



IFRS/U.S. GAAP Convergence Update

Presented by:

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Agenda

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Presenter's Bios

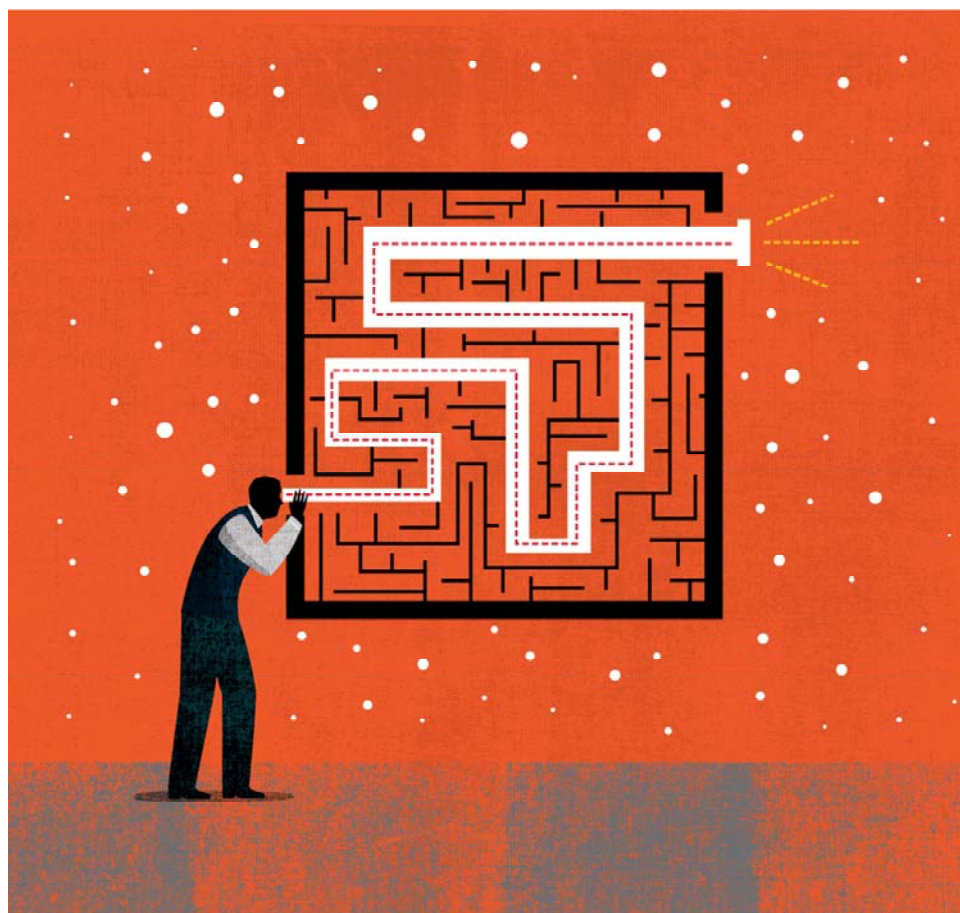
Todd Fagan, CPA, Senior Manager

- Over 17 years of experience in the areas of financial reporting, auditing and risk management
- More than 7 years of public accounting experience
- Specialization in the areas of financial reporting, SOX 404/302 compliance, internal and compliance auditing, corporate governance, risk management and internal control assessment
- Education: MBA from George Mason University and a BBA from Loyola University Maryland
- Active CPA licenses in California and Maryland
- Accredited Mortgage Professional Certification from the Mortgage Bankers Association of America
- Past training leader on firm methodology with a national CPA firm and a past adjunct faculty member

Weston Nelson, CISA, Senior Manager

- Pacific Northwest Regional Leader, Internal Audit/SOX 404 Group
- Over 13 years of external and internal audit experience
- Areas of expertise: internal audit and internal controls, SOX 404 compliance requirements, governance risk and compliance, ethics and compliance reviews, IT strategy and governance, and integrated audits
- Education: B.S., MAcc., Accounting & Information Systems, Brigham Young University

Why Consider IFRS Now?



What is IFRS?



