Accounting & Financial Reporting — 2012 Global Outlook

Major Accounting Changes Hover as Standard-Setting Fatigue Sets In

Outlook Report

Inside This Report

	Page
U.S. Incorporation of IFRS	2
Financial Instruments	3
Sovereign Debt Exposures	5
Revised Exposure Drafts on Leases and Revenue Recognition	6
Exploring Mandatory Auditor Rotation	7

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Convergence Projects Stalling: A renewed emphasis on issuing converged, “high-quality” accounting standards and the need to re-expose updated proposals for comments has significantly slowed the completion of many accounting projects jointly initiated by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). The major priority projects initially scheduled for a June 2011 completion are still at various stages of completion in 2012 and some will likely extend into 2013.

U.S. Decision on IFRS Expected in 2012: Fitch still expects the U.S. to move forward with a plan to incorporate IFRS into U.S. GAAP, albeit in a prolonged, cautious and incremental way. The SEC’s decision on the incorporation of International Financial Reporting Standards (IFRS) for U.S. issuers was delayed in 2011. The decision is now expected in 2012.

U.S. Decision Hinges on Completion: The SEC is looking to the standard setters to complete, or significantly come close to completing, the high priority convergence projects before a decision is made on the adoption of IFRS. Given the current pace of work on the major projects, the SEC may have to wait a while. The completion or substantial completion of three key projects is most critical to that decision. The big three projects include financial instruments, revenue recognition, and leases.

Financial Instruments — Closer Together: The gap between the FASB and IASB on fair value has been significantly closed with the FASB backpedaling from its initial proposal to move all financial instruments to fair value. The new proposal preserves the dual measurement approach of fair value and amortized cost. In addition, the FASB and IASB will likely issue a proposal on the impairment model for financial assets before the second half of 2012. The proposal is expected to introduce a three-bucket expected loss approach, replacing the highly criticized incurred loss approach currently used.

Accounting for Sovereign Debt Exposures: Unsurprisingly, the focus on how entities, particularly financial institutions, account for and disclose European debt exposures will likely intensify in 2012. The SEC recently “encouraged” enhanced and more transparent disclosure of debt holdings of Greece, Ireland, Italy, Portugal, and Spain, regardless of materiality. Also, in an unprecedented move, the IASB criticized the inconsistent application of fair value standards to the accounting for distressed sovereign debt, including Greek government bonds.

Revisions to Leases and Revenue Recognition: The ongoing effort to overhaul lease accounting and revenue recognition will also likely come to a head in 2012. A revised exposure draft on revenue recognition was issued in November 2011 and the revised draft for leases is expected in the first half of 2012.

Exploring Mandatory Auditor Rotation: The European Commission (EC) and the U.S. Public Company Accounting Oversight Board (PCAOB) are separately exploring significant changes to the audit industry. By far, the most controversial are draft proposals to force companies to change auditors over specific time frames. The EC proposed a six-year mandatory rotation with a possible two-year extension, while the PCAOB left the terms open for constituent feedback. If finalized, the eventual outcome of these proposals, which are still in their early stages, will likely reshape the audit landscape.

U.S. Incorporation of IFRS — Prolonged, Cautious, and Incremental

Against all expectations, the U.S. decision on whether to incorporate IFRS into U.S. GAAP was delayed in 2011. At the moment, the quandary seems to have moved beyond whether or not to incorporate IFRS, to how best to incorporate IFRS into U.S. GAAP. While a yes or no decision appears simple and straightforward, the path to a yes decision is a lot more nuanced and complicated.

Generally, the countries that have adopted IFRS have done so in three distinct ways. The first is the wholesale adoption of IFRS as issued by the IASB, without any local interference. For example, IFRS standards issued by the IASB automatically become law in Israel and South Africa, without a local regulator having to ratify the IFRS.

