Special Report

Accounting and Financial Reporting: 2010 Global Outlook

Bumps on The Road to Convergence

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Overview

2009 was particularly memorable for the challenges it presented to accounting policymakers on many fronts — fair value readily comes to mind. Although the financial crisis aggravated the challenges posed to the implementation and interpretation of many pervasive accounting issues, the responses to these challenges by standard-setters, regulators, auditors, and even politicians set the stage for a curious 2010. In Fitch's view two issues look set to dominate the accounting landscape in 2010: global convergence and the accounting for financial instruments.

The first issue is the move toward the adoption of International Financial Reporting Standards (IFRS) by many countries in 2010, including Brazil and Chile, and optional adoption in Japan. In addition, the pending decision to allow U.S. companies to adopt IFRS would largely determine if the dream of a single set of global accounting standards is ultimately realized. While awaiting direction from the SEC on the adoption of IFRS, numerous bumps on the road have emerged. Despite the perceived setbacks, Fitch believes it is highly unlikely that the U.S. will backpedal completely from the ultimate goal of a single set of global accounting standards. Although the option to allow some companies in the U.S to adopt IFRS at the end of 2010 now seems far-fetched, the more likely scenario is for the SEC to amend the current timetable while establishing more milestones to lay the path toward the eventual adoption of IFRS by all U.S. companies.

Secondly, the goal of international and U.S. standard-setters to issue a converged accounting standard on financial instruments, in light of an initial "false start" coupled with looming political and regulatory pressure regarding fair value, will continue to fuel the mother of all accounting debates in 2010. International standard-setters have issued a standard which preserves the dual measurement model of both amortized cost and fair value for financial instruments, while its U.S counterpart is moving toward a fair value measurement model. This initial divergence and prevailing political interference lead many to believe that the march toward a single set of global standards for financial instruments is set for a dead end. However, recent pronouncements from the two accounting boards leave open the possibility — albeit slim — of a converged standard.

In the U.S., the expected consolidation of many former off-balance-sheet structured entities such as securitizations in the first quarter of 2010 will likely produce surprises. Most of the impact will likely be on the balance sheets of financial institutions — in fact, many banks have already disclosed the expected impact on capital and their balance sheets. However, the ultimate impact on most nonfinancial companies largely remains a mystery.

Analysts and investors should also be aware of some important longer-term accounting changes that accounting standard-setters will debate in 2010, including financial statement presentation, lease accounting, and revenue recognition.

Initial SEC Convergence Roadmap Proposed in 2008

2010: Some large multinational companies will be given the option to adopt IFRS. SEC estimates 110 companies in 34 industries would qualify.

2011: A final decision will be made by the SEC to allow others to follow, based on the achievement of specific milestones.

2014: Companies with public float greater than $700 million will be required to adopt IFRS, if move to IFRS is sanctioned in 2011.

2015: Companies with public float between $75 million and $750 million will follow.

2016: All public companies will be required to adopt IFRS.

Source: SEC.

Global Convergence

Is the world still headed for a single set of global standards? The G-20 leaders think it should be. However, the answer may finally lie in the SEC's plan to announce a decision on the adoption of IFRS by all public U.S. companies. The initial SEC "roadmap", which requested comments from market participants in 2008 (see the proposed timeline at left), is now viewed by some participants as overly ambitious, particularly the option to allow some companies in the U.S to adopt IFRS at the end of 2010.

Numerous bumps on the road to convergence have emerged. First, there is the speculation surrounding the SEC's seeming reluctance to finalize the proposed roadmap due to the diversion ushered in by the change in administration and other issues pertaining to the global financial crisis. Second, what appears at least from a U.S. perspective to be a dominant influence of European regulators on the IASB has led many market participants to question the independence of the IASB as a global standard-setter. Finally, divergent FASB and IASB proposals to improve the accounting for financial instruments have raised the possibility of having two fundamentally different standards for financial instruments.

Recently, a number of SEC officials tried to allay the fears surrounding the proposed roadmap. While acknowledging the operational, structural, and transitional concerns of many market participants in the U.S., they announced that a final decision on the convergence timeline would be made in "early 2010," noting that the process was "proceeding deliberately and thoughtfully."