IFRS

- International Financial Reporting Standards
- Started 30-plus years ago

Standard Setter

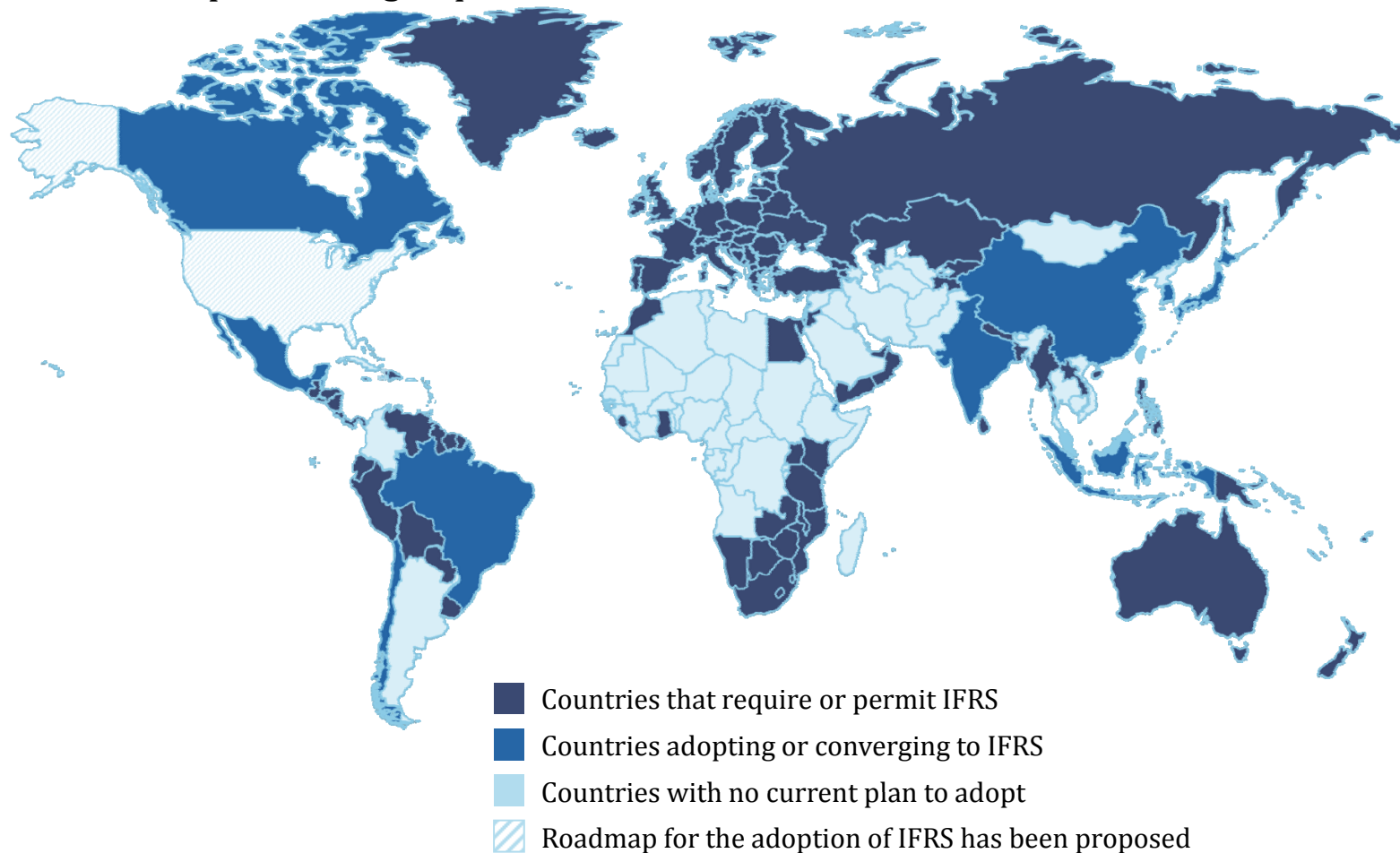
- International Accounting Standards Board (IASB) based in London

Why IFRS?

- Create a global accounting language
- Allow companies access to global capital markets
- Serve information needs of investors
- Convergence with U.S. GAAP and elimination of U.S. GAAP reconciliation requirement by Foreign Private Issuers is driving the move to IFRS acceptance in the U.S.
- Reduce costs to multi-national organizations

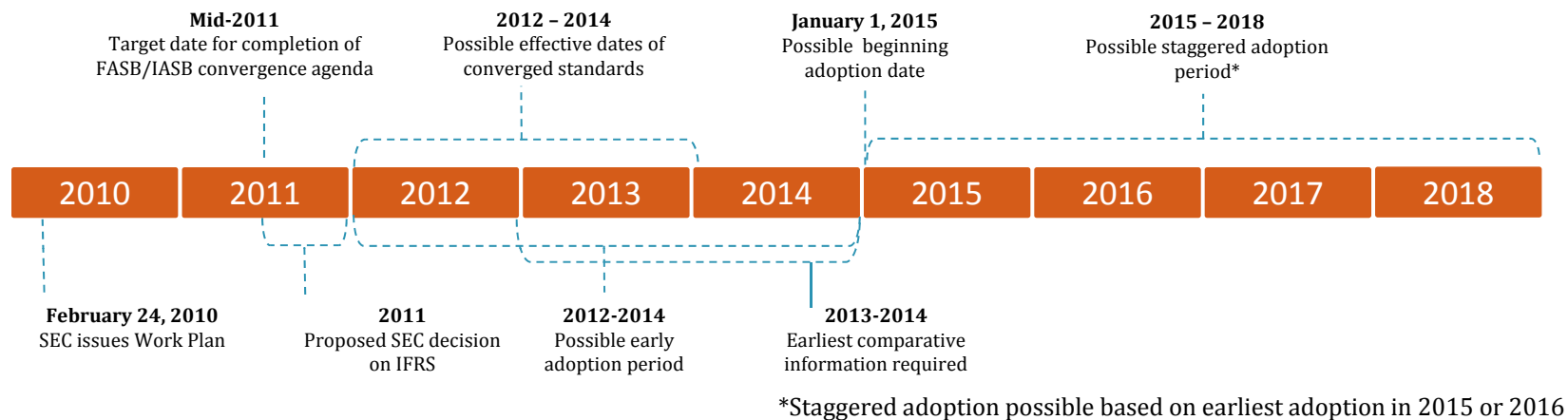
The World has Chosen IFRS

More than 100 countries require or permit the use of IFRS, or are converging to IFRS for public filing requirements



Probable Timeline Based on the SEC Statement

Assuming that the SEC determines in 2011 to incorporate IFRS into the U.S. domestic reporting system, a possible timeline may be:

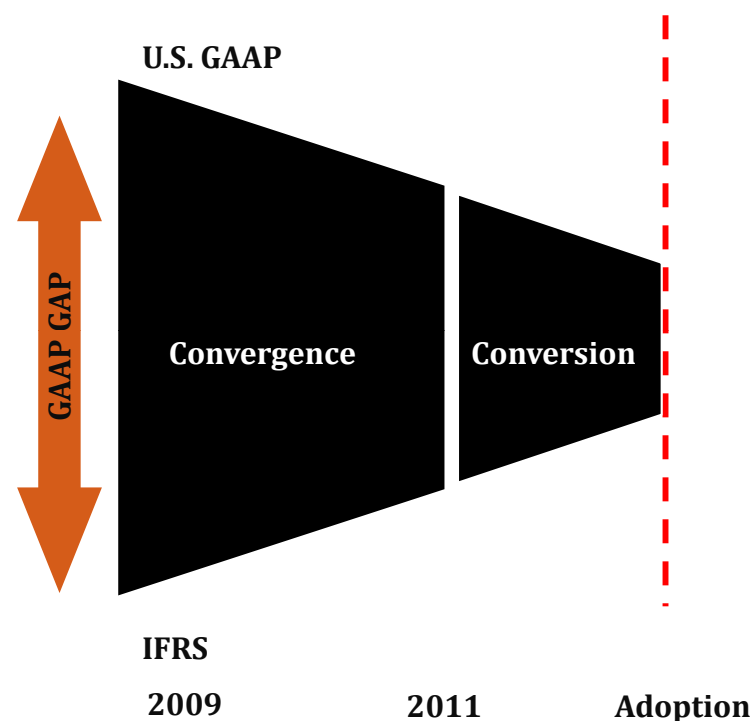


SEC IFRS Work Plan Goals:

- Position the SEC in 2011 to make a determination regarding further incorporation of IFRS into the financial reporting system for U.S. issuers
- Analyze the nature of the appropriate ongoing role of the Financial Accounting Standards Board (FASB) should IFRS be incorporated into the U.S. financial reporting system
- Determine the scope and timeline of a change to IFRS
- Provide adequate time for an orderly and high quality changeover
- Consider optional use of IFRS, including the possibility of allowing early adoption
- The SEC made no reference to the number of required comparative periods, thus the existing two year comparative requirement seems not to be subject to debate
- “Condorsement” idea of reviewing new IASB standards and determining their applicability to the U.S. (12/2010)

IFRS and U.S. GAAP – Convergence and Conversion

The U.S. path to IFRS will likely be one of convergence, ultimately followed by conversion:



- The planned convergence of U.S. GAAP and IFRS will result in a significant number of new U.S. GAAP standards between now and 2014 which will be significantly influenced by IFRS
- Outside the U.S. a growing number of countries will require or permit IFRS or an IFRS equivalent for statutory reporting
- Even after completion of the convergence project between the IASB and the FASB, many differences will remain
- The challenge for U.S. companies is to manage overseas conversions, address convergence changes and anticipate the implications of final conversion changes for those areas that will not fully converge

| Estimated Publication Years of Converging Certain IASB/FASB Standards: | | |
|---|--|--|
| <u>2010</u> Discontinued Operations Consolidation Fair Value Financial Instruments – Classification and Measurement | <u>2011</u> Leases Revenue Recognition Financial Statement Presentation Pensions Financial Instruments – Hedging and Impairment | <u>TBD</u> Income Tax EPS |



Recent IFRS/U.S. GAAP Convergence Events

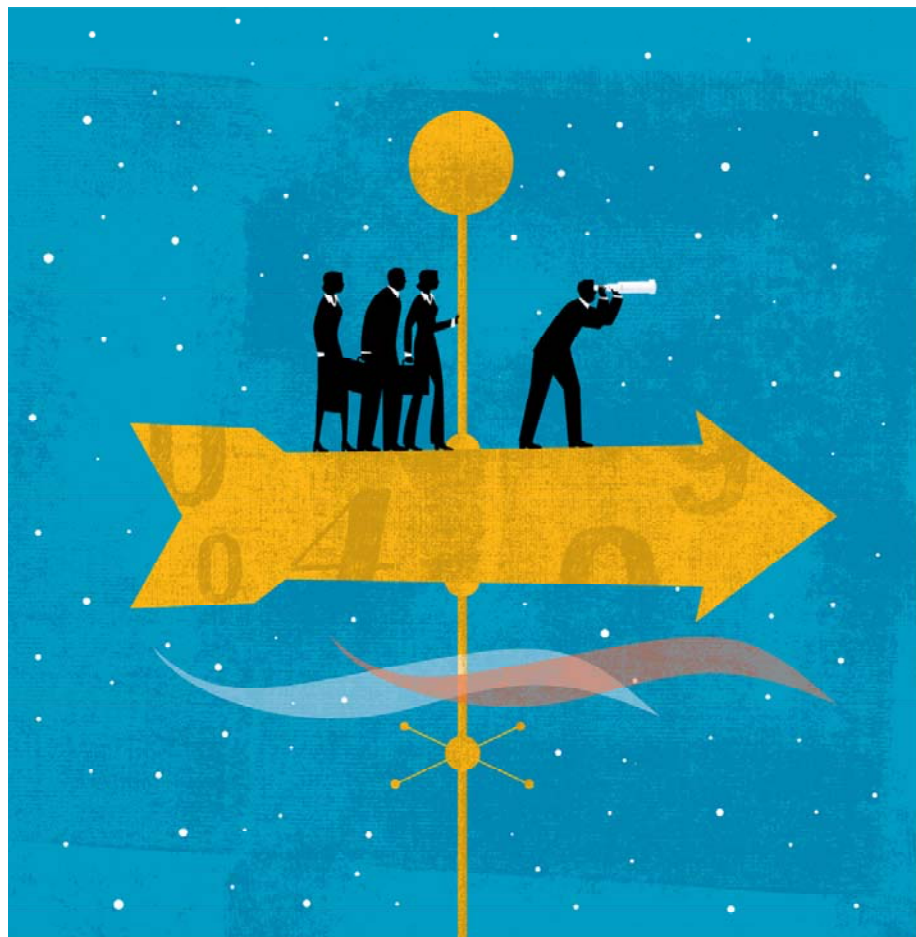
- February 2010 – SEC Work Plan announced
 - Decision will be made in 2011
 - Various desired milestones to be achieved
 - Earliest mandatory adoption would be 2015
- Spring 2010 – Private Company Blue Ribbon Committee begins meeting
- Summer 2010 – Private Company Blue Ribbon Committee requests input on 3 options:
 - Baseline GAAP for public companies with modifications for private companies
 - Baseline GAAP for private companies with public company add-ons
 - Separate stand-alone GAAP for private companies based on current GAAP



Recent IFRS/U.S. GAAP Convergence Events (cont.)

