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The Topsy-Turvy World of US GAAP

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All eyes are on the United States these days in terms of accounting standard moves. This is especially true for global standard setters, regulators, and leaders of the G20 economies. But where do U.S. companies stand? Do companies, whether privately or publically held, realize what is happening and what the impacts are likely to be? Are boardrooms and audit committees knowledgeable about what is likely to be confronting management in 2011? Do investors know that the financial statements they have been reading will look vastly different in the coming years? This article raises some considerations that can help answer these questions.

US GAAP and IFRS Coming Closer Together

What started out as an aggressive push in early 2010 by U.S. accounting standard setters to converge U.S. Generally Accepted Accounting Principles (US GAAP) with International Financial Reporting Standards (IFRS) by June 2011 is now at a much slower speed. As standard setters became bombarded with concerns over the pace of proposed standards, they put the brakes on. Still, 2010 has been a constant parade of exposure drafts, projects, and new accounting standards that shows no signs of relenting in 2011 and beyond. The magic behind 2011 is that this has been and continues to be the timetable that the Securities and Exchange Commission (SEC) has pledged to decide as to whether, when, and how the current financial reporting system for U.S. public companies should be transitioned to a system incorporating IFRS. A lot is riding on this decision as it would directly impact all public companies reporting to the SEC.

The SEC has repeatedly reaffirmed a strong commitment to a single set of global standards. For example, the SEC (Release #33-9109) stated that "*IFRS is best-positioned to be able to serve the role as that set of standards for the U.S. market, and the convergence process ongoing between the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB).*" Since the SEC reaffirmation in February 2010, their Staff has invested significant time and effort in executing a work plan resulting in their first progress report issued on October 29, 2010. This progress report is the first of several anticipated to tackle the following six work plan concerns:

1. Sufficient development and application of IFRS for the U.S. domestic reporting system
2. The independence of standard setting for the benefit of investors
3. Investor understanding and education regarding IFRS
4. Examination of the U.S. regulatory environment that would be affected by a change in accounting standards

5. The impact on issuers, both large and small, including changes to accounting systems, changes to contractual arrangements, corporate governance considerations, and litigation contingencies

6. Human capital readiness

While there are still many concerns that need to be resolved and the pace may appear slow, it is clear the U.S. continues to march towards global accounting standards convergence for the stated benefit of investors. SEC Chairman Mary L. Schapiro stated on December 6, 2010, at the AICPA Annual Conference, "… *investors should be able to make accurate comparisons and judgments regardless of an entity's line of business, ownership status or corporate domicile. And so, the SEC continues to monitor the progress being made by the FASB and the IASB on the convergence of international accounting standards. As expected, the path towards convergence has proved steep and winding at times. But both Boards have responded to the challenges.*"

Priority Projects of the Boards

In June 2010, the FASB and the IASB (collectively, the "Boards") announced modifications to their timetable for prioritizing standards in response to public concerns regarding the ability to properly digest and provide high-quality input on the large number of major exposure drafts planned for publication in 2010. As a result, the Boards committed to publishing exposure drafts in phases to enable more effective public comments in the standard-setting process. Consequently, the Boards have prioritized completion of some of their joint projects by June 2011 while delaying completion of other projects, such as financial statement presentation and loss contingencies, until after June 2011 to help enable the FASB and the IASB to focus on the priority projects. The FASB maintains their Current Technical Plan and Project Updates on their website to communicate information about standards-setting activities to stakeholders. Current joint priority projects include financial instruments, revenue recognition, and leases. While both the IASB and FASB have many additional separate and joint projects in the works, these three are widely considered the most critical for a variety of reasons.

Financial Instruments

Many consider the proposed Accounting Standards Update (ASU), *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, to be a "bellwether" test for the Boards, especially the FASB. However, considering that many of the 2,814 comment letters disagreed or had concerns with key provisions, it calls into question if June 2011 is feasible for a final standard. The proposed standard is attacked for numerous technical reasons and the general sense that it would introduce much more subjectivity and accounting work with limited, if any, benefit to investors.

A key theme is that most financial instruments would be measured at fair value rather than amortized cost in the statement of financial position each reporting period. This would be especially difficult for a financial institution since their statement of financial position is primarily comprised of financial instruments. For example, banks would be required to periodically remeasure their core deposits, which could often result in deposits being recorded at an amount less than the amount owed. There are also questions on when the remeasured amount should be considered realized and recognized in the income statement.

