point of **view**

February 2011

Managing accounting change

Promoting quality implementations

Highlights

- New accounting standards that are expected to be issued in 2011 will have far reaching financial and business impacts.
- The proposed changes are so fundamental and pervasive that companies will need several years to develop the systems and processes necessary for implementation.
- There are no ideal solutions for transitioning to these new standards considering the varying impacts they will have on different companies.
- Companies should be able to decide what is in the best interest of their investors by being given the flexibility to manage their own pace and cost of change.

Time, flexibility and good disclosures are key to quality

- New accounting standards will be issued this year that will fundamentally change how companies account for revenue, leases, and financial instruments. Changes of this magnitude - combined with the complexity of the accounting - will require companies to devote significant time and resources to prepare for and implement the new standards.
- The minimum time required to implement the proposed changes will differ for each company. In most cases, companies will need several years to develop the necessary systems and processes. To give companies sufficient time, we believe that the standards' mandatory adoption dates should be no earlier than 2015.
- No single adoption date for all of the new standards or staggered approach will work for all companies. Since the proposed changes will affect every company and industry differently, we believe that companies should have the flexibility to adopt any or all of the standards before their mandatory adoption dates.
- The costs to implement each new standard will depend on a company's industry, financing, sales strategies, and information technology systems. A company's operating practices and existing agreements may also be impacted by the new standards. Setting a mandatory adoption date of 2015 - assuming new standards are issued by June 2011 - and giving companies the flexibility to adopt standards early yields adoption sequences that are cost effective, while providing sufficient time for quality implementations.
- This approach is also beneficial for investors. Transitions that are tailored by each company will be most cost effective and the resulting implementations will be of higher quality. To facilitate investor understanding and comparability between companies during the transition period, disclosure of the financial statement impacts caused by the changes is critical. The boards should ensure required disclosures are up to the task.

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Background

Adoption requirements must be made operational for all companies

The scale of the proposed changes and their impact are unprecedented. The boards should allow companies sufficient time to implement the changes in high quality ways

The Financial Accounting Standards Board and the International Accounting Standards Board (the boards) are working on about a dozen joint projects designed to improve both U.S. and international accounting standards. The scale of the proposed changes and their potential impact on companies are unprecedented.

Reprioritization of projects

Recently, the boards decided to delay certain projects and to retain the target completion date of June 2011 for projects they consider most significant. These include accounting for revenue, leases, and financial instruments. Two other projects are expected to be finalized in 2011, but will have less impact. Our views in this paper focus on the three significant projects.

The boards seek input

In October 2010, the boards issued consultation papers seeking input on when the proposed changes should be effective and whether they should be implemented retrospectively or prospectively. The boards intend to use the feedback to decide on implementation requirements and timing, and consider the cost to companies and the needs of investors. We applaud the boards' additional efforts to seek the views of their constituents.

Impact on companies

The new standards will fundamentally change how companies account for financial instruments, lease contracts and revenue transactions. Companies may need new systems that can capture data, track contracts, and support processes to develop and reassess complex estimates. Also, tax compliance systems and processes may need changes due to the new accounting. In many cases, systems that can support these changes are yet to be developed.

The proposed changes may also necessitate renegotiation of contracts, such as credit and compensation agreements, due to changes in financial ratios and reported results arising from the new accounting. Further, some companies may revise leasing, hedging, and sales strategies as a result of the new standards.

Impact on users

It's important to investors that companies implement the new standards cost effectively and correctly the first time. The reduced cost and risk of error can only be good for shareholder value. Giving companies ample time and flexibility will contribute to this goal.

Comparability and understanding the impact of the changes on each company will also be important to investors, analysts, and other users. Although some believe it may be ideal to have all companies change at once, the key to investor understanding will be clear disclosures of the changes as they occur and differentiation of the accounting effects from the performance of the business. The boards should ensure that required financial statement disclosures are up to the task.

Retrospective or prospective transition method

Often it is desirable that standards be retrospectively implemented to provide comparable information across periods.

However, each company's transition situation will be different. Factors such as the existence of long-term contracts, agreements with multiple performance obligations, or matters that require significant estimation may make retrospective application difficult or impossible. In these instances, retrospective application may require companies to make overly subjective estimates based on information that is no longer available.

We believe that the final standards should provide impracticability exceptions in a range of situations, including when the use of hindsight would require information that is unavailable or too difficult to obtain. Conversely, for the lease standard for which limited retrospective application is currently proposed, we believe full retrospective application should be available to those companies willing to undertake the exercise.

