

Insights

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Accounting

Goodwill Impairment Application Issues

Both auditors and preparers of financial statements are dealing with a number of very judgmental issues involving fair value and asset impairments in the current environment. The Accounting Standards Group of McGladrey & Pullen's National Office of Audit and Accounting has issued a white paper, *Goodwill Impairment Application Issues*, which addresses certain specific application issues that may arise when evaluating goodwill for impairment under FASB Statement No. 142, Goodwill and Other Intangible Assets:

- Valuation of a reporting unit;
- Valuation of debt for purposes of Steps 1 and 2 of Statement No. 142; and
- Deferred tax issues related to Statement No. 142.

The white paper is available on our Web site at http://mcgladrey.com/Resource_Center/goodwill%20impairment%20application%20issues.pdf.

Discussion Paper on Lease Accounting

Both International Financial Reporting Standards (IFRS) and U.S. generally accepted accounting principles fundamentally split leases into two categories: "capital leases" ("finance leases" under IFRS) and "operating leases". Only the assets and liabilities arising from capital leases are recognized on the balance sheet. For an operating lease, the lessee simply recognizes lease payments as an expense over the lease term. The different accounting treatment of capital and operating leases has given rise to various issues, such as:

- Many users of financial statements believe that all lease contracts give rise to assets and liabilities that should be recognized in the financial statements of lessees, and therefore, these users routinely adjust the recognized amounts in the balance sheet in an attempt to assess the effect of the assets and liabilities resulting from operating lease contracts.
- The split between capital leases and operating leases can result in similar transactions being accounted for very differently, reducing comparability of financial statements.
- The difference in the accounting treatment of capital leases and operating leases provides opportunities to structure transactions so as to achieve a particular lease classification.

In response to these concerns, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have published a joint discussion paper, *Leases: Preliminary Views*. In the discussion paper, the IASB and the FASB discuss a possible new approach to lease accounting aimed at ensuring that leases are accounted for consistently across sectors and industries. The discussion paper deals mainly with lessee

accounting and reporting; however, it also describes some of the issues that will need to be addressed in a future proposed standard on lessor accounting.

In the discussion paper, the Boards propose that lease accounting should be based on the principle that all leases give rise to liabilities for future rental payments and assets (the right to use the leased asset) that should be recognized in an entity's balance sheet. The Boards tentatively decided not to separately recognize the components of a lease contract (such as options to renew, purchase options, contingent rental arrangements or residual value guarantees). Instead, the lessee would recognize (a) a single right-of-use asset that includes rights acquired under options and (b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees. The Boards tentatively decided that the lessee's obligation to pay rentals should be measured initially at the present value of the lease payments discounted using the lessee's incremental borrowing rate, with subsequent measurement on an amortized cost basis. The Boards also tentatively decided that the lessee's right-of-use asset should be measured initially at cost (the present value of the lease payments discounted using the lessee's incremental borrowing rate). The lessee would then amortize the right-of-use asset over the shorter of the lease term and the economic life of the leased item.

The discussion paper is available for comment until July 17, 2009 at http://www.fasb.org/draft/DP_Leases.pdf.

FASB and IASB Discuss Responses to Issues Emanating from Financial Crisis

On March 23 and 24, 2009, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) met to discuss common responses to financial reporting issues emanating from the global financial crisis, while seeking convergence between International Financial Reporting Standards and U.S. generally accepted accounting principles. The two boards agreed to work jointly and expeditiously on a series of initiatives in areas such as off-balance sheet activity, the accounting for financial instruments, and loan loss accounting.

Specifically, the boards will work together toward common standards by developing the IASB projects on consolidation and derecognition as joint projects after the FASB has completed its short-term amendments to its existing standards. Also, the boards have agreed to issue proposals within months to replace their respective financial instruments standards with a common standard that significantly improves financial reporting and leads to a less-complex approach. As part of this project the boards will examine loan loss accounting, including the incurred and expected loss models. Further, the boards discussed projects on financial statement presentation, fair value measurement, financial instruments with the characteristics of equity, and the conceptual framework.