There are many other contentious aspects to this 214 page proposed standard that commenter's identified. The proposed standard is also significantly divergent from the IASB's proposal on accounting for financial instruments thus calling into question if true convergence can be a reality. PwC stated in their comment letter (# 250); "*We are encouraged, however, that the Boards have committed to work together during the redeliberations phase to attempt to achieve convergence in this area. As the financial*

instruments area is fundamental to any convergence efforts, and the cost to the capital markets of divergence would be significant on many levels, we urge the Boards to work collaboratively during the redeliberations phase to resolve remaining substantive differences."

Revenue Recognition

Unlike the proposed ASU for financial instruments, the proposed ASUs for revenue recognition and lease accounting are nearly identical to the IASB's proposals. This is good for convergence purposes as it represents strong collaborative efforts of the boards to tackle these two important areas together. FASB's exposure draft *Revenue from Contracts with Customers* would overhaul U.S. GAAP revenue recognition accounting (Topic 605). Indeed, it is hard to imagine a company that will not be impacted by the proposal.

The proposed ASU would require the following five steps in determining when to recognize revenue arising from contracts with customers:

1. **Identify contract(s) with a customer**: If prices are interdependent, combine contracts.
2. **Identify separate performance obligations in contract**: Treat as "distinct," which is similar to "stand-alone value" treatment of existing GAAP. If not distinct, combine with other goods or services until there is a group that is distinct.
3. **Determine transaction price**: Transaction price represents the probability-weighted amount of consideration an entity expects to receive in exchange for transferring goods or services. If the transaction price cannot be reasonably estimated, a company cannot recognize revenue from satisfying a performance obligation. Companies would need to consider the following in determining transaction price:
   - *Variable consideration* (i.e., relevant experience with similar arrangements): This is an important requirement that is probably a higher hurdle than many may think. It essentially eliminates the "fixed and determinable" criterion that currently exists. This could lead to significant volatility when estimates significantly miss.
   - *Collectability*: Consideration amount adjusted to reflect customer's credit risk at inception of contract. When collectability is significant, changes go through OCI rather than operating income.
   - *Time value of money:* Companies would need to adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicitly or implicitly).
   - *Non-cash consideration:* Applies when the seller receives, or expects to receive, noncash consideration. To determine the transaction price for those contracts, a company must measure noncash consideration (or promise of noncash consideration) at fair value.
   - *Consideration payable to a customer:* Applies when a seller expects to pay consideration to the customer (or to other parties that purchase the entity's goods or services from the customer) in the form of cash or credit, or other items that the customer can apply against amounts owed to the seller.
4. **Allocate transaction price to separate performance obligations based on relative selling price**: The best evidence of a standalone selling price is the observable price of a good or service

when the entity sells that good or service separately. A contractually stated price or a list price for a good or service shall not be presumed to represent the standalone selling price of that good or service. If a standalone selling price is not directly observable, an entity shall estimate it. When estimate changes, the company would need to reallocate and recognize cumulative effect of changes immediately. This could lead to “derecognition” in debiting revenue to reduce it in situations when less revenue is estimated.

5. **Recognize revenue when each performance obligation is satisfied**: It is “satisfied” when goods or services are transferred to customer (i.e., customer obtains control). The challenge can be in determining when precisely the customer obtains control, especially for services. This could call into question the percentage of completion method if no control element is transferred to the customer.

Comments to the proposed ASU have generally been supportive; however, concerns are raised in how some of the requirements would work in practice. There are also concerns that some of the requirements could be onerous, including additional disclosure requirements. Specifically, a company would need to disclose qualitative and quantitative information about its contracts with customers and the significant judgments (and changes in judgments), made in applying the proposed guidance to those contracts.

Leases

Perhaps it is the proposed ASU on *Leases* that will have the most significant impact from a company standpoint. This exposure draft proposes that lessees and lessors apply a “right-of-use” model in accounting for all leases other than:

- biological and intangible assets
- exploration for or use natural resources
- some investment properties

Therefore, for the vast majority of leases this means that a lessee would recognize an asset representing its right to use the leased asset for the lease term and a liability to make lease payments. A lessor would recognize an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset, would either:

i. recognize a lease liability while continuing to recognize the underlying asset (a performance obligation approach); or

ii. derecognize the rights in the underlying asset that it transfers to the lessee and continue to recognize a residual asset representing its rights to the underlying asset at the end of the lease term (a derecognition approach).

