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Fasten Your Seat Belt for New Accounting

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It was October 2005 when I heard Don Nicolaisen, former Chief Accountant with the U.S. Securities and Exchange Commission (SEC), address a group of over one hundred financial executives about the future of accounting standards. He was the keynote speaker at a FEI[1] dinner meeting in Milwaukee packed with corporate board members, CFOs, treasurers, and controllers. Only months removed from arguably the single most visible and important accounting position in the world, Nicolaisen stunned the crowd when he said that something will hit corporate America in the coming years that will likely be more difficult for many companies than the burdensome control requirements of the Sarbanes-Oxley Act (SOX).

Knowing what the corporate world has been through since that infamous day of July 30, 2002, when President Bush signed SOX into law, it is hard to believe that anything could possibly compete with the confusion, stress, resources, and shear commotion of SOX. Nicolaisen then went into a discussion about the unstoppable demise of Generally Accepted Accounting Principles in the United States (U.S. GAAP) in favor of a set of global accounting standards, most likely international financial reporting standards (IFRS) of the International Accounting Standards Board (IASB).[2]

This The demise of U.S. GAAP has accelerated this decade. While the SEC currently looks to FASB3 to set U.S. GAAP, it is the SEC that retains ultimate responsibility. U.S. GAAP has been extensively used since the 1930's, and until recently was widely used around the world. However, its shortcomings are also well known including approximately 200 pieces of fragmented U.S. GAAP on revenue recognition, some of which is not based on consistent concepts. U.S. GAAP has evolved over the years to become overly complex and burdensome as evidenced by the large number of countries and companies abandoning it. One recent example is NEC Corporation, the Japanese electronics giant. NEC announced on September 21, 2007 "that it was not able to complete a U.S. GAAP-required analysis relating to software, maintenance and service revenues."[4] In essence the Company said it simply cannot figure out U.S. GAAP revenue recognition rules and will stop trying, resulting in suspended trading on the NASDAQ.

Indeed, the past two years have seen an acceleration of accounting convergence by the Financial Accounting Standards Board (FASB) and the IASB. It started in earnest when the FASB and IASB agreed through a February 2006 Memorandum of Understanding to converge the two sets of accounting

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[1] http://www.financialexecutives.org/
[2] http://www.iasb.org/Home.htm
[3] http://www.fasb.org/
[4] http://www.nec.co.jp/press/en/0709/2101.html

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standards by 2009.[5] Since then, the SEC voted on Nov. 15, 2007, to abolish a long-standing requirement that foreign companies listed on U.S. exchanges reconcile their financial statements to U.S. GAAP.[6] And even more recently, the FASB approved a suite of new accounting rules pertaining to the accounting for mergers and acquisitions earlier this month.[7] This is the first set of standards issued by FASB explicitly intended to converge with IFRS, although the IASB has delayed publishing its final standards and will likely include some differences on several key elements, meaning that true convergence is still elusive.

There are substantial differences between IFRS and U.S. GAAP. U.S. GAAP is largely rules-based meaning long and complex standards attempting to deal with all scenarios. Financial Accounting Standard No. 133 on derivatives is a fine example with over 800 pages of the standard and implementation issues. On the other hand, IFRS is a principles-based accounting system, meaning it is objective-oriented allowing for more presentation freedom. Financial Accounting Standard No. 123R on share-based payments and the SEC executive compensation disclosure requirements are attempts to move toward principles-based standards.

Perhaps the biggest potential change is a different look to financial statements. Although nothing has been decided, the IASB and FASB are striving to create a cohesive presentation of financial information that will likely do away with a single net income number, or "bottom-line." Instead, the working proposal would require three separate statements: a statement of financial position, a statement of comprehensive income, and a statement of cash flows.[8] Companies would need to breakout in each financial statement information for business activities (including operating and investing activities), discontinued operations, financing activities, income taxes, and equity. This would result in a company classifying its assets, liabilities, and equity items into one of the prescribed categories or sections in the statement of financial position and then similarly classifying changes in assets, liabilities, and equity items in the statement of comprehensive income and the statement of cash flows. It is anticipated that the resulting standard will apply to all business entities (public and nonpublic), but not to not-for-profit organizations or defined benefit plans.

In conclusion, moving U.S companies to IFRS will not be easy. The SEC is "big government" and as such is slow to move. Compound this with questions on funding and the enforcement powers of the IASB, and there are already two strikes against a smooth and timely convergence to one set of global accounting standards. However, there is near certainty that convergence will happen. Companies are well advised to start thinking about IFRS now and educate themselves on likely ramification such as anticipated M&A activity involving foreign companies, new ERP investments, and securing long-term expertise.

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[5] http://72.3.243.42/news/nr022706.shtml
[6] http://www.sec.gov/news/press/2007/2007-235.htm
[7] http://www.fasb.org/news/nr120407.shtml
[8] http://fasb.org/project/financial_statement_presentation.shtml#decisions

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