FASB Codification Proposed to Be Only Authoritative GAAP

Currently, FASB Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, identifies and arranges in a hierarchy the sources of accounting principles and the framework for selecting the principles used in preparing the financial statements of nongovernmental entities that are presented in conformity with U.S. generally accepted accounting principles (GAAP). In January, 2008, the Financial Accounting Standards Board (FASB) released for verification the *FASB Accounting Standards Codification*TM, which reorganizes thousands of U.S. GAAP pronouncements into approximately 90 accounting topics and displays all topics using a consistent structure. In a recent Exposure Draft, *The Hierarchy of Generally Accepted Accounting Principles- a replacement of FASB Statement No. 162*, the FASB proposed that the Codification be approved as the single source of authoritative nongovernmental GAAP.

Per the proposal, the FASB would no longer consider standards issued on or after July 1, 2009, as authoritative in their own right. Instead, new standards would serve only to update the Codification, provide background information about the guidance, and provide the bases for conclusions on the changes in the Codification. The proposed Statement would replace Statement No. 162 and establish only two levels of GAAP: authoritative and nonauthoritative. This would be accomplished by authorizing the FASB Accounting Standards Codification to become the single source of authoritative U.S. accounting and reporting standards to be applied by nongovernmental entities,

except for rules and interpretive releases of the SEC under authority of federal securities laws, which are sources of authoritative GAAP for SEC registrants. All other nongrandfathered, non-SEC accounting literature not included in the Codification would become nonauthoritative. Sources of nonauthoritative accounting guidance and literature include, for example, practices that are widely recognized and prevalent either generally or in the industry, FASB Concepts Statements, American Institute of Certified Public Accountants (AICPA) Issues Papers, International Financial Reporting Standards, pronouncements of other professional associations or regulatory agencies, Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids, and accounting textbooks and articles. Grandfathered guidance consists of two general types. The first is where an entity has followed and continues to follow an accounting treatment that was previously in category (c) or category (d), as described in Statement No. 162, if the effective date of that guidance was before March 15, 1992. The second is superseded accounting standards that have allowed for the continued application of that guidance for transactions that have an ongoing effect on the entity's financial statements.

The FASB believes the Codification retains existing GAAP without changes, except that the FASB decided to include paragraphs 38 through 76 of AICPA Technical Inquiry Service (TIS) Section 5100, Revenue Recognition, in the Codification, which may result in an accounting change for nonpublic entities that had not previously applied this guidance. Those TIS paragraphs address various accounting issues related to computer software revenue recognition. Affected nonpublic entities would be required to apply the guidance prospectively for revenue arrangements entered into or materially modified in annual periods beginning on or after December 15, 2009, and interim periods within those years.

The effective date for the proposed Statement would be July 1, 2009, except as described in the preceding paragraph. The proposed Statement is available for comment until May 8, 2009 at http://www.fasb.org/draft/ed_amendment_fas162.pdf.

Financial statement preparers and auditors are encouraged to familiarize themselves with the Codification. Users who register at <http://asc.fasb.org/register> are able to review the Codification free of charge. The FASB has recorded a webcast that discusses and demonstrates the use of the Codification. The one-hour webcast, *The Move to Codification of U.S. GAAP*, is archived for free access by the public. Click here to register for the archived webcast.

International

Accounting for Embedded Derivatives when Reclassifying Financial Instruments

In October, 2008 the International Accounting Standards Board (IASB) issued an amendment to International Accounting Standard 39, *Financial Instruments: Recognition and Measurement*, and International Financial Reporting Standard 7, *Financial Instruments: Disclosures*, to permit the reclassification of some financial instruments. Among other provisions, that amendment, *Reclassification of Financial Assets*, permitted an entity to reclassify non-derivative financial assets (other than those designated at fair value through profit or loss by the entity upon initial recognition) out of the fair value through profit or loss category in particular circumstances. Following the issuance of *Reclassification of Financial Assets*, there has been diversity in practice stemming from the interaction between the reclassification amendment and IFRIC 9, *Reassessment of Embedded Derivatives*, regarding the assessment of embedded derivatives.

