Assurance Services

FASB and IASB convergence projects at-a-glance

(as of January 15, 2013)

There are unprecedented and significant changes to the authoritative accounting literature on the horizon. Many of these changes arise from the Financial Accounting Standards Board's (FASB) and International Accounting Standards Board's (IASB) efforts to converge their accounting standards. Listed in the table below are four key convergence projects and their current status. The key decisions made by the FASB on each of these projects are provided in the remainder of this overview. While the timelines to complete these projects have been extended over time and a decision has not yet been made by the Securities and Exchange Commission (SEC) with respect to use of International Financial Reporting Standards (IFRS) in the U.S., achieving convergence on these projects remains important and time sensitive given the focus on forging more comparability between U.S. generally accepted accounting principles (GAAP) and IFRS. All parties involved in the financial reporting process should be tracking these key projects given the degree to which their responsibilities and activities will be affected when the projects are completed.

Project timing snapshot

Project	Status[1]
Leases	August 2010 — Exposure draft issued First quarter 2013 — Revised exposure draft expected to be issued
Financial instruments	May 2010 — Exposure draft issued
• Impairment	January 2011 — Supplementary document issued Fourth quarter 2012 — Revised exposure draft issued
• Classification and measurement	First quarter 2013 — Revised exposure draft expected to be issued
• Hedging	February 2011 — Discussion paper issued Redeliberations have not yet commenced
Revenue recognition	June 2010 — Exposure draft issued November 2011 — Revised exposure draft issued Second quarter 2013 — Projected completion
Consolidation	
• Investment companies	November 2011 — Exposure draft issued First quarter 2013 — Projected completion
• Policy and procedures	November 2011 — Exposure draft issued Second quarter 2013 — Projected completion

[1] The FASB does not provide a projected completion timeframe on its website for the leases or financial instruments projects. While it is possible that one or both of these projects could be completed in 2013, we believe it is more likely that these projects will not be completed until 2014.

With respect to the effective dates of the standards that will result from these projects, the FASB has made it abundantly clear that ample time will be provided for implementation of any new requirements. For example, in its revised exposure draft for the revenue recognition project, the FASB indicated the effective date for public companies would be no earlier than annual periods beginning on or after January 1, 2015, and that the effective date for nonpublic companies would be at least one year later. On the subject of transition, it is expected that the FASB will require retrospective application in many cases.

Progress on the convergence projects was a significant element of the SEC staff's *Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers* (the work plan). In July 2012, the SEC staff issued a final staff report summarizing what they learned in conjunction with carrying out the work plan. While this report reiterated the U.S. commitment to the objective of a single set of high-quality globally accepted accounting standards, it did not provide a final recommendation to the SEC with respect to whether U.S. issuers should be required or allowed to apply IFRS as issued by the IASB (for a summary of the report, refer to SEC staff issues final staff report on IFRS work plan). At the 2012 AICPA National Conference on Current SEC and PCAOB Developments (held in December), the SEC staff indicated the use of IFRS by U.S. issuers will continue to be evaluated. However, when addressing the timing for further discussion or a decision on the subject, the SEC staff simply said, "Stay tuned." As a result, it is not clear what the SEC staff's or SEC's next steps and timetable are at this time.

The expectation is that any final standards from the convergence projects would be applicable to both public and private companies in the U.S. However, the efforts of a number of organizations culminated in the Financial Accounting Foundation (FAF) (the oversight body for the FASB) creating a Private Company Council (PCC). One of the PCC's objectives is to identify the changes it believes should be made to U.S. GAAP for private companies. The PCC held its first meeting in December 2012. One of the issues discussed by the PCC was the outreach performed and feedback provided on the FASB's invitation to comment on a staff paper outlining a potential framework that could be used by the PCC and FASB to decide whether a change to U.S. GAAP for private companies is warranted. Further discussion about the framework is expected to take place. Based on the PCC's operating procedures, proposed and final changes to U.S. GAAP for private companies will have to be approved by two-thirds of the PCC and endorsed by a majority of the FASB. The PCC will meet and deliberate at least five times a year and its proposals will be exposed for comment after endorsement by the FASB. The PCC will also be the primary advisory group to the FASB on matters pertinent to private companies. In that capacity, the PCC will likely provide input to the FASB on its convergence projects. However, the nature and effects of that input and other potential actions of the PCC with respect to the convergence projects are unknown at this time.

Leases

Eye-opener: Off-balance-sheet accounting for most leases would no longer be appropriate and the accounting model would depend on whether the lessee acquires and consumes more than an insignificant portion of the underlying asset.

Why are they doing this? To create common lease accounting requirements to ensure the assets and liabilities arising from leases are recognized in the balance sheet.