Despite the perceived setbacks, Fitch believes it is highly unlikely that the U.S. will backpedal completely from the ultimate goal of a single set of global accounting standards. Although the option to allow some companies in the U.S to adopt at the end of 2010 now seems far-fetched, the more likely scenario is for the SEC to amend the current timetable while establishing more milestones to guide the path to the eventual adoption of IFRS by all U.S. companies.

In the meantime, the convergence of IFRS and U.S. GAAP continues. The ongoing cooperation between the FASB and IASB, which was ratified in an updated Memorandum of Understanding (MOU) issued in September 2008 and reaffirmed in November 2009, is

A Mountainous Agenda to Reach Convergence by 2012

						Pensions
						Revenue Recognition
					Consolidations	Leases
				Revenue Recognition	Comprehensive Income	Insurance Contracts
			Emissions Trading Schemes	Insurance Contracts	Fair Value Measurement	Financial Statement Presentation
	Pensions	Financial Statement Presentation	Fin. Instruments with Characteristics of Equity	Leases	Financial Instruments	Financial Instruments with Characteristics of Equity
Discontinued Operations	Financial Instruments	Fair Value Measurement	Comprehensive Income	Consolidations	Discontinued Operations	Emissions Trading Schemes
2010 Drafts Documents					**Final Standards by End of 2010**	**Final Standards by June 2011**

Source: FASB, IASB, Fitch.

G-20 Countries That Have Adopted IFRS

Australia — IFRS Equivalent
France
Germany
Italy
South Africa
United Kingdom
European Union

G-20 Countries Committed to IFRS

Argentina	2012
Brazil	2010
Canada	2011
India	2011
Indonesia	2012
Japan	2011
South Korea	2011
Mexico	2012

G-20 Countries Not Committed to IFRS

China
Russia
Saudi Arabia
Turkey
U.S.

full of major projects, all scheduled to be completed by mid-2011.

If the standard-setters adhere to the MOU, differences in IFRS and U.S. GAAP will continue to narrow. However, serious questions continue to linger about the likelihood that all these projects will be completed by June 2011. Even if completed, implementation risks are likely to arise from adopting so many standards in a very short time. This would likely require enormous resources from preparers and auditors. Furthermore, depending on how these standards are adopted (whether it be retrospectively, prospectively, or optional for a period) the lack of comparability that may arise will likely challenge analysts and other financial statement users.

In other parts of the world, major economies in Asia, South America, and North America are ramping up efforts to adopt IFRS. This is going on at a rapid pace among many countries that have already set a definitive timeline to adopt IFRS over the next three years. Although a change in accounting regime should not normally affect business fundamentals, it will be interesting to see the extent to which the impending adoption of IFRS changes business decisions and strategy. The resource challenges being encountered by many of these countries underscore the need for a well thought-out plan on the road to adopting IFRS.

Accounting for Financial Instruments

The mixed-attribute model of accounting for financial instruments (which includes amortized cost, lower of cost or market, and fair value) has been a consistent issue and concern for the investor community. The debate was further intensified by the strict interpretation of fair value with the advent of a new definition in 2007 and the pervasive illiquid markets shortly thereafter.

In response to incessant pressure from the European Commission (EC) at the onset of the global financial crisis (see the Fitch report, "Accounting and Financial Reporting 2009 Global Outlook," dated Jan. 8, 2009 and available at fitchratings.com), the IASB initiated an accelerated three-part project on financial instruments to address classification and measurement, impairments, and hedge accounting. For the first part, the IASB settled on a dual measurement approach based on an issuer's business model as follows.

- Amortized cost: This would include financial instruments with basic loan features and managed on a contractual yield basis.
- Fair value: All other financial instruments, including equities, derivatives, and hybrids would be measured at fair value.

The final standard (IFRS 9) was released in time to meet the EC's year-end demand, only to be rejected for ratification by the EC over fears that the standard would result in "too many assets measured at fair value." The impairment and hedge accounting parts are expected to be completed in 2010, after which the EC is expected to consider the ratification of all three parts of the financial instruments standard.

