Emerging Issues in Financial Reporting – What’s Next and How to Cope?

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Emerging Issues in Financial Reporting – What’s Next and How to Cope?

- Convergence to Collaboration
  - Updates/ Current Status
    - International Convergence / IFRS – Convergence Plateau
    - Convergence Success – Revenue
    - New Standards – Financial Instruments / Leases

- Fair Value

- Performance Reporting

  *Overall Implications for students, faculty, practitioners.*

**Questions**

*(Disclaimer)*
Accounting Convergence – All Consuming

- Working under the “Norwalk Agreement” and Memo-of-Understanding, the FASB and IASB have made a lot of progress in converging to a closely aligned set of **high quality standards**...

- Convergence refers to the development of a closely comparable set of high quality accounting standards for use in financial statements of companies listed in several international markets.

- High quality means:
  - Comprehensive, can be applied to a broad range of transactions,
  - Conceptually sound with few alternatives… easily implemented,
  - Transparency – full disclosure, understandable.

*Note – This is not about getting to a single standard for convergence sake, but to develop converged standards that are improvements on both GAAPs.*
Status Report – Adoption: Are we there yet?

- U.S. (a major world market) is not yet on board... at one time, there was much momentum to adopt IFRS...
- Nearly 120 countries have adopted some form of IFRS and all traded companies in the EU (since 2005) must use IFRS.
- SEC FPI Reconciliation went away after March 2008 (currently affects ~ 140 SEC registrants)
- 2008 SEC Roadmap, follow-up Policy Statement (2010), and speeches in in late 2011, 2012, and 2014 affirm support for a narrowing differences among international GAAPs with consideration of achieving certain milestones.

Thus, not too long ago, many believed that the U.S. was on track to adopt IFRS in the U.S. in the not-to-distant future.

Maybe not so fast, based on recent developments...
SEC Position on Adoption of IFRS

- Staff Work Plan (2010) -- Conduct several studies to determine if we are ready (protecting investors).
- Staff provided the final report on its workplan analysis (July 2012):
  http://www.sec.gov/spotlight/globalaccountingstandards/ifrs-work-plan-final-report.pdf ... key insights reflect concerns about:
  - Uneven application of IFRS around the world.
  - Uneven auditing and enforcement of IFRS around the world.
  - Funding and independence of the IASB as the international standard-setter.
  - Cost of adoption IFRS for regulation (IRS, & And we need to ensure that investors and other who uses financial statements (IRS, other regulators) are ready to use IFRS statements.
Bottom Line -- recent speeches suggest that (required) adoption is off the table. The SEC staff has sketched out a path from Convergence to an Incorporation model.

- Encourage IASB and FASB continue to work to converge to high quality standards (Big 3 – discussed below).
- SEC might develop a process for incorporation of IFRS in U.S. GAAP over the next several years. FASB will provide input to the IASB and evaluate IFRS for incorporation into U.S. GAAP.
- As the FASB/IASB bilateral efforts are winding down, the FASB and other National standard-setters are collaborating to find a multilateral approach to providing input to the IASB (ASAF and other forums) – still with the goal of limiting differences in IFRS and GAAP.
- ... Convergence to Collaboration with real concerns about staying Converged.

- SEC Chief Accountant has rejected optional adoption of IFRS but has floated the idea of optional IFRS pro-forma disclosures.
Summary -- Convergence Timeline

IFRS

U.S. GAAP

Accounting Domain

Converged
High Quality Standards

Today

- Auditing, Interpretation, Enforcement
- Standard-setting Structure & Governance
- Investor / Regulatory readiness.

Reconcile

~2017-18
(Multilateral Collaboration)

"Infrastructure" Domain
Convergence to Collaboration

- Implications for Accounting Professionals -- Even if SEC does not adopt IFRS, we are still operating in a global environment in which both GAAP and IFRS are being used.
  - Companies have IFRS/GAAP subs
  - Company may be an subsidiary of an IFRS/GAAP parent.
  - Some private companies may wish to adopt IFRS (less costly SME standard). Some may like the GAAP PCC alternatives better.

- All professionals need to be “bilingual”
  - Standards already converged.
  - IFRS provisions that currently do not “exist” in U.S. GAAP.

On the horizon … the way forward on collaboration.
Standards Already Converged

- The FASB and IASB have made a lot of progress in converging to high quality standards.

- Share-Based Payments (FAS 123R, IAS 2); Accounting Changes (FAS 154); Exchanges on Non-Monetary Assets (FAS 153); Business Combinations (FAS 141R, IFRS 3); Comprehensive Income – Only 2 options for presentation.

