereinafter IFRS IN TOURISM, HOSPITALITY AND LEISURE].

recognized as revenue evenly over the period in which the membership is expected to exist.<sup>132</sup>

The second transaction in which IFRS permits the earlier recognition of revenue deals with multiple deliverables.<sup>133</sup> When a company enters into a contract “that require[s] the separate delivery of multiple goods and/or services,” it is said to have entered into a multiple element arrangement or arrangement with multiple deliverables.<sup>134</sup> Under IFRS, a company may recognize:

[R]evenue for partly delivered orders as long as it is probable at the reporting date that the remaining goods will be delivered. [However,] U.S. GAAP does not allow revenue to be recognized if the customer is able to return the delivered goods in the event that the remaining part of the order is not delivered.<sup>135</sup>

For example, assume a cell phone company enters into a contract to provide one year’s service and a phone. Assume also that the company delivers the phone and that the phone may be returned if the company fails to completely perform under the contract. Under IFRS, although the company has not completely performed the contract, it could estimate the value of the phone and recognize revenue for the sale of the phone immediately.<sup>136</sup> However, if the company were using U.S. GAAP, it would not be able to recognize revenue for such a partial delivery since the phone is returnable in the event that the company fails to perform.<sup>137</sup>

Under both examples illustrated above, IFRS would permit a company to recognize revenue earlier than under GAAP.<sup>138</sup> Because revenue is recognized earlier, a company’s income would be greater earlier.<sup>139</sup> Because compensation of an employee may be based upon income, the company will incur its compensation

132. *Planning for Change*, *supra* note 128; IFRS IN TOURISM, HOSPITALITY, AND LEISURE, *supra* note 131, at 11.

133. *Id.*

134. ASHWINPAUL (TONY) C. SONDDHI, EITF 00-21: REVENUE ARRANGEMENTS WITH MULTIPLE DELIVERABLES 3 (2006), [http://www.acsondhi.com/issues/docs/EITF\\_00-21.pdf](http://www.acsondhi.com/issues/docs/EITF_00-21.pdf).

135. *Planning for Change*, *supra* note 128.

136. *See id.*

137. *See id.*; *see also* DELOITTE, CURRENT DEVELOPMENTS IN REVENUE RECOGNITION: MULTIPLE ELEMENT ARRANGEMENTS 2 (2003), <http://www.deloitte.com/dtt/cda/doc/content/March03Fnl.pdf>.

138. *See supra* notes 127-29, 133-37 and accompanying text.

139. *See* *Beginners’ Guide to Financial Statements*, *supra* note 124 (stating that revenues minus expenses equal income).

expense earlier.<sup>140</sup> That is, it will have to pay out money earlier under IFRS than under U.S. GAAP. Having to pay employees earlier will cost a company in that it could have invested that money and yielded a return.<sup>141</sup> However, that return must be offset by the tax savings the company experiences.<sup>142</sup> The net of the two is the cost incurred by the company as a result of the change in accounting principle.

### 3. How Should the Legal Profession Respond to the Effects of the Change?

Consider a scenario in which an attorney drafted a legal instrument which contains terms that reference or incorporate or otherwise tie the legal instrument to the borrower entity's financial statements. Assume also that at the time of the creation of the instrument, the entity prepared its financial statements in accordance with U.S. GAAP, and now the entity is adopting IFRS. In this scenario, what should the attorney do? The attorney, as well as the parties to the instrument, must "review the provisions of the legal [instrument] to determine the impact of the change to IFRS. The provisions [of the instrument] may need to be revised or clarified or, alternatively, new arrangements may need to be negotiated."<sup>143</sup>

Now consider a scenario in which an attorney has been hired to draft a legal instrument that is "dependent . . . on information in financial statements."<sup>144</sup> Since the switch to IFRS is inevitable, the attorney should plan accordingly.<sup>145</sup> The attorney should include a provision that "clearly define[s] what accounting standards govern financial statements to which they are linked."<sup>146</sup> However, attorneys should exercise caution when

