

Get Ready for Sweeping Changes in Accounting Rules



Lately, financial executives in the United States have expressed concern with the rapid pace of accounting standard-setting activity and the numerous business challenges that will result. This is the effect of the current potential convergence of U.S. generally accepted accounting principles with International Financial Reporting Standards.

The Financial Accounting Standards Board and International Accounting Standards Board currently are working on nearly a dozen joint projects with the objective of producing converged major accounting standards by 2011.

Through these projects, some covering major components of the financial statements, the boards intend to improve financial reporting information for investors while also aligning U.S. and international accounting standards. These projects are a significant move toward achieving a common accounting framework, a necessary step in the globalization of business and investment.

To be sure, completing all of these projects within the established timeframe is an ambitious task. This has led some to question whether such an aggressive timeframe will allow for the full and robust due process necessary to produce high-quality standards. In response to the feedback received, the boards recently issued a joint statement extending their existing timeline through the end of 2011 and beyond for certain projects. While the boards' extension is a step in the right direction, it may not be big enough.

However, regardless of whether the boards finalize their proposals by their target dates, changes are

looming. Companies should take notice now, as these projects will have significant business and operational implications and will require considerable lead time to analyze the implications.

Impact of Changes on Companies

How much these projects will affect a specific company will depend, of course, on individual facts and circumstances. There are five projects that will affect virtually every industry and company. These projects are aimed at:

- Determining how and when revenue should be recognized;
- Changing how financial instruments are classified and measured;
- Determining how leases should be accounted for and reported;
- Deciding when to consolidate related entities; and
- Changing the presentation of the financial statements.

Table 1 (below) explains the direction in which the boards currently appear to be heading and the estimated timeline for proposed and final standards.

Although the boards have reached only tentative decisions on these projects, their direction is clear. If the tentative decisions become final, they will influence shareholder communications about a business, affect its contractual

The major standards-setting boards are busy developing the best methods for converging international accounting rules with U.S. GAAP. Regardless of how those deliberations play out, big changes are coming to the business community.

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TABLE 1 PROJECTED DECISION-MAKING SCHEDULE

Project	Current Direction	Proposed Standard Target Date	Final Standard Target Date
Revenue Recognition	Revenue would be recognized when control of the good or service transfers to the customer.	Issued	Second Quarter 2011
Accounting for Financial Instruments	More financial instruments would be recognized at fair value. Impairment losses may be recognized earlier. May be easier to obtain hedge accounting.	Issued	Second Quarter 2011
Leases	Assets and liabilities arising from all lease contracts would be reported on the balance sheet.	Third Quarter 2010	Second Quarter 2011
Consolidations (IASB only)	Focuses on whether an entity has control over another entity in determining whether consolidation is necessary. (The FASB will decide how it wants to proceed after it performs additional stakeholder outreach.)	Issued	Fourth Quarter 2010
Financial Statement Presentation	The statement of cash flows would be presented using the direct method.	First Quarter 2011	Fourth Quarter 2011

Note: Proposed and final standard dates may change. Effective dates have not yet been determined.

agreements and prompt a reassessment of the adequacy of its systems and operations as well as its human capital needs. Training and budgeting considerations will also need to be addressed. The following is a deeper look at some of the factors that may need consideration.

Shareholder Communications

How the changes may require companies to spend more time with, or provide additional information to, shareholders is an important assessment. Shareholders will need to understand the linkage between the change in financial reporting and the company's true financial performance.

For example, the inclusion on the

balance sheet of all leased assets and obligations, as well as additional consolidated entities, would expand the balance sheet and affect capital and leverage ratios. FASB and IASB also have tentatively decided to replace rent expense with interest and amortization expense.

Thus, if a company uses EBITDA (earnings before interest, taxes, depreciation and amortization) to measure financial performance, that measure would increase, perhaps dramatically, with the absence of rent expense.

How will this increase change the company's communications with its shareholders and how can shareholders be helped to distinguish the real performance changes from accounting changes?

The boards' tentative decisions on revenue recognition and leasing would require companies to recognize revenue based on conditional events or performance. Examples, among others, include royalty revenue, early completion award fees — such as in the construction industry — and lease revenue if future rents are a percentage of sales. Since including conditional revenue requires future projection of amounts to be received, expect the possibility of greater volatility in reported earnings for companies with these types of revenue streams.

Shareholders will need to understand the reasons for that volatility, as well as the portion of revenue resulting from regular business

operations and the portion due to changing estimates.

Contracts with Lenders, Suppliers and Employees

Debt agreements with lenders, credit agreements with suppliers and other legal agreements containing financial covenants may need to change so the company does not breach those covenants. The changes in balance sheet ratios and operating metrics caused by the tentative decisions could require revising agreements with third parties to redefine compliance and performance targets.

Employee compensation agreements based on financial metrics may need to change to be consistent with the spirit of originally expected performance levels. For example, stock options, vesting dates or target metrics used to measure management performance may need to be modified.

Systems, Processes and Controls

These projects may require implementing reporting and information systems enhancements to ensure that they can capture and report new data, or summarize existing data in new ways, to meet the new reporting requirements. Thus, a company may need, or simply benefit from, new systems that can capture additional information, continually track individual contract information, support the process of developing and reassessing estimates and report certain newly required information.