The second method of adoption is generally known as the endorsement approach, and it is applied by most countries using IFRS today, including the European Union countries. With this approach, accounting standards issued by the IASB have to be ratified individually by a local regulator before becoming the law of the land. This approach preserves the flexibility to deal with country-specific issues and, therefore, results in some variability across countries.

The final method of adoption is the convergence approach. The country chooses not to formally incorporate IFRS into local GAAP but makes every effort to converge local GAAP to IFRS. This has been the approach in China and, arguably, the U.S. approach so far. The convergence approach, particularly U.S. convergence, is now generally regarded as tedious and sub-optimal, precipitating the clamor to move away to what will most likely be an endorsement approach.

Three Broad Methods of Incorporating IFRS

	Wholesale Approach	Convergence Approach	Endorsement Approach
Description	Full adoption of IFRS as issued by the IASB.	No formal plan to adopt IFRS. Local standards are revamped to substantially mirror IFRS.	IFRS as issued by the IASB will be endorsed into local GAAP by local regulator. Local regulator may add, remove, or amend IFRS for country-specific reasons.
Countries	South Africa, Israel	China, U.S. (until date)	European Union, Australia

Source: Fitch.

Of the three methods described in the table above, the wholesale approach is completely out of contention, while continuing the convergence approach indefinitely is also highly unlikely, given the sub-optimal outcome. This leaves the endorsement approach as the only viable option. The endorsement approach will be a compromise (has been referred to as a “condorsement” — a convergence and endorsement) as U.S. GAAP will be retained and IFRS will be endorsed into U.S. GAAP going forward. The IASB will be the primary standard-setter, while the FASB will endorse IFRS and also retain its ability to set additional standards for U.S.-specific issues.

This compromised approach not only preserves some measure of control of the accounting standards that will be incorporated into U.S. GAAP, but it should also preserve FASB’s active participation in global standard setting. In the long term, the U.S. should end up with a set of global accounting standards that are overwhelmingly converged with IFRS. In addition, U.S. GAAP will be retained as the statutory basis of financial reporting; therefore, legal documents and regulations that refer to U.S. GAAP will be preserved. This should minimize transition costs.

The other major decision to be made by the SEC is the form in which companies will transition to using IFRS standards or “U.S. endorsed IFRS.” Again, there are three broad alternatives being contemplated.

First is the mandatory adoption on a specified date by all companies. This approach will require a long lead time (some have suggested five years) to a specified date to allow for adequate preparation. It is the least likely option. The second alternative will be a staggered approach where certain industries will be mandated to adopt at specific dates over a period of a year or two. The final alternative, which could be challenging to implement, is the option for certain large multinational companies to early adopt IFRS if found to be desirable. All other companies will later be required to adopt a year or two afterwards. This is an option rather than a mandatory requirement and if this alternative is pursued, we could be looking at “U.S. endorsed IFRS” a lot sooner than expected.

If an early option is granted, IFRS expertise would develop among issuers, auditors, and analysts and later adopters would be able to learn from the best practices of the early adopters both in terms of initial adoption strategies as well as general IFRS practice. Investors and analysts in the U.S. should also gradually become more familiar with financial statements prepared in accordance with IFRS. However, comparing U.S. companies in the same sector with different accounting regimes becomes a telling challenge.

Financial Instruments — An Enigma Wrapped in a Puzzle

The goal of developing a largely converged IASB/FASB accounting standard on financial assets and liabilities instruments has been a conundrum in many ways. Thus far, there have been four distinct parts to the financial instruments project with major decisions expected on three of the four parts in 2012. The four parts include classification and measurement of financial instruments, credit impairment, hedge accounting, and the netting of financial assets and liabilities.

Classification and Measurement of Financial Instruments

The IASB completed IFRS 9 Financial Instruments in 2010, effectively preserving the dual measurement approach (amortized cost and fair value) for classifying financial instruments. However, IASB’s recent decision to postpone the required effective date for IFRS 9 from Jan. 1, 2013, until Jan. 1, 2015, with an option to early adopt gives the board enough time to finish related standards before all companies have to implement the standards.