140. Deming, *supra* note 6, at 17.

141. See STEPHEN F. GERTZMAN, FEDERAL TAX ACCOUNTING ¶ 11.01 (2008), available at FTA WGL ¶ 11.01. "'Time value of money' refers to the economic premise that a dollar received today is worth more than a dollar received tomorrow. The term embraces . . . the economic benefit of making . . . a deferred payment." *Id.*

142. See I.R.C. § 162(a)(1) (2006 & Supp. 2009); Time Value of Money: TVM, <http://www.investopedia.com/terms/t/timevalueofmoney.asp> (last visited Jan. 6, 2010) [hereinafter TVM]. A compensation expense is a deduction from taxable income. I.R.C. § 162(a)(1). A company can deduct compensation expenses when they are incurred. *Id.* Because the company incurs the compensation expense earlier, it can deduct it earlier. See *id.* An earlier deduction is advantageous because of the time value of money concept. See TVM. The company can invest the amount of money that it did not have to pay out in taxes and yield a return. *Id.*

143. Deming, *supra* note 6, at 17.

144. *Id.*

145. See *id.*; see also Huff & Newsome, *supra* note 81; Kamman et al., *supra* note 88.

146. Deming, *supra* note 6, at 17; see also Huff & Newsome, *supra* note 81; Kamman et al., *supra* note 88.

choosing the accounting standard that will govern.<sup>147</sup> If they choose U.S. GAAP as the method and IFRS is adopted, then companies will have to maintain two sets of financial statements: one prepared in accordance with GAAP and one prepared in accordance with IFRS.<sup>148</sup> This will impose substantial, additional administrative costs and burdens on the company.<sup>149</sup> The lesson: choose wisely.<sup>150</sup>

C. *The Tax Law May Need to Be Adjusted to Facilitate the Change*

1. *Difference Between IFRS and U.S. GAAP – IFRS Prohibits the use of LIFO*

One of the biggest differences between U.S. GAAP and IFRS is that IFRS prohibits the use of the last-in-first-out (“LIFO”) method of accounting for inventory.<sup>151</sup> To understand the impact of this difference on the legal profession, one must first understand its impact on taxes.<sup>152</sup> Therefore, the effect of prohibiting LIFO on taxes is discussed first. Next, its effect on the legal profession is discussed.

2. *The Effect of Prohibiting the Use of LIFO on Tax*

a. *The Book-Tax Conformity Requirement: To Use LIFO for Tax Reporting Purposes, It Must Also be Used for Financial Reporting Purposes*

The Internal Revenue Code (“IRC”) requires that “taxable income . . . be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.”<sup>153</sup> That is, the IRC requires that the taxpayer use the same methods of accounting in the computation of taxable income as were used in the computation of book income.<sup>154</sup> Much of this book-tax conformity requirement has been eroded in the U.S.<sup>155</sup> The U.S. *only requires* this book-tax

147. Deming, *supra* note 6, at 17; *see also* Gill, *supra* note 107.

148. *See* Gill, *supra* note 107.

149. *See id.*

150. *See* Deming, *supra* note 6, at 17.

151. Gill, *supra* note 107.

152. *See* Katz, *supra* note 6.

153. I.R.C. § 446(a) (2006).

154. *Id.*

155. Wolfgang Schon, *The David R. Tillinghast Lecture: The Odd Couple: A Common Future for Financial and Tax Accounting?*, 58 TAX L. REV. 111, 120 (2005). The Internal

conformity in a few instances.<sup>156</sup> For example, to use LIFO for tax reporting purposes, the taxpayer must have used LIFO for financial reporting purposes.<sup>157</sup> There is a necessity for book-tax conformity in this instance.<sup>158</sup> Without it, a company could show high profits to external users through the use of one set of standards and low profits to the IRS to reduce income tax liability through the use of another set of standards.<sup>159</sup>

b. Prohibiting the Use of LIFO for Financial Reporting Purposes Means LIFO Can No Longer be Used for Tax Reporting Purposes

