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GAAP and IFRS Convergence: The Effect On Lease Accounting

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GAAP AND IFRS CONVERGENCE:
THE EFFECT ON LEASE ACCOUNTING

by

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Table of Contents

I. Introduction

Generally Accepted Accounting Principles (GAAP) are the accounting rules that are fundamental to the preparation of financial statements for all companies in the United States. The Securities and Exchange Commission (SEC) designated that the Financial Accounting Standards Board (FASB) establish and set the accounting principles that represent GAAP. International Financial Reporting Standards (IFRS) are the accounting principles that are used in the financial reporting of many countries outside of the United States. The International Accounting Standards Board (IASB) requires that companies use the standards that are set in the IFRS.

The Securities and Exchange Commission (SEC) and the International Accounting Standards Board (IASB) are reported to be working on a plan to implement the use of International Financial Reporting Standards (IFRS) within the United States. Specifically, the IASB and the Financial Accounting Standards Board (FASB) are working on a convergence plan that will use current IFRS and Generally Accepted Accounting Principles (GAAP) to derive a new set of IFRS to replace GAAP in the U.S. Many differences exist between GAAP, which is used in the United States, and IFRS, which is used by much of the rest of the world. The main goal of FASB and IASB's convergence plan is to achieve an increased level of comparability among the financial statements of companies located in different countries around the world. The main focus of this research is to examine empirically the differences in how GAAP and IFRS account for leases, as well as what the convergence of these two leasing principles/rules implies for companies in the United States.

Currently, GAAP and IFRS each have their own standard addressing the accounting for leases. The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have been working for years to address new standards that will increase comparability of lease accounting among international companies. In 2006, a Memorandum of Understanding (MoU) was issued by the IASB and the FASB. This MoU "described a joint work plan to expedite global convergence in accounting standards." The joint project on leasing was introduced in order to comply with this MoU (IASB & FASB, 2011a). Also in 2006, as part of the convergence plan, the IASB and FASB announced a new international group that will help them work on their joint project reconsidering the standards that are used for lease accounting (IASB & FASB, 2006).

II. Literature Review

Two types of accounting systems exist: principles-based and rules-based. The United States's GAAP is more rules-based, while the IASB's IFRS is more principles-based. Maines et al. (2003) indicate that principles and rules are the two extremes of a continuum. No system is strictly rules-based or principles-based, but a system can lend to being more rules or principles based. Nelson (2003) states that rules "include specific criteria, 'bright line' thresholds, examples, scope restrictions, exceptions, subsequent precedents, implementation guidance, etc." (p. 91). Rules-based standards articulate very detailed methods of accounting; they provide very specific guidance (e.g., The speed limit on I-12 is 70 mph.). These standards have been developed partly in response to many auditors and those who prepare financial statements pushing for more guidance in order to avoid criticism about the way they report or audit information. They want to have an answer spelled out for every single situation or issue that may or may not occur (Agoglia, Doupnik, and Tsakumis, 2011; Bentson, Bromwich, and Wagenhofer, 2006).

In contrast to rules-based standards, there are principles-based standards. Principles-based standards allow for auditors and financial statement reporters to use more of their own judgment because they do not have a detailed list of rules that must be followed to the letter. Carmona and Trombetta (2008) describe principle-based systems of accounting by saying that they "issue generic accounting standards," and these generic standards "do not address every controversial issue at hand but keep considerable ambiguity about such major processes as record keeping and measurement" (p. 456). Accountants employing the principles-based approach have to be able to use professional judgment when providing estimates in the financial statements because they cannot rely on specific rules that articulate exactly what is supposed to be done.

Pros and cons have been given for both rules-based and principles-based systems. Nobes (2005) states that the United States's GAAP has been criticized because rules can often lead to a greater level of unneeded complexity. If something isn't explicitly written in the rules, then accountants tend to try to find ways to use loopholes in order to achieve desired results. Agoglia, Doupnik, and Tsakumis (2011) have "suggested that rules-based standards lead to a 'show me where I can't' attitude," but they also have noted "a perceived benefit of more detailed implementation guidance is greater comparability of financial statements across companies" (p. 749). There are other advantages of rules-based principles along with that of increased comparability. These advantages include such items as "increased verifiability for auditors and regulators…reduced opportunities for earnings management through judgments…and improved communication of standard setters' intentions" (Nobes, 2005, p.26).

