

The Impact of International Convergence on US Accounting Standards

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The Evolution of Accounting Standards

- Accounting standards have evolved over centuries of business and capital market development
- Different norms in countries has lead to GAAP
- US GAAP has been considered the “gold standard” because of its extensive, development and use
- As of 2007, 42% of Global Fortune 500 companies used US GAAP
- US companies represent 35% of worldwide market (down from 48% in 2002)

The Evolution of Accounting Standards

- Capital has no boundaries
- In an increasingly global economy, many market participants are clamoring for uniform global language for financial reporting
- Establishment of uniform standards runs the risk of overlooking economic, political, cultural, legal and regulatory realities as well as egos that exist in different countries and regions

The Evolution of Accounting Standards

- In order to create a uniform global system for financial reporting, the IASB was formed
- IASB is overseen by the International Accounting Standards Committee Foundation – 15 trustees (5 EU, 5 US and member-states China, Japan, Brazil, Australia and South Africa)
- International Financial Reporting Standards (IFRS) have already been adopted by over 100 nations
- The worlds two largest economies, US and Japan, are uncommitted but working toward convergence

The Evolution of Accounting Standards

- Progress toward convergence has been slow
- FASB-IASB convergence commitment since 2002
- The SEC has laid out a roadmap aiming at 2014
- IASB and FASB are meeting monthly trying to complete three major projects by Dec. 2011
- Both are working together to address current issues with the objective to converge and improve

The Evolution of Accounting Standards

IASB/FASB entered into a Memorandum of Understanding to address joint projects

- | | |
|--|---|
| • Revenue recognition | • Consolidation policies and procedures |
| • Leases | • Financial instruments – characteristics of equity ²⁰¹² |
| • Financial instruments | • Emissions trading schemes |
| • Financial statement presentation (Enron) | • Derecognition of fin. instr. |
| • Insurance contracts (2012) | • Stmt. of Comp. Income |
| • Discontinued operations | • Effective date/transition |
| • Balance sheet offsetting | |

Additional FASB Projects

- Goodwill Impairment assessments
- Investment properties
- Business combinations (elimination of pooling)
- Fair value measurement (trying to coordinate with IASB to get identical language)
- Credit impairments
- Disclosure framework
- Disclosure of loss contingencies (problematic)
- Disclosure of risks and uncertainties and Liquidation basis of accounting (going concern)
- Disclosures – participation in multiemployer pension plans (needed but deferred)

The Evolution of Accounting Standards

The impact of accounting changes caused by convergence goes well beyond financial reporting

- Tax planning
- Debt covenants
- Compensation arrangements

Revenue Recognition

US GAAP revenue recognition guidance, while principles based is extensive and rules laden

- Focuses on revenues realized or realizable
- Earned in completed exchange transactions
- Allows use of percentage completion or completed contract methods
- Prohibits use of cost-to-cost percentage completion unless for construction/production

Revenue Recognition

IFRS uses two primary standards to capture all revenue transactions within four categories and considers the probability that economic benefits from a transaction will flow to the entity

- Sale of goods
- Rendering of services
- Other's use of assets
- Construction contracts

Revenue Recognition

- IFRS uses a rights/obligations approach rather than an industry specific "earnings process"
- Revenue is recognized as benefits are transferred to the customer and performance obligations are satisfied

Revenue Recognition

Five key steps in applying the proposed model:

1. Identify the contract(s) with the customer
2. Identify the separate performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the separate performance obligations
5. Recognize revenue when the entity satisfies each performance obligation (transfers control)

Revenue Recognition

Key developments during redeliberations (over 1,000 comments and outreach to highly impacted industries - construction, technology, real estate, health care, higher education:

- More guidance will be issued on transfer of services vs. goods
- Report expected credit losses as contra revenues
- NFP exempt from "onerous" performance tests

Revenue Recognition

- US GAAP uses a proportional performance for service transactions
- IFRS looks at the stage of completion for service transactions which is similar to the percentage completion but it can be determined by a variety of methods, including cost to cost.
- When the outcome of a service transaction cannot be measured reliably, revenue may be recognized to the extent of recoverable costs (zero profit vs. US GAAP completed contract deferral)