The tax code requires that LIFO be used in the computation of book income in order to be used in the computation of taxable income.<sup>160</sup> Because IFRS prohibits the use of LIFO in the calculation of book income, a taxpayer will no longer be able to use LIFO in the computation of taxable income after the adoption of IFRS.<sup>161</sup>

c. If LIFO is No Longer Permitted in the Calculation of Income Tax, Significant Tax Savings will be Lost

Of the many methods available for calculating cost of goods sold ("COGS") and earned income ("EI"), LIFO is one of the most

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Revenue Code ("I.R.C.") provides an exception to the book-tax conformity requirement. See I.R.C. § 446(b) (2006). If the method of accounting used for financial accounting purposes "does not clearly reflect income," then that method is not to be used for tax accounting purposes. I.R.C. § 446(b). The book-tax conformity requirement was eroded further by the court in *Thor Power Tool Co. v. Commissioner*. Schon, *supra*; see *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522, 542-43 (1979). In *Thor Power Tool*, the court held that the book-tax conformity requirement was absurd and unacceptable because of the different goals of financial accounting and tax accounting. *Thor Power Tool*, 439 U.S. at 542-43. "The primary goal of financial accounting is to provide information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc." *Id.* at 542.

156. Schon, *supra* note 155, at 120.

157. *Id.*; see also I.R.C. § 472(e) (2006); Nathan Andrews, *International Financial Reporting Standards for U.S. Companies: Tax Implications of an Accelerating Global Trend*, 60 TAX EXECUTIVE 371, Oct. 1, 2008, available at 2008 WLNR 24602636.

158. See Schon, *supra* note 155, at 121.

159. *Id.*

160. I.R.C. § 472(e)(2) (2006).

161. Andrews, *supra* note 157; see also IFRS FOR U.S. COMPANIES, *supra* note 24, at 2.

common and is used by many companies.<sup>162</sup> One of the other methods available is first-in-first-out (“FIFO”), and as its name implies, the first items of inventory purchased are deemed to be the first items sold.<sup>163</sup> Therefore, the latest purchases are deemed to be still on hand.<sup>164</sup> On the other hand, under LIFO, the last items purchased are deemed to be the first items sold.<sup>165</sup> As such, the first items purchased are considered to be still on hand at the end of the period.<sup>166</sup> In times of rising prices (inflation), LIFO results in higher COGS.<sup>167</sup> Accordingly, companies adopting LIFO experience significant tax savings by lowering their income tax liability.<sup>168</sup>

To illustrate the foregoing, the following example is provided:

Suppose that in Year 1 the taxpayer purchases 100 widgets, none of which are sold in Year 1, for \$10 each (a total of \$1,000), and in Year 2 the taxpayer purchases another 100 widgets for \$13 each (a total of \$1,300) and sells 120 widgets in Year 2.<sup>169</sup>

The taxable income in year two would be equal to sales income minus COGS.<sup>170</sup> In order to calculate COGS, either FIFO or LIFO may be used.<sup>171</sup> Under FIFO, the cost of goods sold is

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162. See Gardner, *supra* note 43. First-in-first-out (“FIFO”), weighted average, and specific identification are three more methods of accounting for inventory that are acceptable. Inventory Accounting Methods: LIFO, FIFO, Weighted Average and Specific Identification, <http://financial-education.com/2007/03/05/inventory-accounting-methods-lifo-fifo-weighted-average-and-specific-identification/> (last visited Jan. 6, 2010).

163. How the Inventory Accounting Method Affects the Income Statement, <http://financial-education.com/2007/02/19/how-the-inventory-accounting-method-affects-the-income-statement/> (last visited Jan. 6, 2010).

164. *Id.*

165. *Id.*

166. *Id.*

167. See *Id.*

168. Robert Bloom & William J. Cenker, *The Death of LIFO?*, J. ACCT., Jan. 2009, <http://www.journalofaccountancy.com/Issues/2009/Jan/DeathOfLIFO.htm>.

