

Are you ready for convergence?

Global accounting standards are almost upon us. Here's what to expect.

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Convergence of U.S. and international accounting standards is finally happening—soon. The rules are a little late and many questions remain, but now is a good time to start thinking about how the proposed changes will affect your company. This review gives you the lowdown on current proposals, continuing debates, and smart moves to make right now.

It's time to take convergence seriously

You've heard about it. Maybe even sweated over it. Now convergence is finally almost here—for real.

After 10 years of debate and issuing a spattering of converged standards, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) are poised to release a significant new wave of converged global accounting standards. Nothing's set in stone, and yet again they've pushed back their target date to later this year (forget about June 30). But after reviewing recent updates, we can tell you this much: while some changes will be fairly simple to implement, others will take serious work.

In the long run, convergence should be a good thing, especially if it eases global capital flow. Companies around the world will prepare financial statements the same way. Whether you're looking at statements from China or Chile, you'll know what you're seeing right off the bat. That should streamline investment and lending decisions, and companies that have foreign subsidiaries won't have to keep extra sets of books.

In the short run, well ... you like coffee, don't you? You may need large doses to power you through the work ahead. Large swaths of the accounting landscape will shift, and a few fundamental rules will change dramatically. Every business, in every industry, will have to comply. How compliance rolls out is an open question. The boards are teetering between two choices: one deadline for adopting all new rules, potentially a few years out (the "big bang" approach), or staggered deadlines. Comment letters and survey responses on these options split nearly down the middle. At this point, the ultimate decision is a coin toss.

As usual, preparation will ease the pressure—whichever side the coin lands on. Despite the lack of final guidance and deadlines, there are actions you can take now, and it always pays to know what's coming.

Buckle up for the big three

In late 2010 the boards agreed to give priority to three projects—revenue recognition, leasing, and financial instruments—in hopes of finalizing these standards by June 2011. In April, the boards extended their timeline to the second half of this year so they could pursue an "open and inclusive due process." In other words, they are likely to submit the proposed rules for public comment again, and they may conduct additional outreach to get a better sense of whether the standards will be an improvement on the status quo.

Based on a review of the current exposure drafts and comments, the new leasing rules probably will have the broadest impact, affecting almost every business. The changes in rev rec are also dramatic, and they spurred the most pushback during the public review.

What we know is summarized in this report. To be clear: these are not final decisions. Anything could change before the final announcement.

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Revenue recognition

What they're proposing:

The current draft uses a contract-based model with an asset and liability approach. Revenue will be recognized when a company satisfies its obligations to customers, which occurs when control of an asset (such as a good or a service) transfers to the customer. Big note: all industry-specific provisions (such as software rev rec) will be removed.

After extensive comments during the initial public review period, the boards have reached decisions in a number of contested areas, including transfer of control, performance obligations, segmentation, warranties, onerous performance obligations, contract costs, and breakage. Details will be part of the next exposure draft, which the boards expect to release later this year.

What they're still debating:

Separate accounting for "distinct functions" in product bundles. The boards are discussing whether to require separate accounting when aspects of a product bundle have a "distinct function"—that is, the company regularly sells the good or service separately, or the customer can use the good or service on its own or with readily available resources.

Revenue recognition for services. The new rules may create separate criteria for determining when service revenue should be recognized continuously.

What you can do now:

- Perform a comprehensive review of existing contracts, business models, company practices, and accounting policies using the current exposure draft rules.
- Review your IT systems and internal controls in light of the proposed rules. Some will need upgrades to capture the information required—ask your system provider what's in the works to comply with the upcoming changes. If you get a blank stare, you may want to look into alternative solutions.
- Make sure your colleagues in departments such as treasury, tax, financial planning, and human resources are in the know. Changes in the timing or amount of revenue recognized may affect long-term compensation arrangements, debt covenants, and key financial ratios.

No matter what happens, taking these steps can help keep you from getting overwhelmed when you have to start complying.