- Fair Value (IFRS 13, FAS 157) -- In May 2011, the IASB issued a fair value standard that is now converged with U.S. GAAP (FASB did some minor amendments to its standard at the same time.)

- Revenue (FASB ASC 606, IFRS 15) – A big accomplishment.

- Thus, we already have a lot of alignment between IFRS and GAAP. As the Boards continue to converge, remaining IFRS / U.S. GAAP differences will diminish… some topics of interest… take a quick look at Revenue…
Convergence Milestone – Revenue Recognition

- **Background** – Work began ~2005. Needed more robust and general framework for recognizing revenue – can be applied to products, multi-elements, service arrangements, etc. - Key convergence milestone in May 2014 (ASC 606, IFRS 15)

- **Why a new standard needed:**
  - Too much revenue recognition guidance - guidance not consistent; “gaps” in GAAP – slow to catch up to new revenue arrangements.

- **Goals**
  - Remove inconsistencies and weaknesses in existing revenue requirements.
  - Provide a more robust framework for addressing revenue issues.
  - Improve comparability of revenue recognition practices across companies, industries, jurisdictions, and capital markets (joint project with IASB).
  - Simplify the preparation of financial statements by reducing the number of requirements to which a company must refer.
Convergence Milestone – Revenue Recognition

Key Elements

- Abandon “earned and realized”, “risk and rewards” as primary recognition criteria.
- Analyze revenue transactions based on contractual provisions of revenue arrangements.
- 5-Step process to identify all performance obligations … next slide.
Convergence Milestone -- Revenue Recognition

General framework...

**KEY OBJECTIVE**

Recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration that the company receives, or expects to receive, in exchange for these goods or services.

**FIVE-STEP PROCESS FOR REVENUE RECOGNITION**

1. Identify the contract with customers.
2. Identify the separate performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the separate performance obligations.
5. Recognize revenue when each performance obligation is satisfied.

**REVENUE RECOGNITION PRINCIPLE**

Recognize revenue in the accounting period when the performance obligation is satisfied.
Convergence Milestone -- Revenue Recognition

- Observations
  - Revenue will be recognized when a performance obligation is met (not based on earned and realized).
    - Accommodates both sales of products & services. And addresses multiple deliverable arrangements.
  - Uncertainty about getting paid is measured separately.
  - For many arrangements, the accounting results will be the same as under current IFRS/GAAP.
    - However, for complex arrangements (returns, buybacks, refunds), the new model will create a variety of “Contract” assets and liabilities. Robust model – apply to yet-to-be developed arrangements.
    - The model is somewhat like the current long-term contract model (% of completion likely to be the same).
Other IFRS/Differences – Candidates for Change?

- IFRS provisions that currently do not “exist” in U.S. GAAP… Provisions you may want to know about:
  - LIFO
  - Development Costs
  - Agriculture
  -Convertible Bonds
  - Pensions / Financial Instruments / Leases – next slides
- Could impact alignment between IFRS & GAAP in the future to the extent the Boards build on each other’s standards for direction in these areas.
Recent IFRS amendments to IAS 19... moves closer to GAAP (before this change, IFRS accounting was about the same as pre-SFAS 158 U.S. GAAP.)

New provisions:

- Report any deficit or surplus in a plan (funded status) on their statement of financial position (similar to GAAP).
- Remove the option allowing companies to defer some gains and losses that arise from defined benefit plans (the “corridor approach”). As a result, companies must recognize these changes as they occur.
- Eliminate options for presenting gains and losses -- pension expense elements arising from service and finance costs are recorded in income and remeasurements (of the pension asset and liability) are recorded in OCI.
The components of pension expense and their recognition are as follows:

- **Net interest**—the interest expense on the net defined benefit liability or interest income on the net defined benefit asset (using one rate);
- **Remeasurements** in OCI are not “recycled” to income via amortization in subsequent periods.

Small step – FASB is considering changes in the presentation of service cost in income.
As Convergence efforts are winding down, let’s take a look at two projects that have / are winding up.

Unfortunately, the Boards were not able to converge on these major projects. And while required adoption is 2-3 years away, we need to be aware of these impending changes.

