

Global Accounting Standards: Not *IF*, but *WHEN*

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In an increasingly global economy, a single, high-quality set of international accounting standards would provide significant benefits. Uniform global standards would improve comparability of financial statements, enhance transparency, facilitate the raising of capital, and reduce accounting complexity and expense for multinational companies. But although most financial experts in the United States agree on the benefits of such standards, there is less consensus on how and when to adopt them.

Concurrent Initiatives

In the United States, two concurrent initiatives are driving the movement toward global accounting standards. The first is a joint project begun in 2002 by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). Their goal is to converge U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) — that is, to improve both sets of standards by narrowing the differences between them.

The second initiative is the Securities and Exchange Commission's (SEC's) roadmap for adoption of IFRS by U.S. public companies. The agency will vote in 2011 on whether to make IFRS mandatory as early as 2015.



Conversion Challenges

To understand the challenge of adopting global accounting standards in the United States, it's important to recognize how much IFRS differs from U.S. GAAP. IFRS is new and principles-based, so it offers few clear-cut answers. This makes it harder to apply — at least initially. Companies adopting IFRS, therefore, will have to look more at the big picture to determine how to account for many items, and accounting staff will need to learn a new accounting system.

Specific differences between IFRS and U.S. GAAP create additional challenges. For example, under U.S. GAAP, companies must expense research and development costs, but under IFRS they're prohibited from expensing development costs and must instead capitalize them. This change will artificially boost profits in the short term.

Similarly, IFRS prohibits the last in, first out (LIFO) inventory accounting method, which is commonly used under U.S. GAAP. This prohibition will force many companies to use the first in, first out (FIFO) method instead. In a volatile market, FIFO creates a discrepancy on the income statement between selling price and cost of sales.

New Timeline

Fortunately, companies have a little extra time to plan how they'll make the transition from GAAP to IFRS. In 2006,

FASB and IASB issued a Memorandum of Understanding (MOU), outlining priorities and milestones for several major convergence projects. In late 2009, they reaffirmed their commitment to the MOU, setting a deadline of June 2011 to complete their work.

But the two boards more recently announced a revised work plan, pushing out the target date for some convergence projects to the end of 2011. The plan also prioritizes the major projects and staggers the publication of exposure drafts (EDs) to avoid overwhelming stakeholders with too many at the same time. (See “Convergence timetable” for specific dates.)

5 Exposure Draft Proposals

Five exposure drafts currently are out for public comment:

1. Financial instruments. In May, FASB issued an ED that would significantly affect accounting for financial instruments. Certain instruments, such as leases and pension obligations, would be exempt. The ED would amend Accounting Standards Codification (ASC) Topics 825 (Financial Instruments) and 815 (Derivatives and Hedging). Among other things, the proposal would:

- Make accounting for financial instruments more consistent, requiring most instruments to be reported at fair value,
- Require companies to present details about both amortized cost and fair value for certain financial instruments,
- Require companies to recognize many credit losses earlier,
- Establish a single credit impairment model for both loans and debt securities, and
- Simplify hedge accounting criteria.

The proposal would affect all companies with financial instruments, but its biggest impact would be felt by entities with a large number of financial assets amortized at cost, such as banks. To ease their pain, FASB’s proposal would defer the effective date for smaller nonpublic banks.

According to the ED, whatever the effective date of the new requirements, nonpublic entities with less than \$1 billion in total consolidated assets would have an additional four years to implement them for certain loans, loan commitments and core deposit liabilities.

2. Comprehensive income. In a move closely related to proposed changes in accounting for financial instruments, FASB issued an ED in May that would amend ASC Topic 220 (Comprehensive Income). To eliminate inconsistencies in financial statement presentation, the proposal would require companies to report total comprehensive income and its components in two parts — net income and other comprehensive income (OCI) — in a “continuous statement of financial performance.”

The significance of this change is that OCI, which is generally more volatile, would be presented together with net income

on a company’s financial statements.

3. Fair value. In June, FASB and IASB issued separate EDs designed to develop common measurement and disclosure requirements for fair value. FASB’s ED would amend ASC Topic 820 (Fair Value Measurements and Disclosures) and would, among other things:

- Clarify that the concepts of highest and best use and valuation premise generally don’t apply to financial assets — in other words, their fair value shouldn’t reflect alternative uses or use within a group of other assets or liabilities;
- Create an exception to the “highest and best use” restriction, allowing a company to measure the fair value of financial assets and liabilities in a portfolio on a net basis if it meets certain requirements; and
- Provide new guidance on measuring the fair value of instruments classified in shareholders’ equity, such as stock issued as consideration in a business combination.

The proposals would also require additional disclosures, including uncertainty analysis for “Level 3” fair value measurements (those based on unobservable inputs).

4. Revenue recognition. Also in June, FASB and IASB proposed a new joint standard for revenue recognition. FASB’s ED, entitled “Revenue from Contracts with Customers,” would amend ASC Topic 605 (Revenue Recognition). The proposal is designed to improve revenue reporting by:

- Eliminating inconsistencies and weaknesses in existing standards and practices,
- Improving comparability across companies, industries and capital markets,
- Enhancing disclosure requirements, and
- Clarifying the treatment of contract costs.