Leasing

What they're proposing:

No more off-balance sheet lease accounting. Under the current draft, leases will be recorded as financings with an asset and an obligation, based on the present value of payments over the term of the lease. Lease terms will include noncancelable periods and certain optional renewal periods, and amortization and interest expense will replace rent expense.

After the public review period, the boards made two critical refinements:

1. A lease term will include extensions if there is a significant economic incentive to extend the lease.
2. Variable lease payments will be included in the value of the asset and obligation if they are contingent and tied to a rate or index, are disguised minimum payments, or are “reasonably certain” contingent payments.

Catch your breath now—these are big changes, with the most potential for immediate impact.

What they’re still debating:

Profit and loss recognition patterns. Should there be a distinction between leases that primarily finance transactions and those used as “other than financing”? The boards had been considering straight-line expensing for “other than financing” leases, but in May they took a U-turn and decided that lessees should apply the finance lease approach to all leases recognized on the balance sheet.

Embedded leases (leases in other agreements). When should a lease element be broken out from an overall contract and accounted for separately?

What you can do now:

- Educate executives and department heads about what’s happening and what it means.
- Create a cross-functional steering committee to work on the transition, including facilities/real estate, treasury, tax, information systems, and financial planning departments.
- Inventory your lease portfolio. Get a handle on what types of assets are leased and where the data reside. Consider centralizing lease document storage. Extra credit: look for contracts that include embedded leases.
- Evaluate existing systems used to track leases. Extra credit: look into new systems that can better accommodate your likely needs.
- Think about potential changes in your real estate leasing strategy (when you lease instead of buy, shorter versus longer leases, modifying common terms, and so on).

Of course, the final announcement could throw a few wrenches into the works. There is some merit to a wait-and-see approach, but a gimlet-eyed look at lease arrangements will at least leave you prepared, regardless of the final rules.

Financial instruments

What they’re proposing:

Right now, we’re looking at an entirely new classification and measurement model for all financial instruments. A new credit impairment model for debt instruments and significant amendments to hedge accounting guidelines are also on the table.

The current draft offers three categories for classifying and measuring financial instruments:

- Amortized cost (historical cost with write-downs)
- Fair value with changes reported in other comprehensive income
- Fair value with changes reported in net income

The classification and measurement, however, must take into account your company's business strategy and an instrument's characteristics.

What they're still debating:

Recognizing impairment of financial assets. FASB wants immediate impairment recognition, while IASB wants amortization of remaining life.

Hedge accounting. FASB is reviewing comments on the recent IASB hedge accounting proposal. Both boards want further simplification, but there are numerous differences in the current and proposed models.

What you can do now:

Start talking with relevant departments, including treasury and tax, and keep them up-to-date. Beyond that, there's not much you can do. Unlike with rev rec and leasing, with financial instruments you wouldn't want to start making changes until the rules are final. Ongoing communication with your treasury and tax departments is the key here.

Other priority projects

In May, FASB and IASB issued converged guidance on fair value measurements and disclosures. The revised guidance provides companies around the world with a uniform framework for applying the principles of fair value measurement. From a U.S. perspective, the amendments are largely clarifications—but look out for some new disclosure requirements. The boards also are addressing the statement of comprehensive income, but that's just a matter of where you show it, so the final rule should be easy for U.S. companies to comply with.

What's next?

Once FASB and IASB started working on convergence, their to-do list started growing. Here are some other projects in the pipeline:

- Derecognition
- Consolidations
- Post-employment benefits
- Balance sheet netting
- Financial statement presentation
- Discontinued operations
- Financial instruments with characteristics of equity
- Insurance contracts
- Emissions trading schemes

Stay tuned

Convergence has been a long time coming, and we still have a way to go. But while the boards are debating, it's smart to get your ducks in a row. Don't have time? Don't have the right expertise? RoseRyan can help you take first steps that make sense for you—and help you comply when the rules come down from the mountain. Contact Maureen Ryan at mryan@roseryan.com to talk about your options.

About Christine Csubak: Christine Csubak is a CPA with more than 17 years' experience, including internal roles at Adobe Systems and KPMG. She frequently serves as a controller and advises clients on SEC financial reporting, technical accounting, and tax issues.