- Financial Instruments
- Leases
**BIG** Area of Contention - In response to financial crisis, Boards have under pressure to improve accounting for FI. Boards have landed in a similar place w.r.t classification and measurement:

- All this work and where do we end up? The IFRS 9 framework is a bit different, but we still have three buckets and accounting based on intent (with a bit more fair value for equity investments).
Impairment

Trying to address “too little, too late” problem of current incurred loss model. Boards are on different paths.

- FASB – started with a fair value model; now working on an **expected credit loss** model (CECL) to be applied to loans, debt investments, and other receivables.
  - Abandons the “probable” threshold (FAS 5) in current GAAP… At each balance sheet date, companies will estimate an allowance for credit losses, based on a current estimate of contractual cash flows not expected to be collected [application of expected cash flow measurement (CON 7)].
  - Less complex – single impairment model, but will require more judgments.

- IASB has proposed a (confusing) “3 bucket” model (strong pushback on any more fair value). Thus, convergence will likely not be achieved on this project.
Leases

- Responding to concerns around the world with respect to off-balance sheet operating leases. Both GAAPs need improvement. Expected provisions.

- Lessees: GAAP – not IFRS - will retain semblances of capital and operating leases (Type A / B) but abandon bright-line tests applied to whole asset.
  - **ALL** leases longer than one year will be recorded on the balance sheet. Lessee records an asset or part of an asset it controls; records a liability for the obligation to make payments over the lease term (based on present value of contractual lease payments).
  - Under GAAP, income effects depend on lease type – Type A: effective interest - like a financing; Type B: straight-line – like a rental. (Under IFRS – all leases Type A).

- Lessors: Continue to record leased asset on books; Sales-type lease provisions align with new Rev Rec. (will look similar to current accounting).
Leases

Facts

- Lessor A owns a 5 story building with a fair value of $1,192,461. The building has a 40 year life and with zero residual value. Lessor A plans to lease each floor of the building to tenants on 5-year non-renewable leases with annual payments at the beginning of the year of $25,000.
- Lessee B leases the top floor of the building for the first 5-year lease term.

Analysis

Under current GAAP/IFRS

- This lease would most assuredly be classified as an operating lease (neither the 75% of life test nor the 90 fair value tests are met.) Lease will be off-balance sheet.

Under the new rules

- Lessee has a right of use asset for the floor that it controls and a liability measured as the PV of the lease payments. Lessor keeps the building on its books but now has a performance obligation for the right of use.
Leases

Leases on BALANCE SHEET
1. All leases other than short-term (small value).
2. Increases in assets and liabilities.
3. Impact on key ratios and covenants.

Impact on INCOME STATEMENT
1. Most equipment leases — front end loading of expenses versus EBITA (IFRS & GAAP).
2. Straight-line expense for most real estate leases and other real property leases (GAAP). Effective interest under IFRS.
   That is, for GAAP, Type A / Type B lease categories permit straight line rent for some long-term leases (e.g., Straight-line for the example above).
Summary – Final Convergence Projects

- Financial instruments, Leases… Why considered “BIG”? Major areas in accounting where both IFRS and U.S. GAAP need improvement.

- Status:
  - Financial Instruments: Final ASU Q1 2016. Earliest adoption in 2019?

Extended adoption windows, but now is the time to get up-to-speed.
Fair Value – Current Landscape & Implications

- Fair Value Evolution
  - Current Status, Myths & Metaphors

- Implications for Performance Reporting

- Implications for Academics – Research / Teaching

- Implications for Students – strap on your boots!

- Summary
Fair Value - Background

- This is one of, if not the most significant issues in financial reporting, especially in light of recent events in the markets for financial instruments.

- Fair values are increasingly demanded in financial reporting
  - Expansion of use of financial instruments, for which fair value is the most relevant measurement attribute:
    - Investments
    - Derivatives
    - Securitizations

- Implementation of Concepts-Based Standards have required expanded fair value measurement to record relevant measures of the changes in assets and liabilities.
  - E.g., Financial Instruments, Revenue Recognition, Impairments, etc.

- Boards agree about the relevance of fair values for financial instruments, as well as in some other settings.
Fair Value Standard-Setting

- Standard-setters have been active... Converged standard – IFRS 13, Update to FASB ASC 820 (FAS 157). Miss-understood standards:
  - Do not require any new fair value measurements... rather comprehensive guidance for how to measure fair when called for in GAAP/IFRS... prior fair value guidance was focused on financial instruments.
  - Note – had no role in causing the sub-prime crisis – simply made the consequences more transparent.
Recent Fair Value Standards

- Reminders about key elements
  - Definition – price at which assets / liabilities could be exchanged between unrelated, willing parties → exit prices in the most advantageous market.