For example, in reassessing financial statement presentation, the boards are likely to require that the statement of cash flows be presented using the direct method. (Under the direct method, companies would present the main categories of cash receipts and payments from operating activities, such as cash received from customers and paid to suppliers. Most companies today use the indirect method, under which net income is reconciled to net operating cash flows.)

FASB and IASB also are likely to require that additional information — for example, detailed roll-forward schedules of balance sheet amounts — be presented in the footnotes. Using reporting systems that can capture and categorize this information will often prove more efficient than relying on spreadsheets and manual labor.

The tentative decisions in revenue recognition and leasing would require estimates of anticipated contract periods and conditional amounts expected to be received. Enhanced systems would likely be needed to capture and report information on individual revenue and lease contracts, conditional payments and expected use periods resulting from options to extend terms, as well as allow for continuous re-estimation.

If the company is required to consolidate a previously unconsolidated entity — which may be the case upon completion of the boards' consolidations project — agreements with the newly consolidated entity may need to be developed to obtain information necessary to properly consolidate.

If the consolidated entity uses a different accounting system, links may be required or the two accounting systems may need to be conformed. Reporting timetables may also need to be coordinated, which may require further administrative changes.

Not only will systems require enhancements, companies would need to plan for and implement new processes and controls to ensure compliance with the financial reporting requirements of any final standards. Changes in the estimation and reporting processes, along with changes in revenue recognition policies and new systems, would require new control processes and updated documentation to ensure that estimates used for financial reporting are reasonable.

Human Capital

Companies would need additional

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time to develop, document and support necessary accounting estimates. If the company engages in transactions that have conditional revenue, incremental effort would be necessary to develop estimates of cash to be received. This may strain a company's existing resources or require adding resources.

For leases, estimates would be necessary for conditional payments (percentage-based rents) and renewal options. Time and resources would be required to assess at each reporting date if a change occurred and, if so, to calculate the amount of change.

In the U.S., tentative decisions in financial instruments would expand the use of fair value measures to more financial assets and liabilities. Despite this being categorized as a joint project, FASB and IASB are working separately on a number of the issues. This focuses on the tentative decisions made by FASB.

Equity investments in private companies would be reflected at fair value, as would loan commitments and standby letters of credit. For banks and other companies that hold significant investments, determining fair value for such items would take more time and effort, especially when the instrument is not liquid.

Fair value amounts at each reporting period would also need to be determined and adjusted. Additional resources to manage the process may be needed, particularly if the valuation process needs to be accelerated to meet earnings release dates and reporting targets.

A significant effort to gather needed information may also be required. For example, all existing leases — not just new leases — would be required to be reported on the balance sheet by all companies. This, in turn, would require companies to devote personnel to gathering the necessary information.

If a business has a significant number of longer-term leases, locating and reviewing contracts that were negotiated decades ago to obtain the relevant lease information could be time consuming.

Training and Budgeting

Additional training would be necessary to ensure personnel understand how to comply with new standards as well as changed processes and procedures. Sales representatives would need training on changing terms and conditions of customer contracts. Real estate teams would need training on the desired terms and conditions of new lease contracts that will best meet the company's operating and financial goals, rather than the goal of keeping the lease off balance sheet.

Budgeting

Anticipated changes in financial reporting would likely affect a company's key performance metrics, because the amounts used to determine those measures will be different. In addition to helping analysts and

others understand those effects as they evaluate the business, to recognize the effects of those changes, internal budget targets may be changed.

Some aspects to consider in developing budgets include changes in revenue amounts and performance metrics and the additional cost of implementing the new standards.

Consider the Impact on Your Business

This discussion of the anticipated impact of the boards' tentative decisions is not meant to be exhaustive, but merely to show how nearly every company will be affected. The accounting changes may directly affect a company's relationships with business partners, suppliers, vendors and shareholders.

Business leaders are focused on the importance of thinking through the likely accounting changes, anticipating how those changes would affect their businesses and doing all of this early, before final standards are imminent.

There is a clear commitment from both IASB and FASB to finalize their convergence projects in due course. Regardless of the timing, changes are coming. And, due to the expected significance of these changes, studying their implications on your particular business and mapping out a course of action now makes sense.

To prepare for the accounting changes likely to emanate from these projects, consider taking the following steps:

- Determine how the boards' tentative decisions will change your company's financial reporting and its business and operations.
- Review existing contracts and business arrangements with lenders, customers, suppliers and employees in light of the anticipated changes and determine whether they should be modified to meet the company's financial reporting objectives.
- Consider how the tentative deci-

sions on revenue recognition and leasing may affect your sales process. For example, if your products are generally leased by customers, their procurement behaviors may be affected with the expectation that all leases are included on the balance sheet.

- Assess whether information systems will need to change to obtain and report necessary information.
- Determine whether resources will be adequate to implement any final standards.
- Plan shareholder communications that explain how the changes will be reflected in your company's financial reporting and results.

Another benefit of considering business and operational issues as the projects progress is that it will provide insights on how practical and operational a proposed standard will be. Conveying those insights to FASB and IASB will provide them with valuable input.

Constituent input is important because it helps the boards produce standards that are both implementable and operational.

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