- Fall 2010 – Private Company Blue Ribbon Committee recommends:
 - Keeping existing U.S. GAAP, but modifying it for privately held companies
 - Rules to be developed by a new board (not the FASB)
- FASB Chairman, Robert H. Herz announces retirement effective October 1, 2010 – two years before his term expires

Questions?





Conceptual Framework: Joint Project of the IASB and FASB

The objective of the conceptual framework project, a joint project of the FASB and IASB, is to develop an improved common conceptual framework that provides a sound foundation for developing future accounting standards.

The Boards are conducting this joint project in eight (8) phases. Each of the first seven phases will address and involve planning, research, initial Board deliberations, public comment and redeliberations on major aspects of the Boards' frameworks. The eighth phase will be used to address any remaining issues.

Conceptual Framework: Status of Phases

The following list provides the status of each phase where work has begun*:

1. Objective and Qualitative Characteristics Completed

On September 28, 2010, the Boards completed this phase of the project and the FASB issued Concepts Statement No. 8, *Conceptual Framework for Financial Reporting*, including Chapter 1, “The Objective of General Purpose Financial Reporting”, and Chapter 3, “Qualitative Characteristics of Useful Financial Information”.

| | <u>Last Updated</u> |
|-----------------------------|---------------------|
| 2. Elements and Recognition | 3/15/2010 |
| 3. Measurement | 11/23/2010 |
| 4. Reporting Entity | 11/23/2010 |

* As of 1/10/2011 as reported by the FASB (via their website)



Description of FASB Concepts Statements

Concepts Statements are not part of the *FASB Accounting Standards Codification™*, which is the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities (Topic 105, *Generally Accepted Accounting Principles*). Rather, *Concepts Statements* describe concepts that will underlie guidance on future financial accounting practices and, in due course, will serve as a basis for evaluating existing guidance and practices.



FASB and IASB

Memorandum of Understanding (MoU)

Agreement in February 2006 between IASB and FASB:

- Set specific convergence goals
 - Accounting issues
 - Progress milestones
- Shared two main objectives
 - Improve quality of financial reporting world-wide
 - Converge IFRS and U.S. GAAP
- Agreed to concentrate efforts on the areas where both U.S. GAAP and IFRS were most in need of improvement or differed widely.

Joint Standards Projects of the IASB and FASB

| | <u>Planned Final Standard Issuance</u> |
|--|--|
| • Fair Value Measurement | Q1 2011 |
| • Statement of Comprehensive Income | Q1 2011 |
| • Balance Sheet – Offsetting | Q2 2011 |
| • Accounting for Financial Instruments | Q2 2011 |
| • Accounting for Leases | Q2 2011 |
| • Revenue Recognition | Q2 2011 |

Other joint projects like Reporting Discontinued Operations are have planned Final Standard issuance dates later than Q3 2011

Exposure drafts for each of the above proposed standards were issued in 2010



Accounting for Financial Instruments

The proposed financial instruments standard would primarily affect financial institutions. Their financial assets and liabilities would be reported at fair value in the balance sheet and their associated impairment losses would be measured in different ways than under current methods.

Financial Instrument Changes Summary

| | Current Approach | Proposed Approach |
|---|---|---|
| Number of categories and methods to measure | Many categories each with different measurement, presentation and impairment methods. | Two key categories: <ul style="list-style-type: none"> • Assets/liabilities traded or with variable cash flows, displayed at fair value with changes in net income. • Assets/liabilities held for collection/payment of principal and interest, present both cost and fair value in balance sheet with changes reported in net income and comprehensive income. |
| Measurement of losses | Different impairment rules depending on category and instrument type. Tension around probable loss thresholds for impairment. | Only instruments in held for collection/payment category are tested for impairment. No longer have to reach “probable” loss threshold before recording credit impairment. |
| Hedging activities | Complex quantitative requirements to qualify for hedge accounting. | Less rigorous qualitative assessment, allowing consistent reflection of economic impacts of hedging activities. |

Source: FASB *In Focus*, May 2010

Accounting for Financial Instruments

Financial statements would incorporate both amortized cost and fair value information about financial instruments held for collection or payment of cash flows.

How Loans and Capital Would Look on the Balance Sheet

Loans:

| | |
|-------------------------------------|-------------|
| Amortized cost | XXX |
| Allowance for credit losses | (XX) |
| <u>Residual FV adjustment</u> | <u>(XX)</u> |
| Fair Value | XXX |

Capital could be presented as follows:

| | |
|---|-------------|
| Common stock | XXX |
| Retained earnings | XXX |
| <u>AOCI, excluding fair value changes ...</u> | <u>XXX</u> |
| Equity, excluding FV changes | YYY |
| Fair value changes on <u>financial instruments</u> | <u>(XX)</u> |
| Total comprehensive equity | ZZZ |

Source: FASB *In Focus*, May 2010



Accounting for Leases – Summary of Changes

1. All leases would appear on the balance sheet, eliminating the distinction between operating and capital leases.
2. Assets and liabilities would be grossed up.
3. Lease obligations would be reevaluated at each reporting date, likely requiring substantial changes to internal controls and IT systems.
4. Leverage ratios and capital ratios would deteriorate.
5. Timing of expense recognition would accelerate and expense would be re-characterized as interest expense and amortization instead of rent.
6. Earnings before interest, taxes and depreciation (EBITDA) would be more favorable.