Revenue Recognition

Barter transactions (nonmonetary exchanges)

- US GAAP uses the fair value of goods or services surrendered as a starting point
- If the fair value of bartered advertising provided is not determinable for US GAAP, it is recorded at cost (usually zero)
- IFRS generally requires the use of the fair value of goods or services received

Postretirement Plan Expense Recognition

US GAAP

- Actuarial gains are recognized systemically in the statement of operations as pension expense
- All components of pension expense are combined and presented as a net amount
- Prior service costs are amortized over remaining years of service, full eligibility or life
- Deferred compensation liabilities are measured at the present value of benefits to be provided

Postretirement Plan Expense Recognition

IFRS

- Actuarial gains may be recognized similar to US GAAP or immediately in other comprehensive rather than operating income
- Pension expense components may be disaggregated (interest expense, gains/losses)
- Prior service costs are recognized on a straight-line basis over the period vested
- Deferred compensation treated the same as OPEB

Postemployment Plans Funded Status

- US GAAP requires companies to record on the balance sheet the full funded status of pension and OPEB plans (difference between fair value of plan assets and projected benefit obligations)
- IFRS requires companies to recognize on the balance sheet the difference between the benefit obligation (as defined) and the fair value of plan assets +/- unrecognized actuarial gains/losses or prior service costs
- Both US GAAP and IFRS are reconsidering rules

Nonfinancial Assets

US GAAP - Intangibles and advertising costs

- Research and development costs are expensed as incurred other than software development costs, making internally generated intangibles rare
- Advertising costs are expensed as incurred or when first used except certain direct response advertising can be amortized over the period of future benefit
- Sales brochures may be expensed as used

Nonfinancial Assets

IFRS - Intangibles and advertising costs

- Research costs are always expensed but development phase costs may be capitalized
- All advertising costs are expensed as incurred
- Prepaid advertising may be recorded when made in advance of when the entity has the right to access the goods or services

Nonfinancial Assets

US GAAP - Property

- Component depreciation is not required
- Capitalization of construction interest is required

IFRS

- Component depreciation is required
- Must review residual value & useful life annually
- Capitalization of construction interest is required only for borrowing directly related to the asset

Nonfinancial Assets

US GAAP – Leases

- Leases classified as operating or capital based on four criteria with specific quantified thresholds
- Gains on sales/leaseback transactions are deferred & amortized over the term of the lease
- Land and building elements are viewed together
- Renewal options are normally evaluated as new
- Real estate leases normally not treated as sales

Nonfinancial Assets

IFRS – Leases

- Classification of leases depends on the transfer of risks and rewards of ownership based on substance rather than form – no bright lines
- Gains on sales/lease back transactions may be fully recognized if executed at fair value of asset
- Land and building components of leases must be bifurcated and accounted for separately

Nonfinancial Assets

IFRS – Leases

- If the renewal option was not considered to be part of the initial lease term, but the option is ultimately exercised, the classification of the lease is not revisited
- A lessor of real estate generally will recognize income immediately on a real estate finance lease if it transfers all of the risks and rewards of ownership, even if title is not transferred

Nonfinancial Assets

Proposed US GAAP revision on leases

- All leases will be accounted for similarly (exceptions)
- Lease obligations will be reported based on the present value of future payments (amortize debt)
- A leasehold asset would initially be recorded equal to the lease obligation (No grandfathering)
- Base lease term (including renewals) as the longest possible term more likely than not to occur

Nonfinancial Assets

US GAAP – Inventory and biological assets

- LIFO is permitted but book/tax conformity is required when used
- Reversal of write-downs are prohibited
- Historical cost is generally used for biological assets (plants, animals, agricultural products)

Nonfinancial Assets

IFRS – Inventory and biological assets

- LIFO is not permitted
- Reversal of write-downs are required for subsequent recoveries
- Biological assets are required to be recorded at fair value and evaluated at each reporting date
- Intangibles, natural resources and biological assets excluded from lease accounting proposal

Liabilities

US GAAP – Income taxes

- FIN 48 requires evaluation of uncertain tax positions
- The impact of changes in enacted tax rates impact on deferred taxes is recorded through the income statement for all timing differences
- Deferred tax assets are recognized in full and then reduced by valuation reserves
- Deferred taxes are classified based on the classification of the related nontax asset/liability

