Accounting's Perfect Storm

Critical 2011 Events Will Change Financial Reporting as We Know It!

By William F. O'Brien, MBA, CPA
Santa Clara University
Executive Education, Inc.

According to Wikipedia, a *perfect storm* is a rare combination of circumstances that aggravates a situation drastically. The accounting profession most likely will face such an experience in 2011.

Three events have the potential to alter dramatically financial reporting for both public and non-public companies alike. The events are:

- International Financial Reporting Standards (IFRS) adoption by public companies
- Introduction of major GAAP revisions for private companies and
- Reformatting of everyone's financial statements.

What makes the situation even more complex is the fact that different agencies are driving each initiative. The Securities and Exchange Commission (SEC) is responsible for IFRS adoption. The Financial Accounting Foundation (FAF) and the American Institute of CPAs (AICPA) are driving the GAAP revisions. The Financial Accounting Standards Board (FASB), as the third party to the process, owns the reformatted financial statement convergence project.

This article will explore the conditions that formulate ***Accounting's Perfect Storm***. My primary goal is to both alert and alarm you with respect to the approaching changes. Ideally, it will generate interest and, hopefully, action to help you weather the impending storm. Never before in the history of United States accounting have so many critical events occurred together. Let us prepare ourselves for the impact!

How This Article Evolved

For the past twenty years, I have taught undergraduate and graduate international accounting courses at Santa Clara University in California. Previously, I was a senior financial executive at several high technology companies in California's Silicon Valley. As the IFRS adoption initiative gained traction, I eagerly awaited the globalization of financial reporting. The situation was dynamic and, often, unpredictable. Clearly, the impact of this event was beyond the scope of a "simple" change in GAAP. It represented a modification in day-to-day operations as well. The pending IFRS adoption for public companies immediately spawned the non-pubic GAAP recommendations. At the same time, changes were also occurring in basic financial statements form and content. It suddenly hit me! All three of these changes were occurring simultaneously.

As I travelled around the country presenting a variety of continuing education programs for state CPA societies, I found that, while many CPAs had working knowledge of the pending IFRS adoption project, most had limited knowledge, at best, of the other two issues. This article attempts to rectify that condition.

The Components of the Storm

As I mentioned earlier the three elements of ***Accounting's Perfect Storm*** are IFRS adoption, non-public company GAAP and financial statement reformatting. Let's briefly explore each one.

IFRS Adoption

In November 2007, the SEC shocked the financial reporting world by announcing their acceptance of IFRS-based financial statements for foreign registrants. They no longer required the time consuming and, often, confusing reconciliation between IFRS and GAAP. In an even more surprising move, the Commission indicated it would explore IFRS adoption by domestic companies.

The following year, the SEC generated a ***Roadmap for Adoption*** that included an early implementation option and a general transition date of 2014. Few companies responded during the original comment period. After a two-month extension, the comments, while generally favorable, indicated the perception that events were moving too fast. Businesses began to realize that more than a simple change in accounting standards was taking place.

The SEC realized this as well and updated their timetable in 2010. The early adoption option disappeared and the anticipated transition date was tentatively set for 2015.

The Commission expects to make a final decision sometime in 2011 pending the successful resolution of several key issues—the most significant of which is on-going progress of the joint FASB-IASB convergence project. In April, both boards announced substantial progress in their efforts.

As I prepare this article, the next step in the adoption process is a July roundtable in which SEC staff will discuss with issuers the benefits or challenges in potentially incorporating IFRS into the U.S. financial reporting system. Look for the results of this meeting on www.ifrs.com–the AICPA's IFRS webpage.

Non-public Company GAAP

As efforts moved forward on IFRS adoption efforts, a new issue surfaced—accounting standards for small and medium-sized enterprises (SMEs). IFRS users eagerly awaited a new standard on IFRS for SMEs. In July 2009, the International Accounting Standards Board issued the standard.

In a prepared video announcement, the AICPA recognized the importance of this standard to private companies in the United States. Small businesses would not have to comply with the more complex aspects of full IFRS adoption. The AICPA went so far as to prepare an implementation "wiki" on their website.