169. JOSEPH M. DODGE, J. CLIFTON FLEMING, JR. & DEBORAH A. GEIER, FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY 47 (3d ed. 2004).

170. See *id.* at 46. The I.R.C. imposes a tax on taxable income. I.R.C. § 1(a) (2006 & Supp. 2009); I.R.C. § 11(a) (2006). Taxable income is computed by subtracting “deductions” from “gross income”. I.R.C. § 63(a) (2006 & Supp. 2009). “Gross income” includes “income derived from a business.” I.R.C. § 61(a)(2) (2006). Income from the sale of inventory is “income derived from business” and is, therefore, includable in gross income. DODGE ET AL., *supra* note 169, at 46; see I.R.C. § 61(a)(2). Since the cost of goods sold is a cost incurred in “carrying on a trade or business,” it qualifies as a “deduction” under the I.R.C. See I.R.C. § 162(a). Therefore, income from the sale of goods minus the cost of the goods sold would yield taxable income. See DODGE ET AL., *supra* note 169, at 46.

171. See DODGE ET AL., *supra* note 169, at 47.

equal to the number of goods sold times the cost of the first items of inventory purchased  $((100 \times \$10) + (20 \times \$13) = \$1,260)$ .<sup>172</sup> Under LIFO, the cost of goods sold is equal to the number of goods sold times the cost of the most recently purchased items of inventory  $((100 \times \$13) + (20 \times \$10) = \$1,500)$ .<sup>173</sup> Since the cost of goods sold under LIFO is higher, the taxable income is lower.<sup>174</sup> Therefore, a taxpayer's tax liability is less when LIFO is used to compute COGS.<sup>175</sup>

Since the use of LIFO will no longer be permitted after IFRS is adopted, taxpayers will no longer be able to take advantage of the tax savings.<sup>176</sup> The magnitude of the taxpayer's loss can be illustrated by the following fact: if Congress were to repeal LIFO, taxes on businesses using LIFO would be raised by more than one hundred billion dollars over ten years.<sup>177</sup>

### 3. The Effect of IFRS on the Legal Profession

Because taxpayers will suffer such a significant increase in taxes due to a change in accounting principles, many do not support the change.<sup>178</sup> It is likely such companies will lobby against the adoption of IFRS.<sup>179</sup> This creates a block in the road toward the adoption of IFRS, which must be eradicated if the benefits of a single, global accounting standard are to be realized.<sup>180</sup> In order to remove the roadblock, it is likely that the law will have to evolve.<sup>181</sup> A law must be passed that will permit the use of LIFO for tax reporting purposes regardless of whether or not it is used for financial reporting purposes.<sup>182</sup>

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172. *See id.*

173. *See id.*

174. *See* Gardner, *supra* note 43.

175. *See id.*

176. Katz, *supra* note 6.

177. *Id.*

178. *Id.*

179. *See generally id.*; *see also* Barriers to Developing Universally Accepted Accounting Standards, <http://financial-education.com/2008/10/01/barriers-to-developing-universally-accepted-accounting-standards/> (last visited Jan. 6, 2010).

180. *See* Katz, *supra* note 6.

181. *See id.*

182. *See id.* (stating that the SEC plans on "discuss[ing] the conflict with the Internal Revenue Service").