Accounting for Leases – Basic Elements of Proposed Standard

- Lessees would record an intangible asset for the right to use the leased item and a liability for the obligation to make lease payments under the “right-of-use model.”
- The initial lease obligation would be measured based on estimates of the lease term, contingent rentals and residual value guarantees, using the lessee’s incremental borrowing rate to discount future payments to the present value.
- Lessees would reassess these estimates at each reporting date.
- The right-of-use asset would be amortized over the shorter of its useful life or the lease term.
- Lease payments would be allocated between interest expense and a reduction of the lease obligation using the effective interest method, rather than be recognized as rent expense under the straight-line method.



Revenue Recognition

The new revenue recognition standard is expected to affect nearly all industries especially construction, technology and real estate.

- Replace the existing patch-work of various industry and transaction-specific requirements with a consistent method of accounting for revenue across all industries and transactions
- Simplify U.S. GAAP revenue recognition while beefing up IFRS requirements

The core principle of the proposed revenue recognition standard is that an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration the entity receives, or expects to receive, in exchange for those goods or services.

Expected Revenue Recognition Changes (under the new proposed standard) ^{t4}

Construction and long term contracts – Continuous revenue recognition would only occur if the customer controls the asset as it is developed or manufactured. If not considered a continuous transfer of goods, revenue is not recognized until assets are transferred to the customer, similar to a completed contract method.

Multiple element arrangements – The requirement to use available third party evidence of selling price in the absence of vendor-specific objective evidence would be eliminated. Differences also exist in the descriptions of how to estimate a stand-alone selling price and in the descriptions of different units of accounting for identifying deliverables.

Slide 23

t4

is this a redundancy here?

tanyar, 1/13/2011

Five-Step Revenue Recognition Proposal

| | |
|---|--|
| <p>Step 1: Identify the contract(s) with the customer</p> | <p>Key proposal: Price interdependence A company would account for two or more contracts together if the prices of those contracts are interdependent. Conversely, a company would account for a single contract as two or more contracts if some goods or services are priced independently of other goods or services.</p> |
| <p>Step 2: Identify the separate performance obligations</p> | <p>Key proposal: Distinct goods or services A contract includes promises to provide goods or services to a customer. Those promises are called “performance obligations.” A company would account for a performance obligation separately only if the promised good or service is distinct. A good or service is distinct if it is sold separately or if it could be sold separately because it has a distinct function and a distinct profit margin.</p> |
| <p>Step 3: Determine the transaction price</p> | <p>Key proposal: Probability-weighted expected amount The transaction price is the amount of consideration a company expects to receive from the customer in exchange for transferring goods or services. The transaction price would reflect the company’s probability-weighted estimate of variable consideration (including reasonable estimates of contingent amounts) in addition to the effects of the customer’s credit risk and the time value of money (if material).</p> |
| <p>Step 4: Allocate the transaction price to the performance obligations</p> | <p>Key proposal: Relative selling price allocation method A company would allocate the transaction price to all separate performance obligations in proportion to the stand-alone selling price (estimated if necessary) of the good or service underlying each performance obligation.</p> |
| <p>Step 5: Recognize revenue when a performance obligation is satisfied</p> | <p>Key proposal: Control A company would recognize revenue when it satisfies a performance obligation by transferring the promised good or service to the customer, which is when the customer obtains control of the promised good or service. The amount of revenue recognized is the amount allocated to that performance obligation in Step 4.</p> |

Source: FASB *In Focus*, June 2010



Financial Statement Disclosure Differences Currently between IFRS and U.S. GAAP

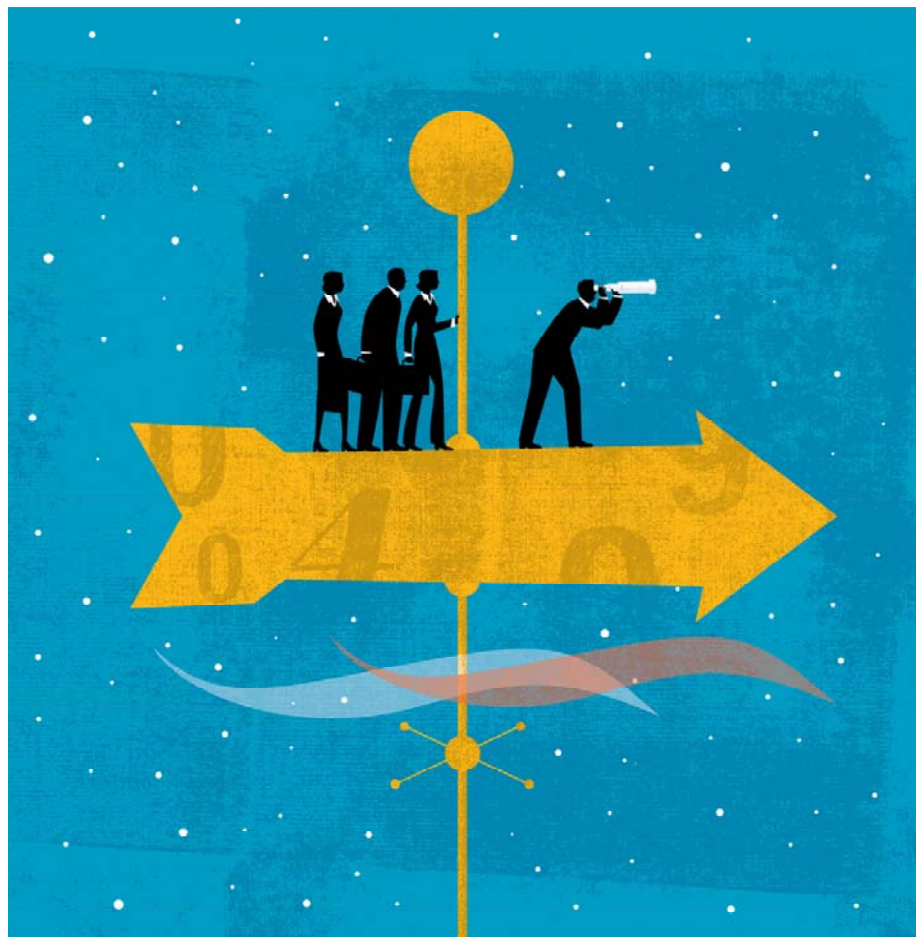
- Year of adoption
 - Requires three balance sheets (four if public)
 - 12/31/10, 12/31/09 and 1/1/09 if adopted this year
 - Two years for income statement, equity and cash flow (three if public)
 - 2010 and 2009 if adopted this year
 - Reconciliations of equity and income from U.S. GAAP to IFRS