  - Valuation Techniques – try to reflect process used by market participants in determining exchanges... May use PV techniques.

- Fair Value Hierarchy
  - Level 1 – Quoted market prices of identical elements – 1st Best
  - Level 2 – Quoted prices for similar elements – next best
  - Level 3 – Based on valuation techniques .. With preference, where possible using market-related inputs.

- Disclosure – amounts measured at fair value, how determined (extent of market inputs), changes in fair values – varies based on Level.
Fair Value – Estimates Everywhere

- Other Fair Value Elements - Fair Value Option (FAS 159, IFRS 9).

Level 3 Measures:
- Asset retirement obligations (FAS 143)
- Impairments (FAS 144, FAS 142)
- Asset Exchanges (FAS 153)

Key Elements
- Introduces the notion of expected cash flows… compared to using the most-likely in prior standards… expectations can account for risk.
- Discounting – use the risk-free rate (pure rate + inflation adj.) – be careful not to double-discount.
- Liabilities – important to incorporate both profit element and credit risk. Gains when in distress? – conceptually yes, recent standards, NO.
- Longer term objective to improve the CF on when to use fair value.
Fair Value Push-Back

- Boards have experienced significant push-back to these fair value directives:
  - Concerns about being on the path to fair value for everything (PPE)
  - Fair values lack reliability – subject to too much management discretion (earnings management).

- My Responses (recall disclaimer)
  - No plans to fair value the entire balance sheet – Boards have adhered to both relevance and faithful representation considerations.
  - HC measures are no less subject to reliability concerns… reflect on estimates in an HC model (bad debts, useful lives, residual values, contingencies).

Lack of transparency with respect to these management judgments.
Fair Value Implications

- Boards are responding to this latter transparency concern -- *Financial Statement Presentation Project... now narrower Performance reporting.*

- Financial Statement Presentation Project
  - Joint project with inception ~ 2001.
  - Partly informed / influenced by a 2005 CFA Report.

- Key Elements
  - Major reformatting of statements to gain consistency *across* statements, but allow companies to choose classifications according to how they manage the business (management approach, a la *FAS No. 131 & IFRS 8.*)
  - Operating / Financing is the main cut – consistent across IS, BS, SCF
  - *Explored new structures to accommodate transparent reporting of fair value re-measurements.*
## Financial Statement Presentation Project

<table>
<thead>
<tr>
<th>Statement of financial position</th>
<th>Statement of comprehensive income</th>
<th>Statement of cash flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business section</td>
<td>Business section</td>
<td>Business section</td>
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<tr>
<td>Operating category</td>
<td>Operating category</td>
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<td>Operating finance subcategory</td>
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<tr>
<td>Investing category</td>
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<tr>
<td>Financing section</td>
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<tr>
<td>Debt category</td>
<td>Debt category</td>
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<tr>
<td>Equity category</td>
<td>Multi-category transaction section</td>
<td>Multi-category transaction section</td>
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<tr>
<td>Income tax section</td>
<td>Income tax section</td>
<td>Income tax section</td>
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<tr>
<td>Discontinued operation section</td>
<td>Discontinued operation section, net of tax</td>
<td>Discontinued operation section</td>
</tr>
<tr>
<td></td>
<td>Other comprehensive income, net of tax</td>
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</table>
### Reporting Financial Performance

<table>
<thead>
<tr>
<th>Changes in Assets and Liabilities, Excluding Transactions with Owners</th>
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<tbody>
<tr>
<td>Not from remeasurements</td>
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<tr>
<td>Cash component</td>
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<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>G</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Caption in statement of cash flows</td>
<td>Cash flows</td>
<td>Accruals, allocations, and other</td>
<td>Recurring fair value changes/valuation adjustments</td>
<td>All other categories</td>
<td>Statement of comprehensive income (B+C+D+E)</td>
<td>Caption in statement of comprehensive income</td>
</tr>
</tbody>
</table>

- Users loved this proposed reporting framework; Preparers not so much.
- FASB / IASB have pivoted to a focus more narrowly on improving the income statement.
Income (Performance) Reporting

- Observations on current practice.
  - Most income statements are quite abbreviated, presenting less than 15-18 line items, including 6 or more totals and subtotals
  - Many of the line items are OCI items
  - This abbreviated reporting causes the user to focus primarily on the one single bottom line number: NI
  - Standard setting efforts in the US, therefore, primarily have taken a bottom up approach concentrating on getting the bottom line summary number right by
    - **Excluding certain purportedly irrelevant OCI items** from NI
    - **Recycling** items reported in OCI to NI - to get that one number right, clean surplus accounting requires all changes in equity be reported in NI, except those resulting from investments by owners and distributions to owners
Growing Prevalence of Non-GAAP Measures