## VII. CONCLUSION

The need for a single, globally accepted accounting standard is understood and appreciated by most, if not all.<sup>183</sup> There are substantial benefits that would be realized if such a standard existed.<sup>184</sup> One of the advantages of having one common set of accounting standards is that the cost of acquiring capital will be reduced.<sup>185</sup> All countries will require the same accounting standard.<sup>186</sup> Therefore, companies will no longer have to incur the costs of translating its financial statements to accord with the accounting standards required by the country in which the company is trying to raise capital.<sup>187</sup> Another advantage is that comparability of the financial performance of companies in different countries will be facilitated since all companies will be using the same accounting methods.<sup>188</sup>

The issue is not whether there is a need for a single set of standards, the issue is which of the many accounting standards will be set as *the* standard.<sup>189</sup> Currently, there are two standards vying for the position: the London-based IFRS and the U.S. GAAP.<sup>190</sup> After the passage of the Sarbanes Oxley Act (“SOX”), which imposed many burdensome requirements upon the accounting profession, the London-based IFRS surpassed the U.S. GAAP in the race for the position.<sup>191</sup> The European Union as well as a multitude of other countries adopted the London-based IFRS standard as a result of the passage of SOX.<sup>192</sup> In addition, the U.S. has taken steps toward the adoption of that standard.<sup>193</sup> Although the United States has not officially adopted the IFRS standard, some feel as if the adoption is inevitable.<sup>194</sup> IFRS will be the single, globally accepted accounting standard in the near future.<sup>195</sup> The adoption of IFRS

183. Morgan, *supra* note 36; *see also* Trott, *supra* note 42, at 209; *Testimony Concerning Globally Accepted Accounting Standards*, *supra* note 41.

184. Deming, *supra* note 6, at 16-17.

185. *Id.* at 16.

186. *See id.*

187. *Id.*

188. *See id.*

189. *See* Morgan, *supra* note 36.

190. KIESO ET AL., *supra* note 14, at 16; *see also* Campos, *supra* note 34.

191. Gardner, *supra* note 43.

192. *Id.*

193. PRICEWATERHOUSECOOPERS, IFRS: THE RIGHT STEP FOR U.S. BUSINESS 3 (2007), [http://www.pwc.com/en\\_US/us/issues/ifrs-reporting/assets/PwC\\_IFRSWP\\_102007.pdf](http://www.pwc.com/en_US/us/issues/ifrs-reporting/assets/PwC_IFRSWP_102007.pdf).

194. *See* Nevius, *supra* note 3, at 1; *see also* Gardner, *supra* note 43.

195. SEC Offers Potential Path, *supra* note 61, at 1-3; *see also* Mapping the Change, *supra* note 5, at 579-81.

will bring many changes and challenges for those in the field of accounting.<sup>196</sup> The effects of a change in the accounting principle are likely to resemble a domino effect.<sup>197</sup> That is, the change will reverberate and be felt by all.<sup>198</sup> Therefore, it is very probable that the change in principle will affect the legal profession.<sup>199</sup>

In order for the switch to be implemented without a hitch, the legal profession must adapt and evolve.<sup>200</sup> It is very likely that new laws will be codified as a result of the switch.<sup>201</sup> For example, because accountants will have to exercise more judgment when accounting for transactions instead of following set rules, their traditional defense that they followed the rules may not be useful.<sup>202</sup> Unless a new defense is codified, it is likely that accountants will be too afraid to practice because of the high risk of liability they will face.<sup>203</sup> The new defense must exonerate an accountant who can adequately justify his chosen method of accounting for a transaction.<sup>204</sup>

In addition, it is very likely that many of the laws currently in force will be changed.<sup>205</sup> For example, the tax law may have to change.<sup>206</sup> Currently, the IRC requires that LIFO be used for financial reporting purposes in order to be used for tax reporting purposes.<sup>207</sup> Because IFRS prohibits the use of LIFO for financial reporting purposes, taxpayers will no longer be able to use LIFO for tax reporting purposes after the adoption of IFRS.<sup>208</sup> The effect on the taxpayers who are currently using LIFO will be dramatic.<sup>209</sup> Their tax liability will increase substantially.<sup>210</sup> Because of this adverse effect, many taxpayers will be opposed to adopting IFRS.<sup>211</sup> The only way to garner their support would be to eliminate the book-tax conformity currently required by law.<sup>212</sup>

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196. Gardner, *supra* note 43; see *Mapping the Change*, *supra* note 5.