Key concepts:

- A lease would be defined as a contract in which the right to use a specified asset is conveyed for a period of time in exchange for consideration
- Short-term leases would be defined as those having (at commencement) a maximum possible lease term of twelve months or less (including renewal options)
- For short-term leases, lessees would be permitted to elect (by class of asset) not to recognize an asset and liability for the lease (as discussed later) and instead generally recognize lease expense on a straight-line basis
- Lessors would be permitted to elect (by class of underlying asset) to account for short-term leases by not recognizing lease assets or lease liabilities and instead recognizing lease payments in profit or loss on a straight-line basis over the lease term, unless another systematic and rational basis is more representative of the time pattern in which use is derived from the underlying asset
- For arrangements with lease and non-lease components:
  - Lessees would: (a) separate those components if there are observable purchase prices for some or all components or (b) treat the entire arrangement as a lease if no observable purchase prices exist
  - Lessors would always separate lease and non-lease components using the guidance in the Revenue Recognition project
- Lessees would initially recognize a right-of-use (ROU) asset and a liability for the obligation to make rental payments and both would be measured based on the present value of the lease payments
- If more than an insignificant portion of the underlying asset is acquired and consumed by the lessee:
  - Lessees would subsequently account for the ROU asset using an accelerated method that recognizes amortization expense and interest expense, the total of which would be higher earlier in the lease term
  - Lessors would initially and subsequently apply the receivable and residual (R&R) approach, which would entail recognition of a receivable for the lease payments,

  - derecognition of a portion of the underlying asset and reclassification of the remaining portion of the underlying asset as a residual asset
- If more than an insignificant portion of the underlying asset is not acquired and consumed by the lessee:
  - Lessees would subsequently recognize lease expense using a straight-line method
  - Lessors would continue to recognize the underlying asset and recognize lease income over the lease term (similar to the operating lease model for lessors under current U.S. GAAP)
- Lessees would account for leases of property (e.g., land, buildings and portions of buildings) using the straight-line method unless the lease term is for a major part of the economic life of the underlying asset or the present value of the lease payments approximates substantially all of the fair value of the underlying asset
- Lessees would account for non-property (e.g., equipment) leases using the accelerated method unless the lease term is for an insignificant part of the economic life of the underlying asset or the present value of the lease payments is insignificant compared to the fair value of the underlying asset
- Lessors would account for leases of property using the approach similar to current operating lease accounting unless the lease term is for a major part of the economic life of the underlying asset or the present value of the lease payments approximates substantially all of the fair value of the underlying asset
- Lessors would account for non-property leases using the R&R approach unless the lease term is for an insignificant part of the economic life of the underlying asset or the present value of the lease payments is insignificant compared to the fair value of the underlying asset
- The lease term would be the noncancellable period plus any optional periods for which there is a significant economic incentive to extend or not terminate the lease
- Lease commencement would trigger initial recognition of the lease and measurements would be based on information available at that time
- Variable lease payments that are in-substance minimum lease payments would be included in the initial measurement of the lessee's liability and lessor's receivable (under the R&R approach) and would be reassessed each reporting period
- Variable lease payments based on an index or rate would be included in the initial measurement of the lessee's liability and lessor's receivable (under the R&R approach) based on the prevailing rates or indices at lease commencement and other variable lease payments would be excluded from the liability and receivable
- Lessees would record lease incentives as reductions of ROU assets
- A sale-leaseback would be recognized if the control criteria in the Revenue Recognition project are met; otherwise, the transaction would be a financing
- Lessees and lessors would be required to provide many new disclosures; for example:
  - Lessees that are public entities would have to disclose a reconciliation of the opening and closing balances of lease liabilities under both the accelerated and the straight-line methods
  - Lessors would have to disclose a table of all lease-related income items, a reconciliation of the opening and closing balances of the receivable for lease payments and residual assets and a maturity analysis of undiscounted cash flows that are included in the receivable for lease payments
- Lessees would apply existing U.S. GAAP on impairment of long-lived assets when evaluating whether a ROU asset is impaired
- Lessors would refer to existing U.S. GAAP on impairment of receivables to assess the impairment of the receivable for lease payments
- Lessors would refer to existing U.S. GAAP on impairment of long-lived assets, as appropriate, to assess the impairment of the residual asset
- In certain situations, more than one transition method would be available to both lessees and lessors
- Lessees and lessors would account for a lease acquired in a business combination as a new lease on the acquisition date

Financial instruments

Eye-opener: The requirement to measure at fair value would be expanded to additional financial instruments (FI) and a new credit impairment model would replace existing guidance.

Why are they doing this? To improve the usefulness of FI reporting for users of financial statements, simplify the accounting requirements and address the perception that credit impairment was recognized too little and too late during the recent economic crisis.