Allowing companies to manage their own pace of change will enhance quality

A forced single transition date or sequence will not be best for all companies. But one thing is certain; most companies will need significant lead time to implement the changes

The core of accounting is changing

Each company is different and the impact on their financial reporting and business will also be different. Companies with older systems may choose to implement completely new reporting systems. A retailer will likely see significant changes as all leases move on to the balance sheet, while a less complex company that owns most of its fixed assets may see less change. Companies with complex long-term sales contracts will be impacted more than those that sell basic products or services. Multinational companies subject to foreign currency movements will be impacted more because of changing hedging requirements and other complexities inherent in operating in diverse environments.

Required effective dates

Because of the pervasive changes, most companies will need significant lead time. Companies have told us that implementation could take up to three and a half years after standards are issued. During the first 12 to 18 months, companies will be interpreting the new standards, working with software developers, setting accounting policies, training staff, and developing technology and operational systems. After systems have been developed, companies may need up to an additional 2 years to implement the standards. This includes processing data, testing systems, and implementing internal controls. Contract renegotiations may also be prudent. During this period, many companies will account for transactions in parallel under existing and new standards for comparative reporting purposes.

Assuming the new standards on financial instruments, leases, and revenue are issued by June 2011, to give companies sufficient time for quality implementations, we believe that the mandatory adoption date for those three standards should be no earlier than January 1, 2015.

Early adoption considerations

Some believe implementing all of the proposed changes on a single date is preferable, because it eliminates multiple retrospective changes to comparative information over an extended period. They believe avoiding these changes to prior year presentations is more cost effective and less confusing to investors. While there are benefits to a single effective date for all, we don't believe that companies should be required to wait. This is because it may be more cost effective for some to adopt any or all of the proposed changes early.

For example, companies that can develop necessary systems quickly may want to early adopt to minimize the cost of running under old and new systems in parallel for comparative reporting purposes. Others, for which certain of the changes will have only a limited impact, may wish to put those changes behind them to focus on the more extensive ones. First time adopters of International Financial Reporting Standards may also want to early adopt, rather than transition to current standards; only to change again for new standards shortly thereafter.

In our view, a forced single transition date or sequence will not be best for all companies. Allowing flexibility is the key.

Concerns over comparability

We acknowledge that our approach may make comparability between companies more difficult during the transition period. However, the impact on comparability can be reduced by providing disclosures for investors and clear corporate communications on the effects of the changes. More importantly, because of the scale of these changes, we believe the benefits of allowing early adoption outweigh the short-term impact on comparability. This is because companies are best positioned to determine transition plans that are most appropriate and cost effective for their particular situations. The resulting higher quality implementations combined with reduced costs will benefit investors.

In conclusion

Companies should be given sufficient time to prepare for the proposed changes and the option to manage their own pace of change. Otherwise, companies may be forced into more costly implementations that risk failing to achieve high quality financial reporting. This would not be beneficial for companies or investors.

Questions and answers

Q: Should the boards consider alternative transition options such as prospective transition?

A: The boards have proposed retrospective transition methods for the proposed standards with some exceptions. In addition, the boards provided a simplified retrospective approach for transitioning to the leases standard. While prospective adoption is the easiest way to adopt new standards, it reduces comparability between periods. Where practical, we accept retrospective transition because it provides the highest degree of comparability. However, where not practical or operational, we believe some form of prospective or modified retrospective approach makes more sense.

Q: Are there standards that should be adopted at an earlier or later date?

A: If the boards do not address many of the operational issues constituents have raised in the comment letter process on the three major proposed standards, an additional year beyond 2015 may be needed to give companies sufficient time to address the complexities.

Further, the financial statement presentation project, which would significantly change how the balance sheet, income statement, and cash flows of a company are presented, has been delayed. Accordingly, depending on when a final standard is issued, a delayed mandatory adoption date may also be appropriate for that project.

Two additional joint projects on the presentation of comprehensive income and changes to fair value measurements are also expected to be finalized before June 2011. For consistency and simplicity, the effective dates of those standards should be aligned with the other standards issued in 2011.

Q: Should private companies be allowed additional flexibility in timing and transition methods?

A: Yes. Some believe that private companies should not be given any additional flexibility as they will be impacted no more by the proposed changes than public companies. We believe that the boards should allow private companies an additional year (2016). Implementation by private companies may have additional challenges because they may not have the same depth of resources. This means it may take longer to renegotiate contracts and implement the necessary systems and accounting policy changes. Private companies can also benefit by learning from public companies that adopt first.

Q: Should the boards require the same effective dates and transition methods under U.S. and international reporting standards?

A: Consistent transition methods would enhance comparability for investors. Using the same required effective date would set a consistent mandatory adoption date by which changes are adopted by all companies. Additionally, both boards should allow companies the same flexibility to choose which standards to adopt early for the reasons previously discussed in this paper.

Contact Information

To have a deeper discussion about our point of view on effective dates and transition methods, please contact:

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