The proposal would apply to all contracts with customers except leases, insurance contracts, financial instruments, guarantees and certain nonmonetary exchanges. It would establish a new core principle: that revenue would be recognized only from the transfer of goods or services to a customer.

This would have significant implications for long-term contracts subject to the percentage-of-completion (PCM) method of accounting. According to FASB, PCM revenue recognition would be allowed only if the customer owns the work-in-progress as it is built or developed.

The ED also outlines a five-step process companies would take in applying the new revenue recognition rules and clarifies the accounting for certain costs related to customer contracts. Finally, it establishes enhanced disclosure requirements regarding the amount, timing and uncertainty of revenue and cash flows from these contracts.

5. Leases. On Aug. 18, FASB and IASB issued a joint proposal that would revamp lease accounting. FASB’s ED would amend ASC Topic 840 (Leases). The proposal’s most significant change would eliminate the distinction between operating and capital leases.

Under current standards, leases that meet certain criteria may be classified as operating leases, which allows for off-balance-sheet financing. This approach has been criticized because it allows similar leases to be accounted for in different ways.

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Under the proposed rules, most leases would be treated as capital leases under a “right-of-use” model. Essentially, lessees would recognize an asset representing their right to use the leased property during the lease term and a liability for the lease payments. The ED also outlines two alternative accounting models for lessors to recognize assets and liabilities in connection with a lease.

The proposal’s biggest impact would be felt by companies with a large number of operating leases. But it would also make significant changes in accounting for capital leases, including new rules for measuring assets and liabilities.

SEC Roadmap Status

In February, the SEC issued a statement reaffirming its commitment to global accounting standards. The agency said it would continue to follow its roadmap for adoption of IFRS by U.S. public companies, though it pushed back the earliest mandatory adoption date from 2014 to 2015.

Next year, the SEC plans to vote on whether to make IFRS mandatory, based on its evaluation of several factors, including investor education, effects on issuers and the U.S. regulatory environment, and the readiness of financial statement preparers and auditors. Meanwhile, SEC staff will issue public progress reports on its own work plan as well as the status of the FASB-IASB convergence project, beginning no later than October 2010.

On Aug. 12, as part of this process, the SEC issued two solicitations of public comment on the impact of IFRS. The first seeks feedback on the level of investor knowledge and preparedness and what would be required to ensure that investors have a sufficient understanding of IFRS prior to potential incorporation.

The second solicitation seeks feedback on how IFRS would affect:

- Compliance with contractual arrangements that require the use of GAAP, such as debt instruments, leases, compensation plans and merger agreements,
- Compliance with corporate governance requirements, such as Sarbanes-Oxley and stock exchange listing requirements, and
- Application of legal standards tied to financial statement amounts, such as statutory restrictions on distributions.

After the SEC receives and analyzes comments on these issues, a clearer picture of the prospects and timing of IFRS adoption should emerge.

Next Move

The future of GAAP is uncertain. But whether the U.S. adopts IFRS or continues to converge GAAP with IFRS, it’s a good idea

Convergence timetable

Subject	Exposure draft issued (or expected)	Comments due	Final standard expected
Financial instruments	May 2010	closed	2 nd Quarter 2011
Comprehensive income	May 2010	closed	2 nd Quarter 2011
Fair value	June 2010	closed	1 st Quarter 2011
Revenue recognition	June 2010	10/22/10	2 nd Quarter 2011
Leases	August 2010	12/15/10	2 nd Quarter 2011
Insurance contracts	3 rd Quarter 2010		2 nd Quarter 2011
Consolidation	4 th Quarter 2010		2 nd Quarter 2011
Derecognition*			2 nd Quarter 2011
Financial instruments with characteristics of equity	1 st Quarter 2011		4 th Quarter 2011
Financial statement presentation	1 st Quarter 2011		4 th Quarter 2011

*FASB and IASB each amended its derecognition requirements, but significant differences remain. This year, the two boards plan to assess the differences between GAAP and IFRS and consider adopting the control-based derecognition model that IASB has been developing.

for U.S. public companies to begin preparing now. Even private companies, which aren’t subject to SEC rules but whose financial statement users may demand IFRS adoption, should draw up a plan.

Both public and private companies should start their IFRS preparation with an impact assessment. This helps them determine how proposed changes will affect their accounting policies and procedures, systems, personnel, and business relationships.

Next, if the SEC votes to use IFRS, public companies need to familiarize themselves with the adoption process. Making the transition to a new set of accounting standards is a complex, challenging process that involves a period of dual reporting and requires companies to make a number of critical decisions regarding accounting policies. At this stage, private companies will want to consider whether transitioning to IFRS will be beneficial or, perhaps, necessary.

Finally, companies should estimate the administrative, technology, training and other costs involved in adopting new accounting standards (or incorporating changes to existing standards). Then they should begin making arrangements to fund these expenses.

Team Effort

The proposed changes described above and the ones to come down the road are complex. Companies, therefore, will need plenty of time to prepare for them.

Talk to your borrowers and clients as soon as possible about global accounting standards and how they are preparing to make the transition. And seek the advice of your audit and accounting professionals to prepare yourself to interpret these changes for your borrowers and clients.





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