Classification of Financial Assets and Liabilities

Current FASB Model	FASB’s 2010 Model	Revised FASB Model (Expected in 2012)	IFRS 9
FV–NI (Trading Securities)	FV–NI (Default)	FV–NI	FV–TPL
FV–OCI (Available for sale securities)	FV–OCI	FV–OCI (excludes financial liabilities)	FV–OCI (excludes financial liabilities)
Amortized Cost (Loans held to maturity securities)	FV–OCI	FV–OCI (excludes financial liabilities)	FV–OCI (excludes financial liabilities)
LOCOM (Loans held for sale)	Amortized cost (Very limited, excludes loans)	Amortized cost (Includes loans and most financial liabilities)	Amortized cost (Includes loans and most financial liabilities)
Includes own credit on income statement	Includes own credit on income statement	Excludes own credit on income statement now OCI	Excludes own credit on income statement now OCI

FV–NI – Fair value through net income. FV–OCI – Fair value through other comprehensive income. FV–TPL – Fair value through profit or loss. LOCOM – Lower of cost or market.
Source: Fitch, FASB, IASB.

In addition to the extension, the board also announced "limited" improvements to IFRS 9 in order to bridge some differences between the IASB and FASB and also address issues pertaining to the interaction of the project with insurance contracts. The specifics on the limited improvements will unfold in 2012.

The FASB is also likely to re-expose for comments its ongoing work on classification and measurement of financial instruments. After backpedaling from what was largely a full fair value model proposed in 2010, the FASB has now outlined another classification model which is a lot closer to IFRS 9 and also keeps the dual measurement approach of amortized cost and fair value.

Credit Impairment — Expected Loss and the Three Bucket Approach

The "incurred loss model" was heavily criticized in the aftermath of the financial crisis for being "too little too late" in recognizing credit losses by financial institutions. This led the two boards and regulators to conclude that a new, more forward-looking approach (tagged "expected loss") was needed. A good book/bad book approach was abandoned in the first half of 2011, and the "three bucket approach" was introduced.

Incurred Versus Expected Loss

The incurred loss model requires recognition of an impairment loss when there is objective evidence that a loss event has occurred that will negatively affect the future cash flows of the asset.

The expected loss model does not wait for the loss to occur before recognizing impairment. It requires companies to continually reassess expected losses at inception and throughout the life of the asset.

For example, in assessing a credit card portfolio, changes in employment trends could trigger the recognition of impairment immediately under the expected loss model. On the other hand, the incurred loss model requires objective evidence in the form of missed payments.

The three bucket approach divides loans and debt instruments into three categories in order to determine the amount and timing of credit losses to be recognized as a result of expected credit impairment. All debt instruments, including loans, will go into the first bucket at inception, and companies will be expected to reserve for all losses expected in the next 12 months in bucket one. Debt instruments will migrate to buckets two and three as companies determine that there is more than insignificant deterioration in credit quality, and it is at least reasonably possible that cash flows will not be fully collected.

The primary difference between bucket two and three is based on the unit of measurement. Therefore, bucket two will capture assets on a collective basis, while bucket three captures financial assets evaluated individually.

A final joint exposure proposal is now expected in 2012, and a final standard on credit impairment may not be forthcoming until 2013.

Hedge Accounting — No Current Efforts to Converge

The FASB and IASB are pursuing hedge accounting projects with very different timetables and scope. The IASB is now set to release a new standard on hedge accounting that will significantly relax the threshold needed to achieve hedge accounting. The FASB is also seeking to improve hedge accounting; however, the project has taken a backseat to the classification, measurement, and impairment of financial assets and liabilities. The FASB still has a decision to make in 2012: continue with the path of narrow simplification, which it proposed in 2010, or take a much broader approach to revamping hedge accounting like the IASB.