Similarly, principles-based standards also have pros and cons. When using principles-based standards, a loss of comparability and consistency may occur among the financial statements of businesses (Bentson, Bromwich, and Wagenhofer, 2006). Also, principles-based standards require auditors and financial statement preparers to use professional judgment when applying these standards versus having strict instructions prescribing what to do. Lindberg and Seifert (2010) propose that a major advantage of using principles instead of rules is that of transparency; they say that this is "primarily due to the significantly expanded footnote disclosures companies must have in order to explain how they interpret and apply IFRS in their organization" (p. 231).

There has been a call for some middle ground between rules-based and principles-based accounting systems. Bentson, Bromwich, and Wagenhofer (2006) call this middle ground "objectives-oriented standards"; they consider these standards "to be optimal…because they offer a much narrower framework that would limit the scope of professional judgment but allow more flexibility than rules-based standards" (p.170). Lastly, Bentson, Bromwich, and Wagenhofer (2006) state that the objectives-oriented standards should:

- Be based on an improved and consistently applied conceptual framework;
- Clearly state the accounting objective of the standard;
- Provide sufficient detail and structure so that the standard can be operationalized and applied on a consistent basis;
- Minimize exceptions from the standard;

- Avoid use of percentage tests that allow financial engineers to achieve technical compliance with the standard while evading the intent of the standard. (p. 170)

III. Analysis Background

U.S. GAAP AND IFRS CONVERGENCE

In 2002, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) met in Norwalk, Connecticut, where they issued a Memorandum of Understanding (MoU) called *The Norwalk Agreement*. In *The Norwalk Agreement*, the FASB and the IASB "acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting" (Norwalk Agreement, 2002). Professor Sir David Tweedie (2007), Chairman of the International Accounting Standards Board (IASB), thinks that some accounting standards have become too complex. He believes that a principles-based system may help to reduce the complexity of some standards. Tweedie (2007) noted that *The Norwalk Agreement* aimed to choose the better standard, merge standards together to form a better international standard, or start over and create a new standard that was better than one formed using the previous methods. In *The Norwalk Agreement,* the IASB and the FASB agreed to remove differences that existed between their standards as well as to interpret standards in the same way in order to maintain comparability among financial statements. These new standards need to be based on clear principles (Tweedie, 2007). The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued another MoU in 2006 as a way to reaffirm their commitment to creating a set of global standards. In this new MoU, the FASB and the IASB derived general guidelines that they both agreed to follow. The guidelines were outlined as follows:

- Convergence of accounting standards can best be achieved through the development of high quality, common standards over time.
- Trying to eliminate differences between two standards that are in need of significant improvement is not the best use of the FASB's and the IASB's resources—instead, a new common standard should be developed that improves the financial information reported to investors.
- Serving the needs of investors means that the boards should seek to converge by replacing weaker standards with stronger standards. (A Roadmap for Convergence, 2006)

In response to *The Norwalk Agreement* and the 2006 Memorandum of Understanding, the U.S. Securities and Exchange Commission (SEC) issued its roadmap for convergence. This roadmap was issued on November 19, 2008, and proposed the required use of IFRS for publicly traded companies. Because the implementation of IFRS is complex and time-consuming, "the SEC does not expect first-time issuers to report under IFRS before 2015" (Gornik-Tomaszewski & Sellhorn, 2010, p. 23). The SEC's roadmap includes the role that IFRS plays in U.S. markets, a potential roadmap that U.S. companies will have to use when switching to IFRS, and a discussion of the proposed changes, among other information. The SEC (2008) recognizes that it will be beneficial for U.S. investors to be able to compare more easily the financial information of U.S. companies with the financial information of companies based outside of the U.S.

The fact that an increasing number of countries (currently around 113) accept and require the use of IFRS also has influenced the SEC's decision to work toward the convergence of U.S. GAAP and IFRS (SEC, 2008). Future joint projects of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) include discontinued operations, financial statement presentation, financial instruments with characteristics of equity, emissions trading schemes, and balance sheet netting. Current joint projects include financial instruments, revenue recognition, and leases (PricewaterhouseCoopers LLP, 2011). The research done for the purposes of this project focuses on lease accounting.

