

CFO insights: IFRS: The emerging convergence challenge

On June 2, 2010, the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (the "Boards") issued a joint statement updating their work plan for the convergence and improvement of U.S. Generally Accepted Accounting Principles (U.S. GAAP) and International Financial Reporting Standards (IFRS). The work plan targets completion of a host of new accounting standards during 2011. Separately, the U.S. Securities and Exchange Commission (SEC) is expected to decide in 2011 whether it will require mandatory adoption of IFRS for publicly traded companies domiciled in the United States (based on currently available information, mandatory adoption is expected to be in 2015 or 2016 at the earliest).

The Boards' convergence work plan represents a large shift in the accounting and financial reporting landscape, the likes of which U.S. companies have probably never experienced before. Virtually all U.S. companies will be affected by the changes, irrespective of the SEC's potential timeline for transition to IFRS. Convergence is not the same as conversion to IFRS. Today, there are a multitude of differences between the IASB and FASB standards, and convergence is the process to reduce these differences.

As the number of differences between U.S. GAAP and IFRS is reduced in the next few years, it will drive significant accounting and reporting changes for U.S.-based companies. These changes occur after one of the more active periods of corporate downsizing, potentially increasing pressure on already lean corporate resources. This convergence challenge may be further exacerbated by any significant changes to information systems, processes and controls, income taxes, or other areas within the organization.

In this CFO Insights article, we outline the major accounting issues that require early consideration given the Boards' current IFRS convergence agenda and timeline. These include changes underway to revenue recognition and lease accounting. We will also address several other convergence projects.

Revenue recognition – The revenue recognition convergence project, which resulted in the issuance of an exposure draft by the Boards earlier this year, is expected to supersede most of the existing industry-specific revenue recognition accounting rules and interpretations which have been used for many years, and evolved under U.S. GAAP over time. The new exposure draft will try to tackle revenue recognition across all industries, and companies would apply broad principles to contracts for the sale of goods or services. The proposed guidance will likely necessitate an evaluation of customer contracts to ensure that revenue is recognized when performance obligations are satisfied.

The revenue convergence efforts will mark a change for those industries that have industry-specific revenue recognition guidance provided under U.S. GAAP. Applying a broad principles-based framework (in contrast to a rules-based framework) also has the potential to generate different accounting interpretations for similar transactions. For example, in the technology industry, software is increasingly delivered as a service, blurring the differences between product and services. The specific application of broad revenue recognition principles to complex combinations of products and services is likely to require extensive



consideration of how to apply and interpret the new guidance. It is also likely to require detailed disclosures of how the principles were interpreted in the financial statements.

Additionally, companies will need to assess whether enterprise resource planning systems and process changes will need to be made in order to comply with the new requirements for revenue recognition.

Leases – The Boards recently released an exposure draft that represents a potential overhaul of current lease accounting treatment. The proposed lease standard, unless modified based on stakeholder comments, will likely result in some of the following changes:

- Discontinuing the operating lease classification, resulting in all leases being recorded on the balance sheet
- Replacing rental expense with depreciation/amortization and interest expense, impacting performance measures, such as earnings before interest and taxes (EBIT) and earnings before interest, taxes, depreciation, and amortization (EBITDA)
- Changing the timing of income statement recognition, since interest expense/income under the effective interest method will be higher in early years compared to the current straight-line recognition of rental expense/income under an operating lease
- Increasing the amount of effort needed to account for leases, as the proposed model requires significantly more estimates at the inception of the lease and a continuous reassessment of those estimates during each reporting period as facts and circumstances change
- Replacing the current accounting model for lessors by a dual model (de-recognition approach and performance obligation approach) based on exposure to risks or benefits of the underlying asset during or subsequent to the expected term of the lease contract
- Increasing the disclosures about leasing activities

The proposed standard marks a significant shift in accounting. Bringing currently off-balance sheet leases onto balance sheets can have a major impact on financial measures and ratios, such as debt-to-equity, EBITDA, interest coverage, and tangible net worth.

A critical challenge to reevaluating lease obligations is that many companies may not track leases in a centralized way. For example, if a company has 1,000-plus leases around the globe, it may not have full visibility into lease terms and obligations, because many of those leases may have been executed in the field. Companies will have to find efficient ways to: 1) gather key lease provisions from the underlying lease agreements, 2) perform the necessary calculations to calculate the amounts to be included on the balance sheet, and 3) calculate the related accounting entries over the life of the lease.

While the exposure draft is not yet finalized, it's important for CFOs to evaluate their current lease obligations and consider how they will affect the company's financial statements when the new standards are adopted. It should also be noted that the current proposed standard does not provide a grandfathering provision, and therefore, an organization would need to apply the new requirements to all existing lease contracts at the date of adoption.

Other convergence projects – Additional changes are being contemplated in areas such as financial instruments, postemployment benefits, consolidations, insurance contracts, and fair value accounting. The changes could bring with them new accounting and disclosure requirements, resulting in greater data requirements. Additionally, the new accounting guidance is generally more principles-based, therefore, a higher level of judgment is often required by management to apply the standards.

Although the proposed changes are not expected to be finalized until 2011, with effective dates not expected until 2013 and 2014¹, many of these issues may have far-reaching implications and long implementation lead times. Addressing these implications will likely be resource intensive and time consuming.

¹ The Boards have released a joint consultation document seeking input about effective dates and transition methods.

Leading from the front on convergence

Although finance organizations have likely been strained by cutbacks over the last few years, a company can undertake selective planning activities and take steps now to manage the additional effort related to the transition to these new standards. One such step could be the creation of cross-functional IFRS focused workgroups. Among other things, these workgroups can:

- Monitor and evaluate exposure drafts and new accounting rules to assess the likely impacts on the company's earnings and other key performance variables important to analysts. This includes considering the impacts on existing agreements, including debt covenant ratios
- Conduct working sessions with key personnel to establish an understanding of the systems, process, accounting, and organizational process changes required by convergence
- Develop work plans with built-in accountability for responsible parties
- Educate stakeholders on convergence issues and build awareness across the organization

As companies consider the significant increase in new accounting requirements and the related deep organizational impacts that convergence will bring, they need to begin building and executing convergence plans. A thoughtful approach to the global accounting convergence challenge is important to help manage the risks inherent in adopting new accounting standards. IFRS convergence does not solely have to be a burden. For example in the area of leases, savvy transformational CFOs can use these new requirements as a lever to drive greater transparency, control, and operational efficiencies in their company.



More information about the progress on the convergence projects can be found on the IASB (www.ifrs.org), FASB (www.fasb.org), and Deloitte (www.iasplus.com) websites.

Primary Contacts

Joel Osnoss
Partner
Deloitte & Touche LLP
josnoss@deloitte.com

Nick Difazio
Partner
Deloitte & Touche LLP
ndifazio@deloitte.com

Alfred Popken
Partner
Deloitte & Touche LLP
apopken@deloitte.com

This Deloitte CFO Insights article was developed with the assistance of Dr. Ajit Kambil, Global Research Director, Deloitte CFO Program.

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