Netting Financial Instruments — Preserving the Status Quo

The FASB and the IASB agreed to disagree on the final project to align the netting of financial assets and liabilities. The two boards could not agree on aligning the accounting difference that usually results in the largest single difference (particularly for derivatives) in the balance sheet of financial institutions that are filing under the IFRS framework and U.S. GAAP. This effectively preserves the very restrictive rules on netting for IFRS filers and the more accommodating rules in U.S. GAAP.

Because the differences will be preserved, the boards opted to improve disclosures, which should provide enough information to mitigate the lack of comparability on the balance sheet. New disclosures on pledged collateral and credit risk will also be welcomed by analysts and investors. The new disclosure rules are mandatory from January 2013; however, we may begin to see some of the recommended disclosures in 2012.

The outcome of the netting project in some ways calls into question the whole notion of convergence. It clearly shows that the stated goal of eliminating differences between IFRS and U.S. GAAP remains an ideal goal and reality may not necessarily conform to the ideal.

More footnote disclosures are increasingly becoming the solution of last resort when the FASB and the IASB cannot agree on an identical approach. While disclosing differences between the two accounting regimes ultimately enhances comparability, it contributes to the increasing complexity and volume of financial statements globally. This trend, if not curtailed, adds to the growing sense that true convergence may never be achieved between U.S. GAAP and IFRS.

Sovereign Debt Exposures — More Disclosures to Come

The widely divergent valuation of Greek bonds on the balance sheet of many large financial institutions at various times in 2011 rightly drew the scrutiny of regulators in the U.S. and in Europe. Investor and regulatory scrutiny is likely to continue in 2012, particularly if the debt crisis in Europe continues to intensify. Unsurprisingly, sovereign bond exposures linked to Italy, Ireland, Spain, Portugal and Greece have thus far been the focus of attention.

In an unprecedented move, the chairman of the IASB openly complained about the lack of consistency in write-downs associated with Greek bonds in August 2011. Afterwards, Europe's securities regulator, the European Securities and Markets Authority (ESMA), added pressure to banks and auditors, openly disagreeing with the relatively mild write-downs of some financial institutions in Europe in third-quarter 2011.

The SEC recently issued disclosure guidance to all registrants pertaining to the direct and indirect exposures to European sovereign debt holdings. The regulator cited current uncertainties together with the lack of transparent, comparable information in calling for precisely detailed country-by-country disclosure on sovereign and nonsovereign debt exposures. Particularly, the SEC encouraged more disclosure on gross funded and unfunded exposures, the effects of credit default protection to arrive at net exposures and other qualitative disclosure on how management is monitoring and/or mitigating direct and indirect exposures to specific countries.

Currently, disclosure is generally limited to aggregate claims outstanding to a country greater than or equal to 0.75% of a bank's assets. Consequently, it is not possible to gather complete exposures for all countries. Total country exposures include deposits, central bank balances, securities, loans, participations, acceptances, fair value of derivatives, and reverse repos, among other items, but details of many categories are not disclosed.

Exposures to Stressed European Markets (Greece, Ireland, Italy, Portugal, and Spain)

($ Bil., As of Sept. 30, 2011)	BAC	C	JPM	WFC	GS	MS
Net Exposures (Including Commitments)	13	16.4	15.2	3.1	3.3	3.4
Sovereign	0.4	2	4.5	0	N.A.	N.A.
Hedges	1.7	9.2	5.2	0	1.7	3.6
Gross Exposures	14.6	25.6	20.4	3.1	5	7
Net/Total Assets (%)	0.60	0.80	0.70	0.20	0.30	0.40
Gross (Before Hedges)/Assets (%)	0.70	1.30	1.00	0.20	0.50	0.90

BAC − Bank of America Corp. C − Citigroup, Inc. JPM − JP Morgan Chase & Co. WFC − Wells Fargo & Co.
GS − Goldman Sachs Group, Inc. MS − Morgan Stanley. N.A. − Not available.
Source: Company reports.

