Uncertainties Regarding GAAP and the IFRS

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Understanding the financial performance of a company is important to investors and regulators. Although measuring financial performance in certain situations is relatively easy, in other situations the issues can be complex.

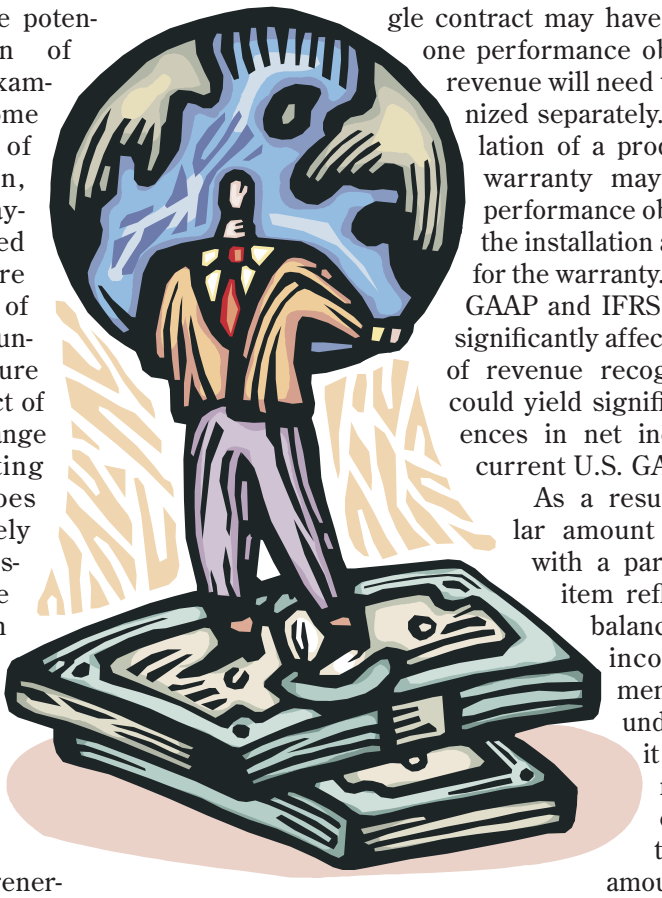
Over the past several years, as business has become more globalized, the accounting profession, corporations, investors and regulators have grappled with the difficulties of comparing financial statements issued in different countries that are based on different accounting rules. In addition, smaller nonpublic companies are crying out for relief from the burdensome accounting rules of public companies.

For decades, the accounting system in the United States has been based on Generally Accepted Accounting Principles (GAAP). Since 1973, the Financial Accounting Standards Board, along with the U.S. Securities and Exchange Commission, have been considered the primary gatekeepers of U.S. GAAP, and that is unlikely to change. However, more than 100 countries have adopted International Financial Reporting Standards (IFRS), and the United States appears to be positioning to transition to IFRS at some point in the future. Although the United States has not set a deadline, IFRS have been adopted in the European Union and in Canada. Even if IFRS is not adopted in the United States, the emergence and importance of IFRS heralds major changes in the interpretation of GAAP.

The process of melding IFRS and GAAP is known in the accounting profession as "convergence." The intent of convergence is to come up with one set of global standards that result in the best of both IFRS and U.S. GAAP, helping clear a path for the United States to adopt IFRS. Convergence already is responsible for significant proposed changes to U.S. GAAP — changes to the guidelines for the accounting for leases as well as new guidelines for revenue recognition are likely to be adopted in 2012. The biggest difference between IFRS and U.S. GAAP is that U.S. GAAP historically has been based on a set of detailed rules, whereas IFRS is based more on principles. Stated another way, IFRS relies more on judgment and disclosure, while U.S. GAAP has relied more on specific accounting treatments based on pronouncements from bodies such as the Financial Accounting Standards Board.

CONVERGENCE

Transactional attorneys need to understand the implication of convergence and the potential adoption of IFRS. For example, where some component of compensation, value or payment is based on the future performance of an entity, counsel should ensure that the impact of a potential change in accounting standards does not negatively affect the transaction in the future. Even in straightforward transactions, where the seller of a business is paid, in part, based on the net income generated by the business in future years, the attorneys assisting in the transaction must carefully define the basis for calculating net income in future years. The typical "catch all" phrase such as "net income prepared in accordance with GAAP" is likely to yield a net income number that is significantly different than the parties contemplated.



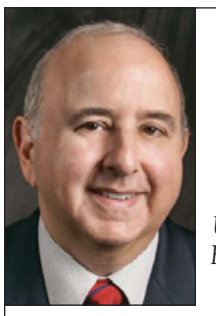
Another example is that a corporate general counsel agreeing to debt covenants needs to consider that under converged GAAP, certain balance-sheet accounts may be "grossed up" where today's GAAP yields a net number for the identical balance-sheet accounts.

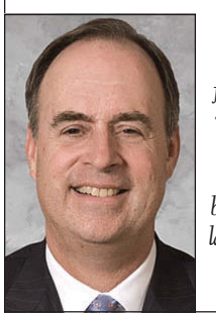
Let's look at one specific example and how things will change. Under GAAP, specific directions exist as to when revenues may be recognized in connection with the sale of a good or service. Often these directives are industry-specific and fairly consistent within industries. As a result of convergence, however, GAAP will no longer have specific directives as to when revenue is recognized. Instead, converged GAAP and IFRS instructs the issuer of financial statements to recognize revenue when "performance obligations" are met. One can readily see the need for judgment to determine when the customer has an unconditional obligation to pay; the customer has legal title to the good; the customer has physical possession of the good; or other relevant factors. It will essentially be the responsibility of the issuer of the financial statement to make the determination as to when performance obligations are met and disclose the performance obligations that were considered in the notes to the financial statements.

To make matters more complicated, under converged GAAP and IFRS a single contract may have more than one performance obligation so revenue will need to be recognized separately. The installation of a product with a warranty may have one performance obligation for the installation and another for the warranty. Converged GAAP and IFRS is likely to significantly affect the timing of revenue recognition and could yield significant differences in net income from current U.S. GAAP.

As a result, the dollar amount associated with a particular line item reflected on a balance sheet or income statement prepared under GAAP as it exists today may not be comparable to the dollar amount associated with the same line item in the future. More importantly, the net income number on an income statement prepared under today's GAAP may significantly differ from the net income number on an income statement prepared under converged GAAP and IFRS even though the underlying transactions are the same.

Many uncertainties remain, and the SEC has stayed on the sidelines thus far. Difficult questions will arise about the IFRS' application to nonpublic U.S. companies where converting to converged GAAP and IFRS may be burdensome and of little benefit. One possibility is that a two-tier U.S. accounting system will emerge resulting in a "private company GAAP" that would exempt nonpublic companies from converged GAAP and/or IFRS. It is important for counsel to be aware of and prepare for the uncertainties associated with future financial reporting issues. IHT





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