In the U.S., congressional pressure forced the FASB to make hurried changes to impairment rules which effectively relaxed the impact of fair value on the volatility of the income statement. Subsequently, the FASB continued its broad revamp of the accounting for financial instruments. The proposal is expected to be unveiled in the first quarter of 2010 with final implementation not expected before 2011. Thus far, the FASB seems to be moving in a direction that diverges significantly from the IASB standard noted above. The FASB proposal would allow for two primary classifications.

- Fair Value through Profit and Loss: This category would be the default category for all financial instruments including loans unless certain criteria are met (see primary criteria below). It would include derivatives, equity investments, and others.

- Fair Value through Other Comprehensive Income (OCI): This category would allow a company to recognize fair value gains and losses through OCI if the business model and management's intention is to hold the financial and instruments for collection or payment of cash flows and the variability of the associated cash flows is low.

Sample FASB Presentation for Loans

Amortized Cost	XXXX
Less Allowance	(XXXX)
+ – FV adjustment	XXXX
Net Loans	**XXXX**

Furthermore, the presentation of financial instruments on the face of the balance sheet and income statement also changes in the FASB model. Two notable changes are expected: (1) The balance sheet would present separate line items for amortized cost and fair value (see sample in the box at left), and (2) OCI would now be shown below net income in the income statement, with the new "bottom line" called a statement of comprehensive income. The FASB's intention is to make OCI as prominent as the rest of the income statement so that the fair value changes going through OCI have equal visibility to analysts and investors. However, earnings per share (EPS), a key metric for equity analysts, will continue to be based on net income not comprehensive income.

The differences between the two sets of proposals and how they have been rolled out have led many to fear that political influence in the standard-setting process has produced a "race to the bottom" with the dream of a single global set of accounting standards left in the dust. In response to these concerns, recent pronouncements from the two accounting boards leave open the possibility — albeit slim — of a converged standard.

Not far removed from the issue of fair value measurement and classification is the impairment of financial instruments measured at amortized cost. The IASB has proposed moving to an expected loss approach that incorporates expectations about future credit losses over the life of the financial asset. The FASB model would have impairment charges based on a credit loss approach that would measure the present value of cash flows not expected to be collected for instruments with fair value changes going through OCI. In contrast to the IASB approach, this method would not consider possible future scenarios but only information relating to past events and existing conditions.

Still to come is a debate as to whether and how to fairly value liabilities. This is especially the case when there is accounting mismatch, such as when assets are measured at amortized cost and liabilities at fair value, or vice versa. Key issues in this debate will be how, if at all, to include an issuer's own creditworthiness in the valuation as well as the measurement of core deposits of banks and the valuation of associated intangibles. There are pros and cons to each side in this debate and it will be a true test as to whether a consensus can be reached.

Off-Balance-Sheet Accounting

2010 U.S. GAAP financial statements will see many securitizations and other structured finance entities return on balance sheet with the implementation of new off-balance-sheet standards in the U.S. The qualified special purpose entity, which received automatic exemption from consolidation, will cease to exist and the test for consolidation will change from a quantitative focus to a qualitative one. (For more details, see the Fitch report, "Off-Balance-Sheet Accounting Changes: SFAS 166 & SFAS 167," dated June 22, 2009 and available at fitchratings.com).

Increased scrutiny by the SEC, coupled with risk-retention provisions by regulators, virtually guarantees consolidation for many structured entities.

Increased scrutiny by the SEC coupled with risk-retention provisions by regulators virtually guarantee consolidation of many structured entities. For financial institutions, consolidation will bring increased regulatory capital requirements given recent proposals adopted by U.S. bank regulators. Therefore, with regulatory capital arbitrage diminished, the use of structured entities may be less attractive for some financial institutions in the future. Less clear is how these new requirements will affect nonfinancial issuers. Surprises might emerge, particularly for companies with complex joint venture arrangements.

The new U.S. standards on consolidation bring U.S. GAAP closer to the IFRS model, although both boards are working on a joint project, with an exposure draft expected in mid-2010. Prominent in these discussions will be whether and how asset managers and private equity investors present their underlying investments in their accounts. This has prompted the FASB to postpone the adoption of the new consolidation standards for such issuers until a joint solution can be reached.