- At a 2012 FASAC meeting, a group of 7 preparers, users & auditors discussed the objectives for providing non-GAAP measures
  - Conclusion: report financial performance through eyes of management
- Overall the reports indicated two primary types of non-GAAP measures*
  - Non-financial measures that most often provide volume information (# of clicks, # of tweets, # of barrels of oil etc.)
  - Financial measures that exclude from net income
    - Items that are distortive of operations and/or
    - One-time, non-recurring items
- The latter financial measures primarily report the results of core, recurring operations and suggest what is the primary number of interest to users.

*Other measures often inform about tax or entity (segment, consolidation) issues
The proliferation of the non-GAAP measures suggests the answer is no.

- Investors try to get insights into a company’s core business activities have the potential to provide a persistent, expected positive return that compensates for the risk taken
  - This view suggests that the primary income number to focus on is operating income
  - In addition, to determine whether that number will recur it also suggests that recurring operating amounts should be presented separately from one-time, non-recurring operating amounts
Both operating and non-operating income items can be predictive of future cash flows and the total amount of net assets available for dividends.

Investors are most interested in two key subtotals:

- **Operating income** (usually the primary interest) and comprehensive income and
- Within each subtotal separate reporting of **recurring and non-recurring** amounts

Note -- because non-operating items never become operating, we are generally not interested in recycling between the categories.
Challenges to a New Reporting Model

- The model proposed on the prior slide might be operationalized by requiring presentation of *one statement of comprehensive income* with one required intermediate operating income subtotal.

- There may be two key concerns with such presentation:
  - The most important subtotal is buried in the middle of the statement, which might cause users to focus more on the bottom line CI number rather than operating income.
  - On which number(s) should EPS be defined?

- Potential solutions:
  - Require **two statements (the Statement of Operating Income and Statement of CI) presented consecutively**.
  - Require an EPS number for both operating income and CI OR provide the user with the EPS denominator only.
An Operational Performance Reporting Model

- How to differentiate between operating and non-operating activities
  - Approach 1: Define operating activities directly; categorize all other activities as non-operating
    - Likely not feasible because the nature of operations varies across companies.
  - Approach 2: Define all non-operating activities directly (investing, financing and tax); categorize all other activities as operating
    - Make categorization an accounting policy choice and require a preferability conclusion before a change can be made

- Will be subject to comparability criticisms – management intent.
Other Challenges

- **How to define one-time, non-recurring amounts**
  - Focus is on the predictive value of the amounts not the frequency of occurrence
  - But… predictive value of amounts not easily defined as an accounting construct

- **Joint project on financial statement presentation proposed the separate presentation of remeasurements, which is one method of describing in accounting terms items that are one-time, nonrecurring amounts … remeasurements:**
  - A transaction-based change in a current price or value (e.g., fair value change in a security, loss on sale of receivable)
  - A change in an estimate of a current price or value (e.g., impairment of goodwill)
  - A change in any estimate or method used to measure the carrying amount of an asset or liability (e.g., change in litigation accrual)
Summary on Performance Reporting

- The current reporting model for net income and comprehensive income is broken
  - Concentrating on separate reporting of OCI items from NI
  - Failing to provide a clean measure of operating income
  - Failing to separate recurring income items from one-time, non-recurring changes in wealth amounts

- Users indicate that in their analyses they first attempt to separate operating income from other income and then to distinguish in both categories recurring income amounts from one time, non-recurring amounts

- Boards are working to find a new model for reporting financial performance that facilitates such analyses

Stay tuned…
Concluding Remarks

- International Accounting Convergence efforts have plateaued. Collaboration is now the mantra.
  - Instructors / Students must be bilingual and stay up-to-date and be ready for the roll-out of FI and Leasing standards.
  - Fair Value - we are well along a path to robust framework for fair value as a measurement objective.
  - Need to consider more than just the fair value standards to gain insights into their broader implications and the workability of fair value measurement - Performance Reporting

- Much work to be done …Monitor the Boards’ agendas – review Preliminary Views & Invitations to Comment documents…Get informed/ Be Involved:
  - Provide input to the IASB/FASB.
  - Continue to nurture continuing professional education and research skills in your students.

Questions?