LEASE ACCOUNTING

GAAP and the IFRS each have their own lease accounting standard. GAAP's standard is the Statement of Financial Accounting Standards No. 13 (FAS 13), and the IFRS's standard is the International Accounting Standard 17 (IAS 17). Both of these standards provide guidance about whether lessees and lessors should classify a lease as a capital lease or an operating lease. A capital lease is one where the lessee accounts for a lease as if it has purchased the asset, and the obligation is recognized on the balance sheet. The lessee will depreciate the leased asset and allocate the payment between interest expense and a reduction of principal. An operating lease is a lease in which the lessee pays a rental expense and does not recognize any amount on the balance sheet (Kilpatrick & Wilburn, 2011, p. 55).

Lease accounting is one of the major convergence projects of the FASB and the IASB because "lease obligations are widely considered a significant source of off-balance sheet financing" (Kilpatrick & Wilburn, 2011, p. 55). One of the project updates released by the Financial Standards Accounting Board (FASB) and the International Financial Accounting Board (IASB) states that accounting models for leases "have been criticized for failing to meet the needs of users of financial statements because they do not provide a faithful representation of leasing transactions" (IASB & FASB, 2011b). The main problem listed in the project update is the omission of "relevant information about rights and obligations that meet the definitions of assets and liabilities in the boards' conceptual framework" (IASB & FASB, 2011b). Major differences exist between these two standards. Deloitte, one of the Big Four accounting firms, published a pocket comparison of IAS 17 and FAS 13. Deloitte's pocket comparison provides a good overview of the differences between the standards for leases that is easily understood (2008, p. 20-21).

Table 1

Differences between IFRS and GAAP accounting for leases

IAS/IFRS	Topic	IFRSs	US GAAP
IAS 17	Scope	Applies broadly to assets with certain exceptions.	Only applies to leases involving property, plant and equipment.
IAS 17	Lease Classification	The classification of a lease depends on the substance of the transaction. Specific indicators and examples are provided.	The classification of a lease depends on the lease meeting certain specified criteria.
IAS 17	Sales-type lease involving real estate	No specific criteria are provided.	Provides specific criteria.

IAS 17	Leases of land and buildings	Land and buildings elements are considered separately unless the land element is not material.	Land and building elements are generally accounted for as a single unit, unless land represents more than 25% of the total fair value of the leased property.
IAS 17	Present value of minimum lease payments	Generally would use the rate implicit in the lease to discount minimum lease payments.	Lessors must use implicit rate to discount minimum lease payments. Lessees generally would use the incremental borrowing rate to discount minimum lease payments unless the implicit rate is known and is the lower rate.
IAS 17	Leveraged leases	No special accounting provided for leveraged leases.	Permits special accounting for leveraged leases if specific criteria are met.
IAS 17	Recognition of a gain or loss on a sale and leaseback transaction	If the leaseback is a finance lease, defer and amortise the gain or loss over the lease term. If the leaseback is an operating lease, recognition of the gain or loss depends on whether the transaction is established at, below, or above fair value.	Depends on the extent of the seller's retained interest in the asset.
IAS 17	Sale and leaseback transaction involving real estate	There is no difference in accounting between sale and leaseback transactions involving real estate and non-real estate assets.	Specific requirements exist for sale and leaseback transactions involving real estate.

The table above is an excerpt from Deloitte's 2008 IFRS and US GAAP: A pocket comparison pages 20-21.

These differences between the two sets of accounting standards result in different amounts of long-term lease obligations being reported on the balance sheet, which will now be examined empirically.

IV. Methodology

The research performed in this study has two main objectives. The first objective relates to lease accounting and the way accounting for leases differs between Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). The second objective relates to how companies will be affected by the convergence of GAAP and IFRS.

RESEARCH DESIGN

This study used the financial statements of companies that prepare financial statements using both IFRS and GAAP in order to compare the differences in lease accounting that exist between these two sets of standards. Information extracted from the financial statements was analyzed in order to provide a comparison between the two methods of accounting for leases.

