

CLOSING THE GAP WHEN MOVING FROM UK GAAP TO IFRS: A CASE FOR THE INTRODUCTORY FINANCIAL ACCOUNTING COURSE

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ABSTRACT

The case draws on the experience of Denelle Smart, assistant comptroller for financial reporting for a New Hampshire subsidiary of a London-based company. She has been assigned a role in her company's transition from UK GAAP to International Financial Reporting Standards (IFRS) taking place throughout the European Union. In addition to describing the many challenges Denelle faces as she leads her company's transition to IFRS, this case discusses specific IAS 38 criteria, which determine how research and development costs must be accounted for under IFRS. The introductory financial accounting student is given a brief introduction to IFRS along with a review of US/UK GAAP treatment of research and development costs and capitalization of costs in general.

BACKGROUND

The case draws on the experience of a fairly recent college graduate, Denelle Smart. Upon completion of her undergraduate degree in management, she accepted a position as cost accountant in her hometown in southwestern New Hampshire, at a manufacturing, marketing and customer service subsidiary of the Smiths Medical division of Smiths Group plc, a publicly traded specialty engineering company headquartered in London, UK. Seven years have gone by,

during which time she has completed her masters degree and advanced to her current position, assistant comptroller for financial reporting.

Denelle faces daily challenges as a manager in a multi-national firm. For example, a conference call may require her to be at her desk by 5 AM, or may require her counterpart in London to remain at his desk till 9 PM. When Tokyo is involved as well, scheduling becomes even more challenging, and language can become an issue as well.

Denelle monitors fluctuations in exchange rates, which could have a major effect on the divisional bottom line. Three-quarters of Smiths Medical's sales are in the United States. With corporate headquarters and a number of operating subsidiaries located in the UK, the division experiences a substantial volume of cross border transactions in both US dollars and UK pounds. At headquarters, Smiths Group maintains a centralized treasury department to help control a variety of risks, including exchange rate risk posed by foreign currency fluctuations. Its hedging activities are designed to reduce the effect of exchange rate volatility on results of operations and cash flow.

In 2004, the medical division experienced growth, due to increased demand for healthcare devices by aging populations throughout the developed world, as well as improvements in technology which have enabled companies like Smiths Medical to meet this demand. Divisional sales grew by 5% in 2004 and operating profits rose by 12%. However, when translated into British pounds in Smiths Group's annual report, the weakness of the dollar against the pound throughout the year caused *reported sales* to remain flat and *reported operating profit* to rise by only 4%.

A Major Professional Challenge

Denelle is a financial reporting manager for a European company. As such, she has been assigned a role in the transition from a wide variety of national accounting standards to International Financial Reporting Standards (IFRS) taking place throughout the European Union. The International Accounting Standards Board (IASB), headquartered in London, is responsible for developing IFRS. From 2005 on, Smiths will be required to prepare its financial statements in accordance with IFRS instead of UK Generally Accepted Accounting Principles (UK GAAP).

For some months now, Denelle has been involved in planning for the transition. She has attended training sessions focused on interpreting the new accounting standards and setting future company accounting policies in accordance with IFRS, as well as identifying the new accounting and disclosure requirements that will require changes in the company's accounting information systems.

Denelle is aware that a major component of her work on the transition to IFRS will be in the area of accounting for the company's research and development expenditures. Smiths Medical operates in the specialty medical devices sector and focuses its research and development in four product areas: respiratory care, infusion therapy, critical care, and vascular access and safety. The division has recently completed a major reorganization and a significant investment in new technology, both aimed at improving and expanding product development activities. In 2004, research and development costs approached 6 % of total sales revenue companywide for Smiths Group. Smiths Medical's spending was above that average.

Under UK GAAP, research and development costs are expensed as incurred (consistent with US GAAP). At her corporate training session, Denelle just learned that under IFRS, research and development costs must be separated into 2 categories—*research* and *development*. Research costs

will continue to be expensed as incurred. Under IFRS, development costs meeting all the following IAS 38 criteria are capitalized:

- The asset meets the definition of an intangible asset (i.e., identified and controlled by the entity).
- It is probable that future economic benefits that are attributable to the asset will flow to the entity.
- The cost of the asset can be reliably measured.

Development costs that do not meet these criteria will continue to be expensed as incurred. Capitalized development costs are to be amortized over a useful life of up to 20 years.

If Denelle is unable to separate the development component from the research component of a particular project, IAS 38 requires that these development costs be expensed as incurred. Additionally, the new standard is to be applied retroactively, meaning development costs on the balance sheet may include amounts expensed in prior years. Denelle is already anticipating that the new accounting requirements will have a significant impact on both Smiths Medical's balance sheet and its bottom line.

This case is based on IASB's web summary of IAS 38: Intangible Assets; Smiths Group PLC 2004 Annual Review; and conversations with Denelle Gourley, Assistant Controller of Smiths Medical, Portex Division.

QUESTIONS

1. Go to www.smiths-group.com to learn more about the parent company, its businesses and geographic scope. In a paragraph or two discuss your findings, including answers to the following questions: How big is the company? In what product divisions and in what geographic regions does Smiths Group operate? (Financial information is under "Investor Centre")
2. Go to www.iasb.org, "About Us," "General Information," and "History," and review the IASB's history and activity from 1995 through 2001 (listed in descending order on the website). What role has the EU had in the development of IFRS?
3. As globalization and international trade increase, what benefits do you see in using a single set of global accounting standards?
4. Refer to the three IAS 38 criteria presented in the case. Will Denelle need to use her professional judgment in determining whether to capitalize or expense development costs? Would you expect to see different interpretations of these criteria across companies, industries and countries? Explain.
5. After reviewing US GAAP for research and development costs and capitalization of costs in general, consider IAS 38 as discussed in the case and answer the following questions: Do you anticipate an increase or decrease in Smiths Medical's expenses and net income? Will total assets, total liabilities and total owners' equity increase or decrease? Explain your answers. As a result of adopting IAS 38 will Denelle add any new balance sheet accounts to Smiths' chart of accounts?

6. What additional costs and benefits will businesses, including Smiths Group, incur from the transition to IFRS? Specifically, identify impacts (both quantitative and qualitative costs and benefits) relative to the Smiths Medical Division and its parent company. HINT: Consider the impact on the various user groups, i.e., investors, creditors, managers, employees, etc.

GLOSSARY

European Union (EU) – First proposed in the 1950's as an economic union, the EU initially consisted of 6 countries. In 2004, in its largest expansion, 10 more countries joined, bringing the total membership to 21 nations. The EU has focused on building a single European market, launching a single European currency, the euro, and strengthening Europe's voice in the world. The European Commission (EC), the executive body among the EU's 5 governing institutions, acts independently of the governments of member nations, and is responsible for drafting all new EU legislation.

Exchange rate – The rate at which one currency can be traded for another.

Exchange rate risk – The risk that international business transactions will earn less than expected because of (unfavorable) movement in exchange rates.

Hedging – Activities or contracts that are designed to reduce or eliminate risk. For example, in international trade, managers may reduce exchange rate risk by purchasing contracts for receipt of foreign currency at an agreed upon exchange rate at a future date, for example the date that a particular invoice comes due.

Multi-national firm – A company with divisions or branches in several countries.

TEACHING NOTES

Teaching notes are available from the editor. Send a request from the "For Contributors" page of the journal website, <http://gpae.bryant.edu>.