In a recent pronouncement, *Embedded Derivatives: Amendments to IFRIC 9 and IAS 39*, the IASB clarified the accounting treatment of embedded derivatives for entities that make use of the reclassification amendment issued in October 2008. *Embedded Derivatives* clarifies that on reclassification of a financial asset out of the fair value through profit or loss category, all embedded derivatives must be assessed as to whether they are required to be separated from the host contract and accounted for as a derivative. If an entity is unable to measure separately the embedded

derivative that would have to be separated on reclassification of a hybrid (combined) contract out of the fair value through profit or loss category, that reclassification is prohibited. In such circumstances the hybrid (combined) contract remains classified as at fair value through profit or loss in its entirety. The amendments set out in Embedded Derivatives apply retrospectively and are required to be applied for annual periods ending on or after June 30, 2009.

Discussion Paper on Lease Accounting

The International Accounting Standards Board and the Financial Accounting Standards Board have published a joint discussion paper, *Leases: Preliminary Views*, which discusses a possible new approach to lease accounting aimed at ensuring that leases are accounted for consistently across sectors and industries. For further information about this discussion paper, please see a related article, "Discussion Paper on Lease Accounting" in the Accounting section above. The discussion paper is available for comment until July 17, 2009 at <http://www.iasb.org/NR/rdonlyres/FF3A33DB-E40D-4125-9ABD-9AF51EB92627/0/DPLLeasesPreliminaryViews.pdf>.

IASB Proposes New Standard on Income Tax Accounting

The application of existing income tax accounting requirements to different jurisdictions can be difficult, resulting in complex and potentially diverse interpretations. To achieve a clearer, more principle-based standard that will make income tax accounting requirements easier to apply and will result in more consistent reporting, the International Accounting Standards Board (IASB) recently published an Exposure Draft of a proposed new standard on the accounting for income taxes. If adopted, the Standard would replace the existing requirements in International Accounting Standard (IAS) 12, *Income Taxes*.

The proposed Standard retains the basic approach to accounting for income taxes, known as the temporary difference approach. The objective of that approach is to recognize now the future tax consequences of past events and transactions, rather than waiting until the tax is payable or recoverable. Although the proposed standard retains the same principle, the IASB proposes to remove most of the exceptions in IAS 12 to simplify the accounting and strengthen the principle in the Standard. In addition, the draft IFRS includes proposals on the treatment of uncertain tax amounts. For example, existing IAS 12 is silent on how to account for uncertainty over whether the tax authority will accept the amounts reported to it. The Exposure Draft proposes that current and deferred tax assets and liabilities should be measured at the probability-weighted average of all possible outcomes, assuming that the tax authority examines the amounts reported to it by the entity and has full knowledge of all relevant information. Further, the IASB proposes a changed structure for the Standard that will make it easier to use.

The Exposure Draft, *Income Tax*, is open for comment until July 31, 2009 at <http://www.iasb.org/NR/rdonlyres/8A6D0AC9-B6BE-4B87-BD02-B058B5F12148/0/EDIncomeTaxesStandard.pdf>.

IASB Proposes Amendments to Derecognition Requirements

"Derecognition" happens when an entity removes a financial instrument from its financial statements because it no longer controls a financial asset or no longer has an obligation to settle a financial liability. As part of the International Accounting Standards Board's (IASB) comprehensive review of off-balance sheet activities, it recently published an Exposure Draft of proposals to improve the derecognition requirements for financial instruments. If finalized, the proposed amendments would revise the approach to derecognition of financial liabilities in International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*, to be more consistent with the definition of a liability in the IASB Framework. The proposed amendments are similar to the current approach in IAS 39, except that the proposed approach would differ in that it does not combine elements of several derecognition concepts, but rather focuses on a single element - control. As a result, unlike IAS 39, the proposed approach does not have:

- A test to evaluate the extent of risks and rewards retained;
- Specific pass-through requirements; or

- A requirement for a transferor (in a transfer that fails derecognition) to recognize and measure a financial asset to the extent of its continuing involvement.