INSTRUMENTATION

This research is an archival study and is quantitative in nature. Results from this study were obtained through data collection acquired through the extraction of information from the financial statements of companies that use both International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (GAAP). These statements were obtained through the SEC's Electronic Data Gathering, Analysis, and Retrieval system (EDGAR). According to the SEC's website, EDGAR

> performs automated collection, validation, indexing, acceptance, and forwarding of submissions by companies and others who are required by law to file forms with the U.S. Securities and Exchange Commission (SEC). Its primary purpose is to increase the efficiency and fairness of the securities market for the benefit of investors, corporations, and the economy by accelerating the receipt, acceptance, dissemination, and analysis of time-sensitive corporate information filed with the agency. (2010)

The information gathered from the financial statements included long-term lease obligations and total assets.

PROCEDURES

Throughout the research process, it was discovered that limitations existed on the companies that could be used. Companies in the United States are not required by the SEC to reconcile financial statements to IFRS, and no centralized foreign database exists comparable to EDGAR. The SEC required foreign companies to reconcile their financial statements to U.S. GAAP only through the year 2007. The last limitation is many countries outside of the United States (with the exception of the European Union and China) use accounting standards unique to that individual country. Because of these limitations, a high rate of data mortality occurred. Hundreds of companies' financial statements were examined using EDGAR, and only three of these companies' financial statements were useable. The substantive limitations of the empirical analysis performed are the small sample size and the relatively short event period, which inhibit the ability to make inferences to a broader set of companies and time periods.

China Eastern Airlines Corporation Limited, China Southern Airlines Company Limited, and Delhaize Brothers and Co. are the companies for which multiple years of financial statements were able to be gathered and analyzed. Each company has one set of financial statements prepared using IFRS, with reconciliations to GAAP in the disclosures for comparison. Long-term lease obligations and total assets were obtained from each set of the financial statements. For each individual company, the information obtained from the financial statements prepared using IFRS with reconciliations to GAAP was compared.

DATA ANALYSIS

The data gathered during this study are reported in appendix Table 2 and include long-term lease obligations for GAAP and for IFRS, as well as total assets. The absolute value of the difference between GAAP long-term capital lease obligations and IFRS long-term lease obligations was converted into a percent of total assets. The difference between the lease obligations exists because lease obligations under GAAP are higher than those under IFRS. Financial statement data for China Eastern Airlines Corporation Limited were collected for the years 2005 and 2006. In 2005, there was no difference in the value of the lease obligations under the two different standards. In 2006, the absolute value of the difference between GAAP and IFRS lease obligations to GAAP total assets was 2.0656% (1,282.5/62,089.3), and the absolute value of the difference between GAAP and IFRS lease obligations to IFRS total assets was 2.0968% (1,282.5/61,165.9). Data from China Southern Airlines Company Limited were collected from 2003 to 2006. In 2003, the absolute value of the difference between GAAP and IFRS lease obligations to GAAP total assets was 15.9973% (9,376/58,610), and the absolute value of the difference between GAAP and IFRS lease obligations to IFRS total assets was 24.0029% (9,376/39,062). In 2004, the absolute value of the difference between GAAP and IFRS lease obligations to GAAP total assets was 3.5890% (2,338/65,144), and the absolute value of the difference between GAAP and IFRS lease obligations to IFRS total assets was 3.7478% (2,338/62,383). In 2005, the absolute value of the difference between GAAP and IFRS lease obligations to GAAP total assets was 3.1902% (2,376/74,479), and the absolute value of the difference between GAAP and IFRS lease obligations to IFRS total assets was 3.3248% (2,376/71,464). In 2006, the absolute value of the difference between GAAP and IFRS lease obligations to GAAP total assets was 2.9174% (2,272/77,877), and the absolute value of the difference between GAAP and IFRS lease obligations to IFRS total assets was 3.0059% (2,272/75,584). Financial statement data from Delhaize Brothers and Co. "The Lion" were collected from 2004 to 2006. For the year 2004, the absolute value of the difference between GAAP and IFRS lease obligations to GAAP total assets was 0.1870% (16.5/8,824, and the absolute value of the difference between GAAP and IFRS lease obligations to IFRS total assets was 0.1896% (16.5/8,702). For the year 2005, the absolute value of the difference between GAAP and IFRS lease obligations to GAAP total assets was 0.1910% (19.9/10,417), and the absolute value of the difference between GAAP and IFRS lease obligations to IFRS total assets was 0.1941% (19.9/10,254). For the year 2006, the absolute value of the difference between GAAP and IFRS lease obligations to GAAP total assets was 0.1736% (16.4/9,445), and the absolute value of the difference between GAAP and IFRS lease obligations to IFRS total assets was 0.1764% (16.4/9,295).