In the fall of 2009, after further review with senior members of its council, the Institute announced the creation of a Blue Ribbon Panel to assess further private company financial reporting in the U.S. Rick Anderson, the former Moss Adams, LLP, chairman headed the panel.

The panel considered a variety of private company reporting options, but dropped the use of IFRS for SMEs as a recommended alternative. Earlier this year, it proposed the Financial Accounting Foundation (FAF) establish a separate board to identify private company exceptions and modifications to GAAP. The five-person board would report to the FAF and focus on creating financial reports of use to lenders and other private company stakeholders. The panel further recommended re-evaluation of its proposed changes in the 3-5 year timeframe.

The FAF has established a working group to evaluate the adequacy of FASB's efforts to set standards for the private company and nonprofit sector. Expect final resolution of these proposals later in 2011.

Financial Statement Reformatting

With both public and private companies focusing on changes in accounting standards, an elephant snuck into the room. In the fall of 2008, the FASB—as part of the convergence project—published its proposal for changes in the form and content of traditional financial statements. The proposal went largely unnoticed.

In July 2010, a detailed staff draft of an exposure draft updated the original proposal. Interest began to climb. It was becoming clear that the world of financial reporting under both GAAP and IFRS was on the brink of change. The proposal realigns the balance sheet and the income statement along the lines of the statement of cash flows. The statements reclassify assets, liabilities, revenues and expenses into operating, investing and financing categories. New terms such as business assets and business income appear.

The balance sheet becomes the statement of financial position. The income statement becomes the statement of comprehensive income and the statement of cash flows abandons the indirect method for operating cash flows.

Although the FASB is deferring a final pronouncement on these changes until the end of 2011, many experts believe an implementation date of 2013 is possible.

What Does This Mean?

There you have it. Three significant events are all coming to a head in 2011-- public company reporting, private company reporting and financial statement formats for all enterprises.

All three of these activities have distinctive timetables. Moreover, as noted above, they each have different agencies as their decision makers. It boils down to a period of dramatic change for all businesses.

In order to meet successfully the challenges these issues will present, companies need to prepare. Here are ten tactics for addressing these challenges—tactics you can implement today!

Ten Tactics for Preparation

The table to the right shows the Ten Tactics for Preparation. Let's explore each one in detail.

Determine What Impacts You

The initial step a company needs to take is deciding which perfect storm elements will affect your business. The division between public and private company may seem trivial; however, lending, underwriting or business strategy considerations may force many private companies into public company reporting. Decide in which camp you reside and the approximate the impact date or dates. Many issues cannot be successfully addressed at once.

Identify Your Experts

The number of IFRS, SME reporting and convergence experts currently on the payroll will surprise most companies. These employees bring formal

Table 1

Ten Tactics for Preparation

1. Determine What Impacts You
2. Identify the Experts
3. Consider the Issues
4. Develop a Plan for Success
5. Generate Pro-forma Financials
6. Keep Executive Management Informed
7. Monitor the Landscape
8. Continuously Improve Competencies
9. Communicate with Critical Stakeholders
10. Don't Panic

education, IFRS-based reporting experience and direct foreign subsidiary management expertise to the office every day. Take advantage of their skills. Prepare a roster of these critical subject matter experts.

Consider the Relevant Issues

Using your team of financial subject matter experts, meet with senior management and assess how the storm will impact your business. Impact areas will include at a minimum, computer systems, financial reporting policies and procedures, user education, incentive compensation, loan agreements, tax planning, and performance metrics. Brainstorm each of these areas to avoid surprises as your implementation plans move forward. Remember, the more your can do without consultant assistance the less costly the process becomes.

Develop a Plan for Success

Approach this process as product development or construction project. Prepare an activities timeline with deadlines and individual responsibilities. Review the plan frequently since the storm is dynamic and may suddenly change direction. Use this plan as a vehicle for updating senior management and other key stakeholders, including your external auditors. Recall the old adage: "Those who fail to plan; plan to fail."