Financial Statement Disclosure Differences Currently between IFRS and U.S. GAAP (cont.)

- Disclosures are more in-depth and take more time
 - Analysis of receivables and payables
 - Discussion of risks
 - Components of employee compensation
 - Key management compensation
- Typical financial statement “length” will nearly double due to expanded disclosures

Questions?



Planning for IFRS



Planning for IFRS

As we have seen, there are multiple dimensions to the way IFRS and accounting change might impact a company.

The most important step in planning for the impact is to move the conversation down to a level of detail where the impacts can be assessed.

Planning Steps:

- Step 1 - Component Evaluation
- Step 2 - Mapping processes to Components to show which processes are impacted
- Step 3 - Aligning the process to systems, and so showing which systems are impacted
- Step 4 - Mapping the existing systems change projects, to show how these projects and the existing IT roadmap could be impacted

Understanding the different components, processes and systems will help the team make better decisions around which new developments or projects will have the biggest impact. This will allow teams to adjust existing plans to account for IFRS during development rather than redesigning after the projects are completed.

One important point is that we would not envision an IT project called IFRS. It is more likely there will be projects called Changing the Revenue Recognition Process or Changing the Asset Management Life Cycle.

Planning for IFRS – The Impacts

Changing numbers

Addition of another GAAP and/or change in primary GAAP – accounting policies determination; chart of accounts review, opening balance sheet, comparative financial statements, quarterly financial statements

Changing people: a new business language

Communication

- Internal
- External

Training

- At different levels
- Not only Finance people

Changing processes

Existing processes to be revised:

- Not adequate with volume (e.g. leasing, share-based payments)
- As an alternative to system change (?? need to update)

New processes created

Budgeting & forecasting

Internal controls revisited

Changing systems

Data availability and system requirements – Data Stewardship

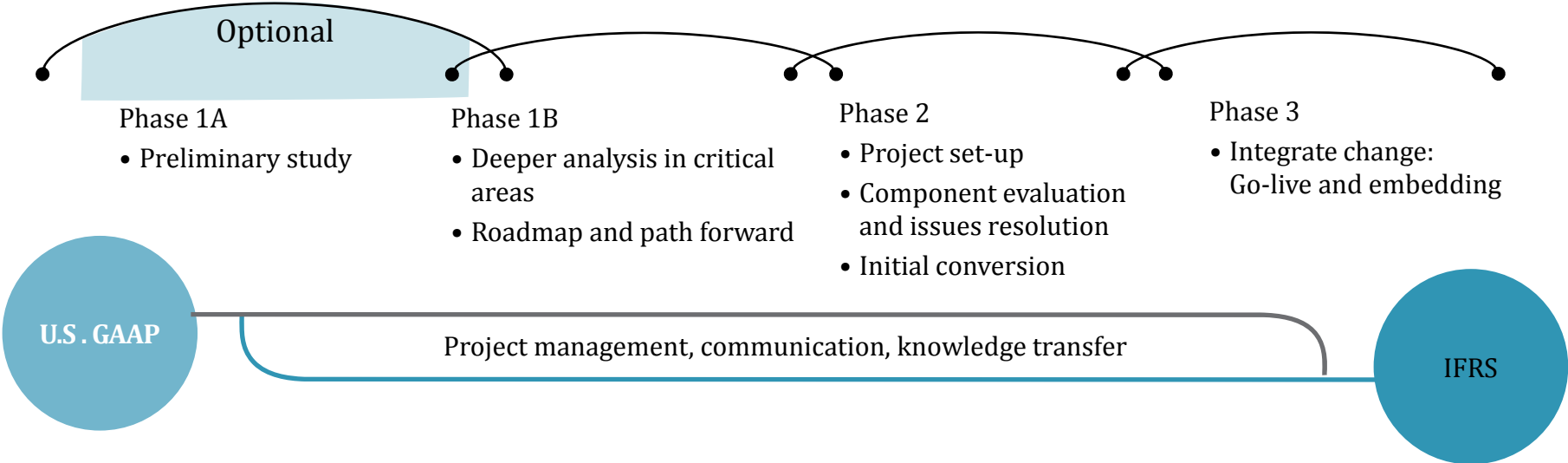
- Lease Administration system
- Valuation/calculation software
- Financial Reporting systems

Changing business

Changes to be embedded across:

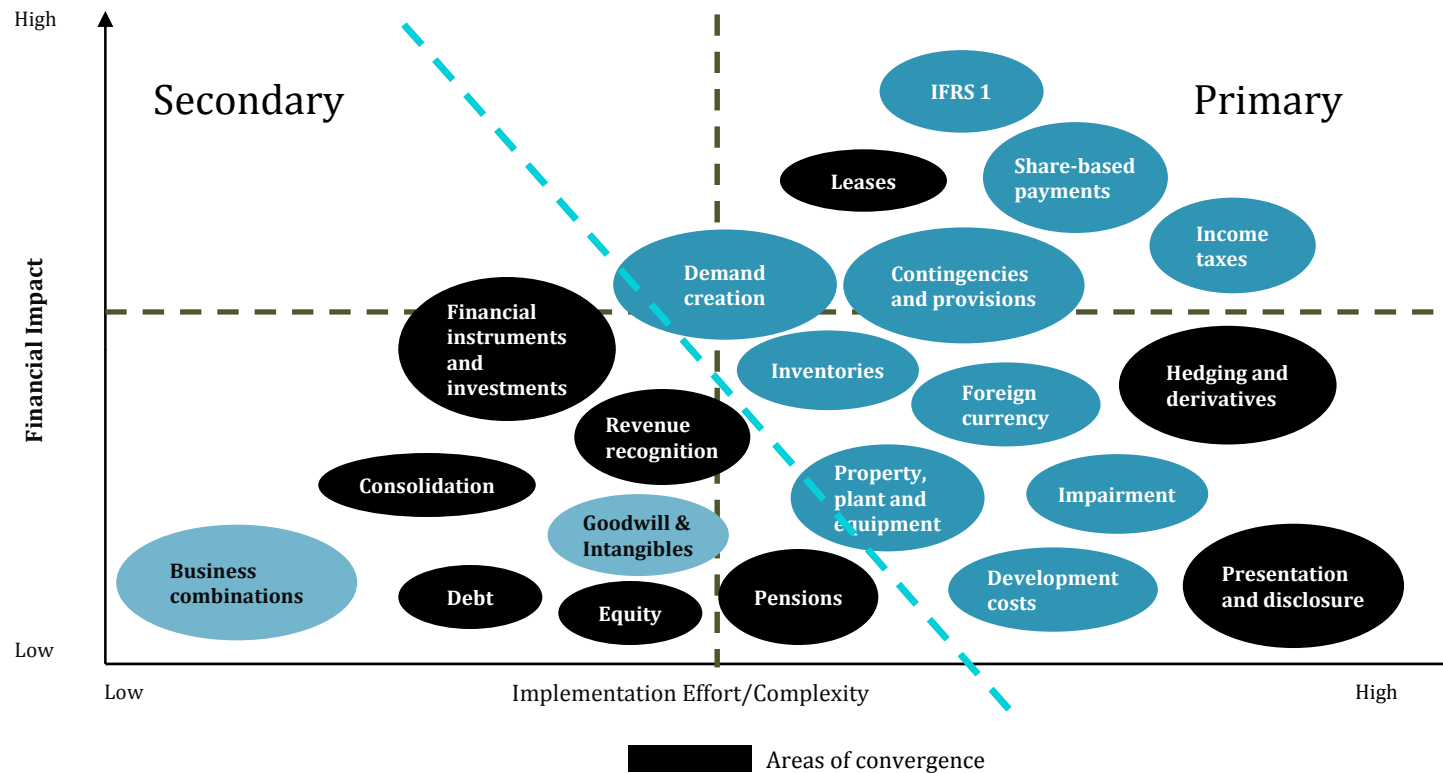
- Divisions
- Departments
- Product lines
- Geographic locations

Example Conversion Approach



- The objective of Phase 1A is to provide sufficient information to make informed decisions about how to proceed with addressing the impact of these changes on its business
- Specifically, looking to identify differences between current accounting practice, IFRS requirements, and areas of U.S. GAAP converging towards IFRS over the next several years, with a focus on determining the following in each selected area:
 - Key accounting, disclosures and financial reporting impacts from convergence with and/or conversion to IFRS
 - Broader impacts of convergence and IFRS adoption on the organization including impacts on systems, processes, tax, structuring of long-term contracts and statutory reporting
 - Inter-relationship with and impacts on other business initiatives