Pensions

Globally, pension plans are still under pressure. The funded status of most pension plans at the end of 2009 experienced a modest recovery from the lows of late 2008 and early 2009. The uptick was primarily due to robust gains in the equity and credit markets during 2009. However, the year-over-year impact of market gains in 2009 financial statements has been tempered by higher pension liabilities due to the effect of historically low discount rates on the liabilities of most pension plans.

The real issue for credit analysts and investors is the potential amount of cash a company may be required to pay into a plan and the timing of this. The complexities surrounding pension funding rules in various jurisdictions, coupled with poor disclosure requirements about regulatory funding requirements, make it difficult to ascertain future cash contributions. Analysts and investors are dependent on voluntary disclosure by issuers to estimate pension funding requirements.

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In the U.S., cash contributions to underfunded pension plans during 2009 were affected by two key regulatory changes which provided significant cash funding relief for most companies in 2009. The impact of this pension funding relief is expected to extend through 2010.

First, the Worker, Retiree and Employer Recovery Act, signed into law in December 2008, generally allows companies to utilize expected returns (rather than actual returns) and a 24-month average for assets in determining required cash contributions. This effectively allows the smoothing of unexpected losses (as well as gains) over a 24-month period. The more important relief was a one-time election granted by the IRS — the taxing authority — in March 2009, which allowed companies to select a more favorable discount rate to compute the pension liability and, consequently, the cash funding requirement of pension plans in the U.S.

With the impending expiration of the one-time IRS relief in 2010, many companies are already clamoring for additional relief for 2011 and beyond. The ultimate outcome of the push for new relief is anybody's guess. However, it is important to note that funding relief only postpones the day of reckoning for issuers as "real" obligations do not change. If the IRS relief is not renewed and efforts to legislate a new round of relief fail, minimum required pension plan cash contributions in 2011 and beyond are likely to ratchet up significantly in the U.S.

On the financial reporting front, the IASB has been working on major changes to pension accounting, expected to culminate in an exposure draft in 2010 and a final standard in 2011. The proposal appears likely to require all changes in pension plan assets and post-employment obligations to be recognized in the period in which they occur. This is in contrast to current rules that allow the option for changes in plan assets and obligations to be recognized over multiple periods. A further point that has been tabled is the inclusion of all changes in pension liabilities and assets in the income statement, compared to the current process of splitting such changes into expected amounts, which typically go into the income statement, and balancing items, which can be taken directly to reserves. Combined with the recognition of all asset and liability changes in a period this is likely to result in increased volatility in both the income statement and the balance sheet. This will make Fitch's current focus on cash contributions (which are unaffected by accounting changes) an even more appropriate tool for determining the true credit impact of pension scheme deficits. U.S. issuers should also be paying attention to this debate; if finalized, the proposal would likely be adopted by the FASB into U.S. GAAP.

Disclosures

Disclosures in U.S. GAAP and IFRS are set to improve on multiple fronts, with most of the improvements in the U.S. Under IFRS, improvements to financial instruments disclosures bring IFRS 7 closer to U.S. standards by mandating the disclosure of the fair value hierarchy: Level 1, 2, and 3 disclosures, starting with 2009 annual reports. This new disclosure ensures regular and consistent disclosure of this information, in contrast to prior disclosures, which were often inconsistent when disclosed at all. (For more detail, see the Fitch report, "Fair Value Disclosures — A Reality Check," dated June 26, 2008 and available at www.fitchratings.com.)

In the U.S., in response to some prodding by the SEC, the FASB is completing work on further improvements to fair value disclosures by requiring additional disclosures likely to take effect in 2010. The disclosures would require new information on significant transfers in and out of Levels 1 and 2, measurements, and a description of the reasons for the transfers. In addition, detailed information around gross purchases, sales, issuances, and settlements of Level 3 measurements would be required.