In the U.S., direct sovereign exposure represented a small fraction of total net exposure for the banks disclosing this information. Not all large U.S. banks disclosed the sovereign component as detailed above. Exposures to corporations and financial institutions are generally more sizable and a large part of the corporate exposure is to the operations of multinational corporations in those markets.

Large U.S. banks have been reducing direct exposure to stressed markets for well over a year. Overall, net exposure appears manageable but not without financial costs. Aggregate net exposure to these markets totaled approximately $50 billion at third-quarter 2011 for the six largest U.S. banks. The extent of hedges to large European markets is not fully disclosed, but the top six U.S. banks had $22 billion in hedges associated with the stressed markets.

Fitch supports the call for additional detailed disclosure by the SEC, which should hopefully serve as a guide to companies using the IFRS framework — even though they are not required to follow U.S. SEC guidance.

Revised Exposure Drafts on Leases and Revenue Recognition

The ongoing effort to overhaul lease accounting and revenue recognition will also likely come to a head in 2012. A revised exposure draft on revenue recognition was issued in November 2011, and the revised draft for leases is expected in the first half of 2012.

The latest exposure draft on revenue recognition is largely consistent with the 2010 version. However, the latest version clarifies a number of principles in the 2010 draft and significantly boosts disclosure. A final standard will likely be required for all companies no earlier than Jan. 1, 2015 for IFRS and U.S. filers. However, IFRS filers will have the option to early adopt.

For simple customer transactions and revenue contracts, the proposed revenue 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 services, revenue recognition may be delayed until the very end of the transaction with some exceptions.

The leasing project, which eliminates almost all operating leases, is also now planned for completion in 2012. A new exposure draft is expected in the first half of 2012. The two boards

have struggled with the accounting model for lessors, particularly with the scope exception for lessors of investment properties, having largely developed a widely acceptable model for lessees (*see Fitch's report, "Global Lease Accounting Proposal: Will It Change Credit Metrics or Corporate Behavior?" dated Dec. 9, 2010*).

As it stands, lessors of investment properties will continue to apply current operating-lease accounting rules that allow for the straight-lining of rental income. This exception does not extend to lessees of investment properties. Therefore, the general principle of accounting symmetry between lessees and lessors, to which the boards have tried to adhere, will likely be violated with investment property leases.

Exploring Mandatory Auditor Rotation — Resistance May Doom Effort

The EC and the PCAOB are separately exploring significant changes to the audit industry. By far the most controversial are draft proposals to force companies to change auditors after a stated time frame.

The EC proposed a mandatory six-year auditor rotation with a possible two-year extension, subject to regulatory approval. The proposal also seeks to encourage joint audits by allowing a mandatory nine-year rotation, also with a possible three year extension. In addition to the mandatory rotation of audit firms, the EC proposed an outright ban on the provision of consulting services to audit clients and is seeking to force large accounting firms to spin-off their consulting arms.

In the U.S., the PCAOB also issued a concept release in August 2011 to seek public comments on mandatory audit firm rotation; a public roundtable is planned for the first quarter of 2012. The concept release is a list of 21 questions about if and how auditor rotation should be required. The release did not specify a definitive period; instead, it asked constituents to respond with advantages and disadvantages of terms of 10 years or greater.

In addition to the concept release on auditor rotation, the PCAOB also issued another proposal for public comments on the auditors report by proposing to change the standard audit report. Specifically, the concept release proposes an Auditor's Discussion and Analysis (AD&A) as a supplement to the current mechanical form of audit reports. Just like the Management Discussion and Analysis provides management's perspective on the company, the AD&A would be designed to provide the auditor's perspective on audit risks, procedures, results, etc.

The U.S. and E.U. proposals on mandatory rotation still has some ways to go before becoming final. Proponents cite the need to improve auditor independence and audit quality as the primary reason for supporting the rotation of audit firms, while opponents cite operational challenges as the bane of the proposal. The proposal stands more of a chance to become final in the E.U., while stiff resistance by accounting firms and issuers may prove to be too formidable for the proposal to become law in the U.S.

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