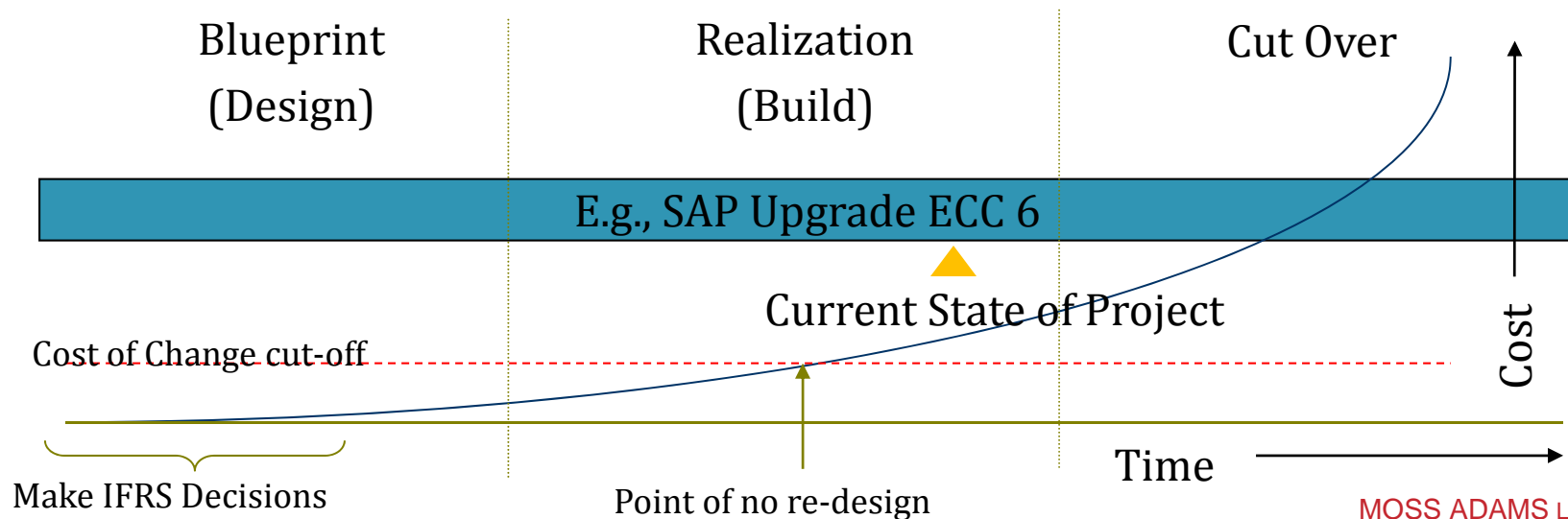
Scoping – Selected Components



- Detailed assessment of each component will be performed in those areas on the right hand side of the above chart, leveraging deep technical specialists as required (primary)
- A higher level assessment will be performed for all other areas (secondary)

In-Flight SAP Projects / Transformation Initiatives and IFRS

- Where an organization has an in-flight major technology program, the decision must be made as to whether the IFRS requirements can be established in time to be incorporated into the Blueprint.
- The run rates of major ERP projects can run into hundreds of thousands of dollars per day, delaying projects to wait for the IFRS requirements, may not be affordable. Trying to incorporate them too late into the design could put the entire project at risk.
- The IFRS decisions made will change the requirements that form the basis of the systems design when planned up front; however, some projects are past the point of redesign and are no longer feasible to make adjustments without delaying the project





Internal Audit's Role with Convergence

1. Project Manager – Public or private, there are financial reporting changes coming for virtually all entities. The entities ability to properly plan and execute needed changes in a manner that does not cause significant issues for the operations of the entity is key.
2. Navigator – Many of these proposed rule changes and their timing are not definite and will continue to change. An entity needs to know how the new standards will affect them and the latest updates on how they will be impacted. They need to where to spend the money and time.



Internal Audit's Role with Convergence (cont.)

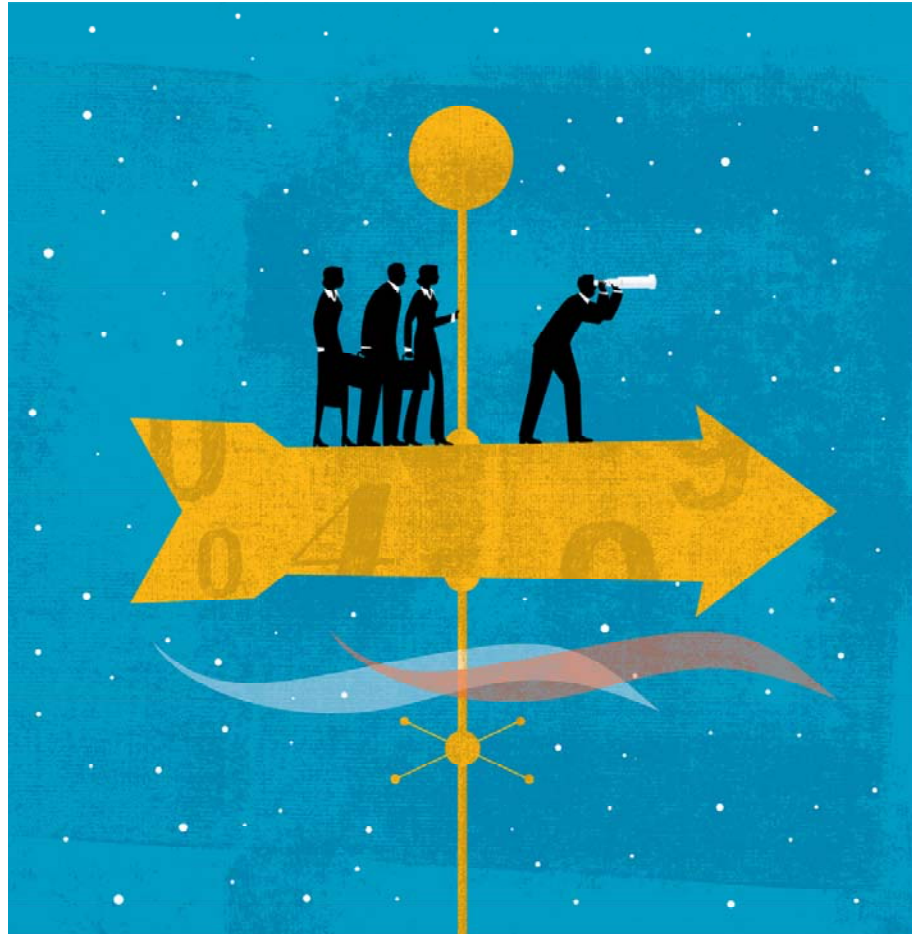
3. Educator – Even if IFRS adoption never fully occurs, many of the convergence efforts related to the MoUs will most likely become effective in the next four to five years. These standards can be somewhat complex and require substantial changes to operations, information technology and the financial reporting functions of an entity.
4. Post Implementation Auditor – An organization needs to know how effective they were in implementing the new standards and how they affect the organization as a whole.



Closing Thoughts

- The convergence efforts that have generated the joint exposure drafts by both the FASB and IASB are likely to become effective in the next five years.
- Full adoption of the IFRS is unlikely in the next eight years based on the current progress and statements made in December 2010 by the SEC.
- When possible, Internal Audit should not perform the implementation activities as this may cause a loss of objectivity when performing audits.
- Look for the FASB's final Revenue Recognition joint stand to be issued this Spring/Summer – it is likely to affect most entities.

Discussion and Questions



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Expanded Timeline (from AICPA publication)