More disclosures on loan portfolios are also expected in the U.S. in 2010. New disclosures related to the credit quality of loans and the allowance for credit losses are expected to be finalized in the first half of 2010. The credit crisis prompted a more urgent need to provide more disaggregated information on credit losses, credit quality, impaired loans, and the fair value of loans. For many financial institutions the proposed disclosures bring into the financial statements relevant information that is already being provided to various regulatory bodies, and increasingly disclosed by regulated banks under pillar three of Basel II.

Disclosure surrounding the pension plans of U.S. companies should also be more robust starting in 2010. Issuers will now be required to disclose more information on investment policies/strategies and how investment allocation decisions are made. In addition, plan assets are expected to be disaggregated a lot more. For example, debt securities are now to be broken down into national, state, local governments, corporate, and structured debt securities. The new disclosure also requires U.S. companies to disclose where pension plan assets fall within the Level 1, 2, and 3 "buckets," as well as the effect of Level 3 assets on overall changes in plan assets.

> 2010 will likely see U.S. companies disclosing more information about potential losses from lawsuits.

2010 will likely see U.S. companies disclosing more information about potential losses from lawsuits (loss contingencies). This has been a hotly debated issue because the initial proposal required companies to disclose both quantitative and qualitative information about the most likely outcome of contingencies. However, the FASB backed down from forcing companies to disclose "privileged information" about settlement negotiations and lawsuit outcomes. Three broad disclosure principles are expected to be in the standard. First, the disclosures would focus more on the contentions among the parties to litigations rather than be predictions about future outcomes of the litigation. Second, disclosures about loss contingencies are expected to be much more detailed as the loss contingency inches closer to a resolution and the likelihood/amount of a monetary loss becomes more apparent. Finally, pertinent publicly available information about a potential loss due to litigation would be summarized and the source of more detailed information would have to be provided in a footnote.

The IASB, in a recent exposure draft, also addresses the measurement of contingent liabilities. It proposes to measure them as the amount an issuer would rationally pay at the end of the reporting period to be relieved of the liability. Current standards only require recognition when it is more likely than not that the issuer would have to pay. Any change adopted would most likely be effective for 2011 results.

The fragmented nature of existing disclosures and the constant barrage of new ones have led the FASB to initiate a disclosure framework project with the goal of making disclosures less redundant and more coordinated and integrated. This initiative, widely welcomed by investors and analysts, is still very preliminary. However, if the project is finalized, the seeming overload of disclosures should be somewhat mitigated.

Long-Term Accounting Projects

A number of significant joint projects between the FASB and the IASB will continue to be developed during 2010. All the projects are scheduled to be completed by June 2011. These projects could change financial reporting substantially, and their importance underscores the need to briefly highlight them in this report. They include financial statement presentation, lease accounting, and revenue recognition.

Financial Statement Presentation

After a decade, the financial statement presentation project is progressing to a more decisive stage. The project, a major overhaul of the presentation of financial statements, would radically change the presentation of the balance sheet, the income statement, and the cash flow statement as we know them today. At the crux of the proposed new format is the requirement to subdivide all three statements — financial position, comprehensive income, and cash flows — into sections and categories. (For more detail, see the Fitch report, "Financial Statement Presentation: Is It Time For Change?," dated May 12, 2009 and available at www.fitchratings.com.)

Proposed Classification Scheme for Financial Statements

Statement of Financial Position	Statement of Comprehensive Income	Statement of Cash Flows
Business	**Business**	**Business**
• Operating assets and liabilities	• Operating income and expense	• Operating cash flows
• Investing assets and liabilities	• Investing income and expense	• Investing cash flows
Financing	**Financing**	**Financing**
• Financing assets	• Financing income	• Financing asset cash flows
• Financing liabilities	• Financing expense	• Financing liability cash flows
Income Taxes	**Income Taxes** on continuing operations (business and financing activities)	**Income Taxes**
Discontinued Operations	**Discontinued Operations**, net of tax	**Discontinued Operations**
	Other Comprehensive Income, net of tax	
Equity	—	Equity

Source: FASB.

An exposure draft on the project is expected in April 2010 and it seems clear that the boards are going to require the direct method for presenting the statement of cash flows in conjunction with an indirect reconciliation of operating income to operating cash flows in the notes. A roll-forward schedule, which would show an analysis of the changes in the balances of all significant assets and liabilities, would also be a new addition to the footnotes.