DISCUSSION

The main question when analyzing the magnitudes of the differences between the lease obligations under GAAP vs. IFRS is their materiality. According to U.S. SEC Commissioner Richard Y. Roberts (1993), “Materiality is a concept used to measure the influence that knowledge of certain facts could have on the decision of a prudent investor” (p. 13). Roberts (1993) also states,

> Materiality remains very much of an issue both inside and outside the Commission. Materiality from a quantitative perspective is usually expressed as a percentage based upon a comparison of dollar amounts. The staff of the Commission has long applied an informal "rule of thumb" as a guideline in determining materiality from a Quantitative perspective:
>
> above 10%-material
>
> 5-10%--may be material
>
> under 5%-usually not material. (p. 14-15)

Using the guidelines presented above, a material difference does not exist between the methods under which GAAP and IFRS account for leases. Only one result may be material, as an 8% difference exists between the GAAP and IFRS methods for China Southern Airlines Company Limited in the year 2003. This result appears to be an outlier in the data set, as all other results have differences ranging from 0% to 0.1588% as reported in appendix Figure 1. For these companies, since these percentages are so small, there would not be any material differences to the financial statements with respect to leases when changing from one set of standards to the other.

There are a few possible implications that the convergence of GAAP and IFRS will have on lease accounting. One possible implication of the convergence is that there will not be a significant change in the way leases are accounted for because there is not a material difference between the two standards when comparing the absolute value of the difference between GAAP and IFRS lease obligations to GAAP total assets and to IFRS total assets. There may not be any significant changes in lease accounting policies, but since the amount of long-term lease obligations under IFRS is less than those under GAAP, companies changing from IFRS to the converged standards may have more leases classified as capital leases instead of operating leases, resulting in an increase in the long-term lease obligation account on the balance sheet. This result may be just the opposite for companies changing from GAAP to the converged standards; they may have more leases classified as operating leases instead of capital leases, resulting in a decrease in the long-term lease obligation account on the balance sheet. These implications do not hold much weight due to the small sample size. PricewaterhouseCoopers LLP (2013) notes that the impacts may not just be accounting related. They may also have the following real impacts:

- Many of the standards may have significant business and operational implications and may require significant lead time to analyze and implement, especially for larger companies.
- If the tentative decisions become final, they will influence shareholder communications about the business, affect contractual agreements, and prompt a reassessment of the adequacy of systems and operations, including human and other capital resources.

- Training and budgeting considerations will also need to be addressed. (PricewaterhouseCoopers LLP, 2013)

A limitation of the study is that the sample size is small. Therefore, generalizations to other firms, industries, and time periods cannot be made. This study can serve as a basis for future research.