Generate Pro-forma Financials

Access the FASB's website and download a copy of the staff draft of the financial statement presentation exposure draft. Use this document to prepare several pro-forma financial statement alternatives. Once again, your financial subject matter experts will provide valuable assistance in completing this task. Depending on your company's unique facts, circumstances and business strategy, I would suggest three sets of pro-forma financials:

1. New format financials based on current U.S. GAAP
2. New format financials based on IFRS or proposed private company U.S. GAAP
3. Current format financials based on IFRS or proposed private company U.S. GAAP.

These modified financial statements will highlight the most significant measurement and reporting changes areas. Identifying these key areas will help focus your management team's efforts in dealing with the relevant day-to-day business issues, including the all-important loan covenant discussions with your lenders.

Keep Executive Management Informed

Do not keep executive management in the dark. Although your operating management will most likely participate in transition activities, executive staff will generally remain interested observers—some more interested than others. Take the time to positively support the reasons for these changes and the numerous long-range benefits of globally consistent financial reporting. Consider this fact. Research showed a sixty basis-point drop in the cost of capital when the European Union adopted IFRS in 2005.

In addition, keep the Board of Directors and C-Suite occupants up-to-date on the current status of the storm's three components and your company's preparation efforts. Quarterly updates should become a standard reporting practice.

Finally, encourage executive management to critically respond to the regulators serving as the decision makers in the process. This is an extremely important task. If the regulators do not hear from the issuers, the entire implementation project can veer from a practical enhancement to a more theoretical exercise.

Monitor the Landscape

Stay current! Begin with the AICPA's IFRS website and continue with the dedicated websites of your current auditors. Routinely scour the media for updates in each storm component. You may nominate one of your financial subject matter experts as your company's "Weather-person". This individual will have the responsibility to monitor the information sites and report on any significant happenings that might potentially impact the company. In addition, the Weather-person can also provide the executive management team motivation and resources in their on-going communication with regulators.

The landscape will change. Don't get caught in an unexpected downpour!

Continuously Improve Your Competencies

Begin a personal commitment to continuing education not only in the the financial reporting field but also in the business areas impacted by the storm. If you initiate the process now, the large volume of required knowledge will not seem as daunting in the future.

Lay out a formal curriculum for both yourself and your staff. Look for sources of interesting, but relevant, courses. Discover what other companies are doing in response to the storm.

As you become more knowledgeable, it will be easier for you to communicate concepts to your co-workers. It addition, you will become more versed in dealing with the business issues related to the transition efforts. This will ultimately help to ease the the entire process's complexity.

Communicate with Critical Stakeholders

Communicate, communicate, communicate! As the storm clouds gather closer to our shore, rumors and concerns will heighten. Consider producing a periodic newsletter relating current status, preparation activities and issues important to each stakeholder. For example, employees are generally more concerned about workload rather than bond ratings. Keep the various readers' perspectives in the fore-front of your mind.

Pay special attention to your external auditors. Make sure that they are clearly on the same page as your financial subject matter experts. Failure to do this could result in some unexpected reporting surprises downstream.

Don't Panic

Remember this is simply a process, rather large and encompassing, but none the less, a process. Approach it step-by-step. Do not allow yourself to become over-whelmed. Your company will not be the only player in this game. Listen and learn from what other organizations are doing. Become a sponge for information.

Above all, start now! Do not procrastinate.

Some Final Thoughts

Change is never easy. Learning to adapt to new environments and embracing new perspectives is equally challenging. Ten simple steps of anything rarely solve the complex issues we face in business and life. It is my desire, however, that these Ten Tactics for Preparation will encourage you to adapt and embrace the changes and challenges you face, as the "Perfect Storm" gets closer in the months ahead.

The preparation you take today will help protect you from the future's unknown impact.

WILLIAM F. O'BRIEN, MBA, CPA, a Santa Clara University faculty member, is an internationally recognized author and lecturer in the areas of corporate financial management and international accounting. He is an Executive Education, Inc. discussion leader and a frequent speaker at professional CPA events.