This essentially means that “operating” leases under US GAAP and “non-finance” leases under IFRS would no longer exist as all leases would be captured in the statement of financial position (i.e., balance sheet). Assets and liabilities recognized by lessees and lessors would be measured on a basis that:

a. assumes the longest possible lease term that is “more likely than not” to occur, taking into account the effect of any options to extend or terminate the lease.

b. uses an expected outcome technique to reflect the lease payments, including contingent rentals and expected payments under term option penalties and residual value guarantees of the lease.

c. is updated when changes in facts or circumstances indicate that there would be a significant change in those assets or liabilities since the previous reporting period.

The consequences of these proposed changes to lease accounting are significant. Companies would need to identify all of their current operating leases and run them through some intense analysis to identify longest possible likely term and the present value of the lease payments discounted using the lessee's incremental borrowing rate or, if it can be readily determined, the rate the lessor charges the lessee. This could prove to be a monumental task for companies with a vast number of operating leases spread around the world.

Although the proposed changes may first appear to be insignificant for capital leases, think again. There would be significant changes in the measurement of the assets and liabilities arising from those leases to account for options and contingent rentals. In addition, the pattern of income and expense recognition in the income statement would change significantly. Finally, balance sheets would likely be "grossed-up" for both the lessee and lessor to now reflect operating leases. In essence, a double accounting of the asset would occur on the lessor's books for leases, especially for the performance obligation approach when the lessor retains exposure to significant risks or benefits associated with an underlying asset. This occurs because the lessor would account for both the underlying asset and the "right to receive lease payments" on their balance sheet.

Some concerns exist as expressed in comment letters pertaining to contingent rentals, lease terms, renewal options, impairments, residual value guarantees, reassessments, and discount rates for calculating present values. As usual, the changes will impact some companies more than others. For example, retailers subject to rental leases tied to percentage of sales will need to factor in these contingent payments.

While work remains with the proposed standard there is also an implicit silver-lining. Historically, the complacent mindset of leaning towards operating leases due to the favorable accounting treatment of keeping them off the balance sheet would no longer exist. Companies may now opt for deeper analysis on lease-buy decisions and tend to look at longer lease durations since there no longer would be any danger of breaching a bright-line test for operating leases. This could lead to overall cost reductions as companies have more ammunition to rationalize a "buy" decision or longer lease terms.

There is clearly plenty of work left for the two boards regarding financial instrument, revenue recognition, leases, and a slew of others accounting areas. Look for revised proposals in early 2011 to address some of the more important concerns raised through the comment letters.

Private Companies Also Need to Tune-In

The reality is that U.S. GAAP has historically been written for public companies as FASB is funded by public companies and is influenced by the SEC who holds legal authority for setting US GAAP. Another reality is that all entities who prepare financial statements in accordance with US GAAP are impacted by the on-going convergence with international accounting standards. This includes legions of private companies who opt to adhere to US GAAP for a variety of reasons, such as satisfying creditor and investor requests.

While the long standing debate of "big-GAAP" versus "little-GAAP" is ongoing, private companies have had an alternative to US GAAP since the summer of 2009 when *IFRS for SMEs* was published by the IASB. According to IASB's website: "*The IFRS for SMEs is a self-contained standard of less than 230 pages, designed to meet the needs and capabilities of small and medium-sized entities (SMEs), which are estimated to account for over 95 percent of all companies around the world.*" Refer to an article

published on September 30, 2009 entitled *Little GAAP Has Arrived* to learn who can use this streamlined set of rules in recording transactions and preparing financial statements, as well as some of the big differences and challenges.

In addition to *IFRS for SMEs,* a Blue-Ribbon Panel on Standard Setting for Private Companies exists to address how accounting standards can best meet the needs of U.S. users of private company financial statements. The Panel was established by the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Foundation (FAF; the parent organization of FASB), and the National Association of State Boards of Accountancy (NASBA). The Panel held their first meeting on April 12, 2010, and continues to actively meet to consider if US GAAP is meeting user needs in a cost-beneficial manner, as well as to explore possible alternatives for private company accounting standards.

Concluding Thoughts

As 2010 draws to a close, 2011 promises to be an action-packed year on the accounting standards front. There is simply too much global pressure on the SEC and FASB to miss key 2011 target dates. Therefore, look for FASB to do everything in its power to conclude upon their priority projects by next summer. This will also help the SEC with their pending decision regarding IFRS; however, the SEC probably will not decide on use of IFRS in the U.S. until very late in 2011. Regardless of the pending outcomes and decisions, what is clear is that companies need to prepare now. For example, current decisions pertaining to material lease and customer contract transactions should be influenced by likely final standards in the coming months. Some early planning can save a lot of accounting implementation pain as these standards become effective. Yes, we are likely a couple years away from effective dates for these standards, but time has a tendency to creep up quickly so plan now.

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