Litigation Risk Unabated Following Failed Efforts at ACCOUNTING CONVERGENCE

by,
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After more than a decade of efforts designed to achieve so-called convergence between the financial reporting standards mandated in the U.S. (U.S. GAAP) and those employed by much of the rest of the world (International Financial Reporting Standards, or IFRS), the death knell was seemingly sounded this summer when IASB chair Hans Hoogervorst stated that fully achieving this is now out of reach.

More specifically, as both FASB and IASB wind up work on major projects such as accounting for leases and the procedures to be mandated for the recognition of credit losses – as required for banks regarding their loan portfolios and for other financial instruments held as investments – it is now clear that divergent paths will be followed. Although both standard setting bodies have sound reasons for their differing solutions to these admittedly complex accounting issues, it will mean that investors will continue to face "accounting risk" as they attempt to make decisions on the basis of financial reports prepared under alternative reporting regimes. It also means that outright adoption of IFRS in the U.S., the prospects for which have already dimmed under current and immediate-preceding SEC leadership, is now quite unlikely to occur.

The failure to converge financial reporting standards employed by U.S.-based and the vast preponderance of foreign-based publicly-held enterprises is, however, only one element contributing to the anticipated continuation of difficulties for those attempting to make investment or other decisions based on published financial statements and information based thereon.

Even within specific jurisdictions, such as the U.S. and Canada, there have been and will continue to be a proliferation of financial reporting regimes, albeit the other sets of standards are not intended for publicly-held entities' use. However, in terms of litigation risk, the profusion of reporting regimes is a concern, given that many disputes (e.g., regarding post-acquisition performance of purchased or merged operations) do erupt into lawsuits – such as when earn-outs are impacted by changes in accounting practices imposed by acquirers, or when post-acquisition audits find unexpected accounting methods that, with benefit of hindsight, may have distorted the reported results of operations upon which purchase price multiples were applied.

For example, Canada adopted IFRS in 2011 for publicly-reporting enterprises, superseding Canadian GAAP, which was largely identical to then-extant U.S. GAAP. For privately-held entities, it was decided to create a new, somewhat streamlined set of financial reporting rules, based not on IFRS but on old Canadian GAAP. In so doing, the standard-setters chose to reject an already-formulated, simplified version of IFRS known as IFRS for SMEs (the reference to "small and medium-sized entities" being a misnomer, in any event, since these are usable by entities having no public-reporting responsibilities, of whatever size). A similar situation exists in the U.K., where a smaller-company reporting regime known as FRSSE (Financial Reporting Standards for Smaller Entities) has been in place since 2001.

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In the U.S., two separate groups, FASB and the American Institute of Certified Public Accountants (AICPA), are each developing financial reporting frameworks for this same target group – companies not having or planning on having public reporting obligations – and these will be dissimilar from each other. Furthermore, privately-held businesses often employ either the income tax basis or the cash basis for financial reporting, which are also distinct from the previously cited sets of standards. Leaving aside contractually prescribed, statutory or regulatory financial reporting regimes applicable to some entities, such as insurers, those engaging in financial or other transactions with U.S. companies will soon have at least seven alternate financial reporting schemes (since U.S. auditors are also permitted to opine on financial statements prepared under full IFRS or under IFRS for SMEs) about which to remain cognizant when attempting to parse information upon which investment, merger and acquisition, or other decisions are to be made.

There are other implications of this unsettling state of affairs. For corporate counsel, the need is to urge that clients engage in the most thorough due diligence when reviewing potential acquisitions, in order to avert misunderstandings. For business litigators, there is a need to gain knowledge about – or retain assistance from qualified accounting experts regarding – the diverse range of financial reporting practices engaged in by those transacting acquisitions or other business arrangements such as joint ventures.

In the author's experience, accounting risk (the risk that financial information being relied upon does not mean what the reader assumes it does, not because of fraud but rather because the underlying principles of recognition, measurement, presentation or disclosure are not those presumed applicable) is often underestimated, because many decision-makers lack an accounting background and because more substantive matters, such as the existence and condition of physical assets, extent of order backlogs, and status of labor contracts are given primacy in due diligence exams.

The profusion of litigation resulting from "buyer's remorse" – hardly limited to such headline cases as those involving Caterpillar's recent Chinese acquisition or Hewlett-Packard's British one – should, however, stand as testimony to the ubiquitousness of costly and reputation-damaging misunderstandings arising from accounting miscommunications. Counsel can and should assist in mitigating these occurrences.

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