2015 Could Be a Big Year for Accounting Changes, Risking Future Disputes

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Certain changes in accounting rules portend risks for attorneys and their business clients because they give rise to misunderstandings that sometimes escalate into litigation or regulatory concerns. Such changes have been slow to come to fruition in 2014, but two that have been under development for years, pertaining to how revenues are to be recognized and how leases are to be presented, are projected to take effect in the 2017/2018 timeframe. Coming a bit later will be a major change in how expected credit losses on financial instruments, including routine customer receivables, will have to be recognized.

After a long gestation period, the joint FASB-IASB project to produce a uniform set of revenue recognition principles was finalized in May 2014, superseding a host of industry-specific guidance and fundamentally altering the concept of revenue recognition to embrace, somewhat counter-intuitively, a balance sheet framework. For many businesses, such as retail merchandising, changes might prove to be minimal. For more complex businesses – where there are actual contractual commitments to produce or sell goods or services – timing of recognition will likely change. Particularly when performance is to occur over an interval of time, internal accounting procedures will have to become capable of identifying multiple "performance obligations" as they are satisfied over time.

Disputes over timing of revenue recognition – perennially a top-named culprit in financial reporting fraud allegations – are likely to increase as reporting entities struggle to adapt the new rules. The complexity of the rules and difficulty in making systems changes should not be underestimated. Publicly-held companies ("issuers") need to have already begun implementation efforts; private companies should begin their efforts to address this in early 2015.

The other dramatic change in financial reporting, not yet finalized but a virtual certainty to be completed during 2015, pertains to leases, and will impact reporting by both lessees and lessors. Simply put, the long-desired "off the balance sheet" treatment of so-called operating leases will no longer be permitted, with only minor exceptions. Essentially all leases of real and personal property will be treated as acquisitions of "rights to use" assets, with corresponding long-term obligations to be reported as liabilities. Among other things, this will impact debt/equity ratios and, when the changes become effective, will instantly create debt covenant compliance challenges for many companies, unless relief has been preemptively sought from and granted by lenders, or if covenants had "frozen GAAP" provisions that, in effect, grandfathered the GAAP accounting methods being followed at the inception of the covenants.

In contrast with the revenue recognition standard, where full US – international convergence was achieved, it now appears that the IASB version of the new lease standard will differ, in a significant way, from that adopted in the US, adding to challenges for multinational companies and for investors and other users of financial statements from various jurisdictions.

Under the US approach, many leases (particularly those involving real estate) will result in a hybrid approach for lessee financial reporting: for the balance sheet, capital lease treatment will be adopted, with full capitalization of the future property use rights and related debt; for the income statement, straight-line recognition of rental expense will persist. The income statement treatment for most equipment leases will be similar to the manner that capital leases are handled under current practice with expenses being recognized for a combination of declining interest as the lease obligation is reduced over time and straight-line amortization of the right-of-use asset. A slew of specific computational directives will address such matters as cancellation clauses, renewal options, variable lease payments, and other features affecting the amounts to be recognized.

FASB is re-deliberating the most recent version of the proposed lease standard, and is very likely to finalize it in 2015, although reporting entities will be given extended time for implementation. However, since retrospective application is expected to be required – existing leases will need to be recast to comply with the new rules – a significant, possibly costly, effort will be needed.

A third major convergence project addresses recognition of impairments on financial instruments, such as accounts receivable, loans receivable, and investments in bonds, that are generally accounted for on the basis of historical cost, rather than fair value. Impairments of these instruments, held as assets, have, in the US, only been formally recognized – i.e., accrued – when a relatively high threshold of likelihood (called "probable," which experts say means something in excess of an approximately 75% expectation) has been met. (Under corresponding international accounting rules, a likelihood of just over 50% has generally been prescribed for recognition.) Following the financial crisis of 2008, many critics argued that this approach had delayed the accounting recognition of diminished creditworthiness, and then exaggerated the suddenly reported losses, which thus contributed to panic-driven further declines.

In response, the former approach (in hindsight called the "incurred loss model") will be replaced by a "current expected loss model," which will require that probability-weighted loss estimates, no matter how minor, be given income statement recognition. This will provide continuous (i.e., quarterly or annual) reporting of deterioration in the credit quality of such instruments, via adjustments of the allowance for uncollectible receivables or other appropriate contra-asset (sometimes called valuation) accounts. In theory, this would have given earlier warning of deteriorating prospects for realization of amounts owed to banks, companies, and other entities, which investors and other users could have better employed in making investment, credit granting and other decisions. This project, ongoing since 2008, should come to a conclusion in 2015, and will have a significant impact on many companies, both issuers and non-issuers. It is hoped that the U.S. and international versions of this standard will be fully converged, but this is not a certainty.

As always, these enacted and prospective changes increase the risk, in the near term, that honest errors will be made during implementation, that some users will misperceive reported effects on financial statements, and, unfortunately, that some may attempt to deliberately misapply them to distort financial position and results of operations. If past experience is any guide, some of these missteps might result in disputes, even in civil litigation and allegations of fraudulent reporting. Early and close attention to both proper implementation of, and clear communications about, these new standards should be encouraged.

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