Liabilities

IFRS – Income taxes

- There is no equivalent to FIN 48 in IFRS
- The impact of changes to enacted tax rates for equity related items is recorded directly in equity
- Deferred tax assets are recognized when it is considered probable that sufficient taxable profits will be available to utilize the temporary difference
- All deferred taxes are classified as noncurrent

Liabilities

US GAAP – Contingencies

- An accrual for a loss contingency is required if it is probable that there is a present obligation from a past event
- Probable is generally defined as >75% likely
- When no estimate within a range of possible outcomes is better, the low end of the range may be accrued

Liabilities

IFRS – Contingencies

- An accrual is recorded when
 1. A present obligation from a past event exists
 2. The obligation is probable and
 3. A reliable estimate can be made
- Probably is defined as any chance over 50%
- When considering a range and each point is as likely as another, the midpoint of the range is used

Other Areas

- Consolidation/Joint Ventures (effective control)
IFRS provides an option for proportionate consolidation whereas US GAAP does not
- Offsetting assets and liabilities
As a general principle, US GAAP does not permit offsetting except where a right of offset exists whereas under IFRS a right of offset is permitted when it is a debtor's legal right

Other Areas

- Classification of refinanced obligations
US GAAP allows one to classify debt based on post balance sheet date refinancing, IFRS does not
- US GAAP allows extraordinary items to be separately classified in an income statement, IFRS does not
- US GAAP reports bank overdrafts separately, IFRS does not

Other Areas

- Comparative financial statements
US GAAP does not require comparative financial statements, IFRS requires one comparative period
- Compensation
US GAAP does not require management compensation to be reported in the financials, IFRS does in total and by category of compensation

Financial Statement Presentation

Financial statement presentation should be based on the principles of disaggregation and cohesiveness (exposure draft deferred to 2012)

- Format will change to a European style presentation divided among business (operations and investing), financing (debt and equity), income taxes, other comprehensive income & discontinued operations
- Cash flows will be presented using the direct method with no cash equivalents – you will have to present these financial instruments as investments

Financial Statement Presentation

Disaggregation means

- The activities of the organization engages in are clear
- The cash flows of the entity are clear
- The relationships between an asset or liability and the effects of a change in that asset or liability are faithfully represented across the statements of financial position, comprehensive income & cash flows

Financial Statement Presentation

Cohesiveness means that any item to be disaggregated in financial statements make it clear what the function and the nature of the item is, and on what basis the item is measured for its value.

Disclosure – Even if it hurts!

- There is no exemption for disclosures that might be considered prejudicial to the companies own interests i.e. disclosure must be made if it is considered probable a material claim will be asserted and there is a reasonable possibility of an unfavorable outcome
- Critics say the proposal could require disclosure of premature or unsubstantiated information and thus cause unnecessarily unfavorable market reaction (and lawyers refuse to confirm)

SEC and Convergence

The SEC is monitoring progress on MOU projects, among other factors, to help determine whether to incorporate IFRS into the US financial reporting regime for domestic registrants. Three options:

- Convergence (IASB sets the rules rather than SEC)
- Adoption (endorsement)
- Condonement (endorsing and converging over time)
- Trying to manage the “big bang”
- Increases the risk of “national GAAP”

The Convergence Timetable

The most likely timetable for implementation:

- 2012 – 2014 possible effective dates of converged new standards
- 2013 – 2014 earliest comparative information required
- 1/1/2015 possible beginning adoption date
- 2015 – 2018 possible staggered adoption period

Possible Private Company Alternative

Blue Ribbon Panel on Standard Setting for Private Companies

- Formed December 2009, met five times
- Jointly sponsored by FAF, AICPA, NASBA
- Mission is to address how accounting standards can best meet the needs of users of US private company financial statements
- Presented recommendations to FAF in 1/2011

Blue Ribbon Panel Recommendations

- Private Company US GAAP options (SME)
 - **One GAAP with private company exceptions**
 - Baseline GAAP with add-ons for public companies
 - Separate stand-alone GAAP for private companies
- FASB Board Structure
 - Enhanced board or **Separate Board**
- Differential framework (set of decision criteria) is essential