Further, if finalized, the Exposure Draft would amend International Financial Reporting Standard 7, *Financial Instruments: Disclosures*, to enhance disclosure requirements, especially in situations where an entity continues to have an ongoing involvement in a financial asset that would be derecognized under the proposals. The additional disclosures would allow users to make a better assessment of the risks associated with such an asset.

The Exposure Draft, Derecognition, is available for comment until July 31, 2009 at http://www.iasb.org/NR/rdonlyres/74354283-FBBE-4B0D-9D45-FFB88BFE313B/0/ED_Derecognition0309.pdf.

Revenue Recognition: IFRS vs. U.S. GAAP

This article is the sixteenth in a series of articles that takes our readers on a journey through International Financial Reporting Standards (IFRS) with a special focus on the standards' quintessential feature: they are principles-based. In this article, we provide an overview of some of the most significant differences between IFRS and U.S. generally accepted accounting principles (GAAP) with regard to revenue recognition. Actual differences in the accounting treatment between the two frameworks depend on specific circumstances.

Revenue recognition is an area where it is particularly difficult to compare IFRS and U.S. GAAP. International Accounting Standard (IAS) 18, *Revenue*, and IAS 11, *Construction Contracts*, are the IFRS standards dealing with revenue recognition, but IFRS authoritative literature also includes a few specific Interpretations on this topic: SIC 31, *Revenue – Barter Transactions Involving Advertising Services*, IFRIC 13, *Customer Loyalty Programmes*, and IFRIC 15, *Agreements for the Construction of Real Estate*. U.S. GAAP includes hundreds of relevant sources for guidance on revenue recognition. SEC Staff Accounting Bulletin No. 104, *Revenue Recognition*, provides comprehensive guidance in this area for publicly traded companies.

Under IAS 18, revenues are measured at the fair value of the consideration received or receivable, and are recognized when all of a series of criteria are met. Clearly these criteria are principle-based and do not include bright lines, like numerical thresholds. IAS 18 thus is commonly considered to be a bit underdeveloped, and therefore when applying IFRS revenue recognition principles, it is often helpful to refer to U.S. GAAP for further guidance, particularly in cases where no significant industry guidance is available.

U.S. GAAP revenue recognition literature is built on principles that are similar to those in IFRS. However, U.S. GAAP has industry-specific revenue recognition literature, such as that for the software industry, which is very limited under IFRS. U.S. GAAP also includes more detailed implementation guidance. For example:

- U.S. GAAP focuses on the “persuasive evidence that an arrangement exists”, which could, in certain circumstances, lead to the recognition of revenue only when written sales agreements customarily are signed by customers. IFRS does not include similar prescriptive guidance.
- Emerging Issues Task Force (EITF) Issue No. 00-10, “Accounting for Shipping and Handling Fees and Costs”, states that all amounts billed to a customer in a sales transaction related to shipping and handling should be classified as revenue. IAS 18 does not have a similar prescriptive requirement. Instead, preparers should analyze the transaction focusing on the general principles in IAS 18 dealing with the determination of whether an entity is acting as a principal or as an agent.
- EITF Issue No. 00-21, “Revenue Arrangements with Multiple Deliverables”, contains detailed guidance on how to account for multiple-element arrangements. IAS 18 contains a similar principle, but the guidance is much more limited.

These examples highlight that the accounting treatment might be similar and possibly culminate in similar conclusions in the vast majority of circumstances. However, it is evident that it really depends on facts and circumstances of the specific transaction to be accounted for. The International Accounting Standards Board and the Financial Accounting Standards Board are conducting a joint project to rewrite their standards on revenue recognition. A related discussion paper on preliminary views has already been issued, and it is expected that a concise and highly principles-based standard on revenue recognition will result.

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