197. See *Mapping the Change*, *supra* note 5, at 2-3.

198. See *id.*

199. Deming, *supra* note 6, at 14-15, 17.

200. See *id.*

201. See Crovitz, *supra* note 6.

202. See *id.*

203. See *id.*

204. See *id.*

205. See Katz, *supra* note 6.

206. See *id.*

207. IFRS FOR U.S. COMPANIES, *supra* note 24, at 2.

208. *Id.*

209. See Katz, *supra* note 6.

210. See *id.*

211. *Id.*

212. *Id.*

In addition to coping with the changes in the law, lawyers will have to exercise special care when drafting legal instruments that consist of terms dependent upon financial statements.<sup>213</sup> Since the financial statements upon which they depend may change considerably, the legal instruments will be affected.<sup>214</sup> In order to minimize or eliminate the effects of the adoption of IFRS on the legal instruments, lawyers should include a provision in the legal instruments specifying which accounting principle will govern.<sup>215</sup> For those instruments already drafted without such a provision, the lawyer may have to revise, amend or re-negotiate the terms after the adoption of IFRS.<sup>216</sup>

Although the legal profession will encounter many challenges and will have to evolve, the benefits of adopting IFRS will be great.<sup>217</sup> One advantage of adopting IFRS is that the financial statements will better reflect economic reality.<sup>218</sup> Under IFRS, accountants will examine each transaction individually and then determine how best to account for it.<sup>219</sup> Under U.S. GAAP, the accountant does not take into account the unique attributes of each transaction.<sup>220</sup> Instead, they follow a set rule to account for the transaction.<sup>221</sup> Therefore, the financial statements prepared under IFRS more accurately reflect the underlying transaction.<sup>222</sup> Because the financial statements will better reflect economic reality, they will be more useful to the decision-making processes of the users of the financial statements.<sup>223</sup>

Another advantage of IFRS is that there will be fewer errors in the financial statements.<sup>224</sup> Under IFRS, the number of rules that accountants must follow is fewer.<sup>225</sup> In addition, the rules are less rigid.<sup>226</sup> Therefore, accounting will become less complex; there will be fewer errors in the financial statements.<sup>227</sup>

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213. Deming, *supra* note 6, at 17.

214. *See id.*

215. *Id.*

216. *See id.*

217. *See* Shortridge & Myring, *supra* note 83.

218. *Id.*

219. *See id.*

220. *See id.*

221. *Id.*

222. *Id.*

223. *See* Shortridge & Myring, *supra* note 83.

224. Roy Harris, *PwC Rivets Attention of IFRS Tax Issues*, CFO.COM, Jun. 5, 2008, [http://www.cfo.com/article.cfm/11518576/c\\_2984354](http://www.cfo.com/article.cfm/11518576/c_2984354).

225. *Id.*

226. *See* Neri Bukspan & Ron Joas, *The Road to Convergence: U.S. GAAP at the Crossroads*, in FOREIGN ISSUERS & THE U.S. SECURITIES LAWS 2008: STRATEGIES FOR THE

In addition to the many advantages, the use of IFRS poses many disadvantages.<sup>228</sup> For example, because accountants are able to exercise discretion when determining how to account for a particular transaction, there will be a lot of subjectivity.<sup>229</sup> This element of subjectivity creates the risk that users may not be able to compare the financial statements prepared by one accountant with the financial statements prepared by another accountant.<sup>230</sup>

The impact of the change in accounting principles can only be speculated at this point. Whether the beneficial effects of the change will outweigh the adverse effects remains to be seen. We may end up lamenting the death of our beloved accounting system just as much as the narrator in *Requiescat* laments the death of his lover. Alternatively, the opposite may be true.

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CHANGING REGULATORY ENVIRONMENT 251, 258 (PLI Corp. L. & Prac., Course Handbook Series No. 1669, 2008).

227. Harris, *supra* note 224.

228. Buksan & Joas, *supra* note 226, at 257.

229. *Id.*

230. *See id.*