Fitch believes that the roll-forward schedule of all significant assets and liabilities would provide a significant improvement in financial reporting, as it would capture better the necessary information that analysts sometimes struggle to extract from financial statements today. Analysis of financial institutions will particularly benefit because their transaction flows and analysis of asset quality, capital adequacy, and liquidity are primarily balance sheet-focused.

Lease Accounting

The lease accounting project is likely to bring all operating leases onto the balance sheet.

The boards are moving along in their established goal of eliminating the concept of operating leases and bringing all lease contracts on the balance sheet. Given the estimated value of leases (mostly operating) signed annually — $760 billion according to the World Leasing Yearbook of 2009 — this is a development that would likely change corporate behavior by making leases less attractive as a financing option. If the boards stick to their plan, an exposure draft on the accounting for lease contracts is expected in 2010, with a final accounting standard expected by June 2011.

The standard-setters have settled on a "right to use" model, which essentially applies the finance or capital lease model to all leases — i.e. the initial asset and liability would be the present value of all lease payments. For simple lease contracts this concept is relatively straightforward. However, most lease contracts are not simple. They usually include options to purchase, options to renew or terminate the lease, residual value guarantees, contingent rental arrangements, and other factors.

The proper accounting for most of these options is still being debated; however, an important tentative decision has already been made on leases with an option to renew. For these leases, the value of both the asset and liability would be based on the longest possible lease term that is likely to occur. This should capture the economics of a lease contract, if the true spirit of this principle is applied. Hence, if a one-year lease contract with an annual renewal option for four years is likely to be used for the full five-year span, the asset/liability on the balance sheet should reflect a five-year lease and not a one-year lease.

Fitch already treats operating leases largely as debt obligations (see Fitch's criteria report, "Operating Leases: Updated Implications for Lessees' Credit," dated Aug 13, 2009 and available at www.fitchratings.com). While the agency will continue to monitor developments and if necessary adapt its criteria to take into account any final standards, at present any impact on credit ratings is expected to be minimal.

Revenue Recognition

The boards are currently working on a joint revenue recognition which seeks to comprehensively revamp revenue recognition under both U.S. GAAP and IFRS. In the U.S., existing revenue recognition standards are drawn from over 100 sources and the standards are inconsistent. Under IFRS, the standards (IAS 18 "Revenue" and IAS 11 "Construction Contracts") are considered by those accustomed to the specific nature of U.S. GAAP to be too vague. Therefore, the development of a new standard is expected provide a more robust framework and eliminate the inconsistencies in current standards.

The boards have settled on a "contract-based revenue recognition model." The proposed model starts with the transaction price, which is allocated as recognized revenue based on management's assessment of performance obligations. In other words, revenue is recognized as the goods and services are transferred to the customer. Hence, the new model will preclude recognizing revenue at the inception of a contract and may allow management to remeasure some performance obligations based on the company's expected cost of performance.

For simple customer transactions and revenue contracts, the new model does not change existing revenue recognition methods. However, in manufacturing and construction contracts where revenues under current standards can be recognized over time without immediate transfer of goods or service, revenue recognition may be delayed until the very end of the transaction when it can be proven that a performance obligation was duly satisfied.

U.S. companies involved in transactions where multiple elements are sold together are set to benefit from new revenue recognition rules which go into effect for years beginning after June 15, 2010.

On a related note, U.S. companies involved in transactions where multiple elements are sold together (multiple deliverables) are set to benefit from new revenue recognition rules which go into effect for years beginning after June 15, 2010. This change would likely accelerate the recognition of revenues for many technology-related companies and other industrials.

Current U.S. GAAP forces some companies to defer revenue recognition on multiple deliverables over the economic life of the products if certain criteria cannot be met. However, the new accounting changes relax those rules, giving management more discretion in determining the timing and the amount of the revenues that are recognized on transactions with multiple deliverables. Fitch does not expect any rating impact from this accounting change as it should not change the underlying economic and cash flow characteristics of the companies concerned.