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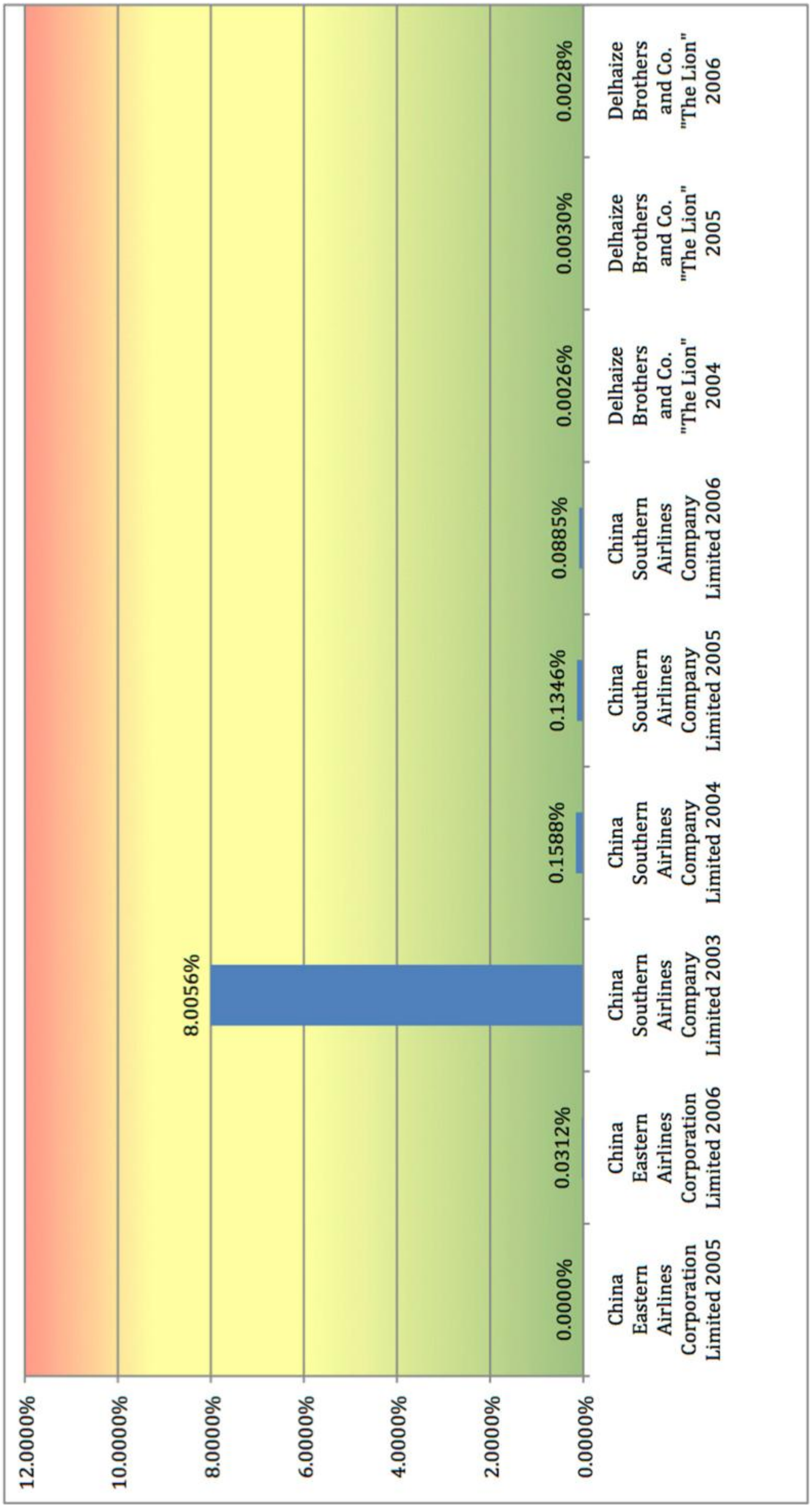
Appendix

Table 2
Calculations of financial statement data

Company Name	**GAAP Lease Obligations (in millions)**	**IFRS Lease Obligations (in millions)**	**Absolute value of difference between GAAP and IFRS lease obligations (in millions)**	**GAAP Total Assets (in millions)**	**IFRS Total Assets (in millions)**	**GAAP and IFRS lease obligations difference to GAAP Total Assets**	**GAAP and IFRS lease obligations difference to IFRS Total Assets**
China Eastern Airlines Corporation Limited							
2005	10,587.5	10,587.5	0	58,731	58,899	0.0000%	0.0000%
2006	13,135.0	11,852.5	1,282.5	62,089.3	61,165.9	2.0656%	2.0968%
China Southern Airlines Company Limited							
2003	16,217	6,841	9,376	58,610	39,062	15.9973%	24.0029%
2004	14,081	11,743	2,338	65,144	62,383	3.5890%	3.7478%
2005	18,208	15,832	2,376	74,479	71,464	3.1902%	3.3248%
2006	17,670	15,398	2,272	77,877	75,584	2.9174%	3.0059%
Delhaize Brothers and Co. "The Lion"							
2004	575.5	559	16.5	8,824	8,702	0.1870%	0.1896%
2005	673.9	654	19.9	10,417	10,254	0.1910%	0.1941%
2006	618.4	602	16.4	9,445	9,295	0.1736%	0.1764%

Figure 1

Difference between GAAP and IFRS percentages



Green=0%-5% Not material Yellow=5%-10% May be material Red=Above 10% Material