Key concepts:

- Investments in equity securities (other than certain redeemable securities and those measured based on the equity method of accounting) would be accounted for at fair value with changes in fair value recognized in net income (FV-NI)

  - A practicability exception would permit nonmarketable equity securities to be measured at cost with adjustments for impairment and observable price changes that meet certain conditions
- Equity investments that otherwise qualify for the equity method would be accounted for at FV-NI if the investment is held for sale
- Impairment of equity method investments and nonmarketable equity securities for which the practicability exception was elected would be assessed using a single step model and qualitative impairment indicators
- Financial assets (other than equity securities) with contractual cash flows that do not consist solely of principal and interest would be accounted for at FV-NI
- Financial assets (other than equity securities) possessing certain characteristics, including contractual cash flows consisting solely of principal and interest, would be accounted for based on one of the following three accounting models depending on the business strategy used to manage those instruments:
  (a) Amortized cost (AC): Those instruments for which the strategy is to hold the assets to collect contractual cash flows
  (b) Fair value – other comprehensive income (FV-OCI): Those instruments for which the strategy is both to hold the instrument to collect the contractual cash flows and to sell the instrument
  (c) FV-NI: Those instruments not covered by the business strategies that would result in the application of the FV-OCI and AC accounting models
- Reclassifications between the three preceding categories would occur only when the business model changes (which should be very infrequent) and when certain conditions are met
- A single lifetime expected loss model would replace multiple existing models for measuring credit impairment of debt securities as well as loan, trade, reinsurance and lease receivables, regardless of whether the instruments are originated or acquired
- The lifetime expected loss model will likely result in significantly higher allowances for credit losses on certain longer term assets such as loans
- Financial liabilities would be accounted for at AC unless the liability is a short sale or the business strategy at acquisition, inception or issuance is to subsequently transact at fair value, in which case the financial liability would be accounted for at FV-NI
- Availability of a fair value option would be limited to certain hybrid financial liabilities and groups of financial assets and liabilities that meet certain conditions, such as the group being managed on a net exposure basis
- Significant new requirements would apply to the financial statement presentation and disclosure of financial instruments
- Hedge accounting is subject to redeliberations

Revenue recognition

Eye-opener: Most industry-specific revenue recognition guidance would be replaced.

Why are they doing this? To clarify the principles for recognizing revenue and develop a common revenue standard that would replace almost all existing revenue recognition guidance.

Key concepts:

- Scope would include contracts with customers except those for which other authoritative guidance will remain (e.g., financial instruments, certain guarantees, insurance, leases)
- Contracts would be combined under certain circumstances if they are entered into at or near the same time
- A performance obligation would be defined as a promise in a contract to transfer a good or a service to a customer
- Performance obligations would be accounted for separately if the underlying good or service is capable of being distinct and is distinct within the context of the contract
- A transaction price would be the amount of consideration an entity expects to be entitled to, which would include estimated variable consideration subject to a constraint, but exclude any adjustment for expected credit losses
- Any impairment from expected credit losses (i.e., bad debt), whether at contract inception or later, would be presented in the income statement as a separately stated line item within operating expenses, if material
- If a contract has multiple performance obligations, the transaction price would generally be allocated to each separate performance obligation based on their standalone selling prices in relation to one another
- A residual technique could be used to estimate the standalone selling price of a separate performance obligation in certain cases
- Revenue would be recognized as the separate performance obligations are satisfied (e.g., at a single point in time or over time), based on transfer of control of the underlying goods or services
- Revenue would generally be recognized at the amount allocated to each separate performance obligation

- The incremental costs of obtaining a contract (e.g., sales commissions) that are expected to be recovered would generally be recognized as an asset (subject to amortization and impairment) as would fulfillment costs (e.g., set-up costs) that meet certain conditions

Consolidation

Eye-opener: The consolidation models for variable interest and voting interest entities would be more closely aligned.

Why are they doing this? To consider comprehensive guidance for consolidation of all entities, including entities controlled by voting or similar interests, as well as to provide comprehensive guidance that would be used to: (a) assess whether an entity is an investment company and (b) measure an investment company's investments. To facilitate achievement of these objectives, this project has been separated into two projects covering consolidation policy and procedures and investment companies.

Key concepts:

- A separate qualitative analysis would determine if a decision maker for certain types of entities is acting in the capacity of an agent (in which case it would not consolidate the other entity) or a principal (in which case it would consolidate the other entity) and a number of factors would be considered in that analysis, including: (a) whether substantive kick-out rights can be exercised by a relatively concentrated group of other parties, (b) whether the compensation of the decision maker is commensurate with the level of service and (c) the extent of other interests held by the decision maker
- An entity regulated as an investment company under the SEC's Investment Company Act of 1940 (the 1940 act) would be an investment company for accounting purposes and would not be required to assess whether it: (a) meets the required criteria or (b) possesses the typical characteristics of an investment company
- An entity not regulated under the 1940 Act would have to meet certain criteria focused on the fundamental nature of its business and also possess at least some of the typical characteristics of an investment company (e.g., fair value management of investments) to be considered an investment company; however, justification of how the entity's activities are consistent with those of an investment company would be required in the absence of one or more typical characteristics
- Investment companies would continue to account for controlling financial interests in other investment companies using the guidance in Subtopic 946-810, "Financial Services—Investment Companies – Consolidation," of the FASB's Accounting Standards Codification
- Real estate investment trusts would be excluded from the scope of investment company guidance
- The specialized accounting applicable to an investment company would be retained by the investment company's parent even if the parent is not an investment company itself
- Disclosures about an investment company's investment in another investment company and significant investments held by an investee fund would be required

The discussion herein is based on information available as of January 15, 2013. Refer to www.fasb.org for the current status of the FASB's projects.

800.274.3978
www.mcgladrey.com

McGladrey