2009 Financial Reporting Year in Review:

CHANGES IN PRACTICES AND RULES, AND MORE ON THE WAY

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Contrary to some perceptions, accounting and financial reporting (commonly referred to as GAAP, or generally accepted accounting principles) are dynamic fields, constantly evolving to meet user demands for decision-relevant information, and to cope with the ongoing evolution and invention of new types of business transactions and structures, and complex instruments such as financial derivatives. Although grounded on a stable conceptual foundation, specific practices must and have changed to meet these challenges.

For several years, US GAAP has been actively evolving to meet the promise of convergence with another set of rules, international financial reporting standards (IFRS), and this has resulted in substantive changes. It is now expected that within the next half-decade it will be acknowledged that IFRS is to be the mainstream, if not universal, rule book for all financial reporting, not only in the wider world, but also in the US.

Additionally, the financial crisis that began in 2007, and which some predict may "double dip" in 2010, has raised to a high profile certain "fair value" accounting rules. Rightly or wrongly, some of these requirements have been blamed for exacerbating the crisis, and the accounting profession has responded by mildly moderating them, while professing its commitment to expanding the role of fair value measures in financial reporting.

Changes to GAAP can have major effects on financial reporting in general, and on certain classes of business transactions or requirements – including mergers and acquisitions, and computations of obligations under earn-out agreements and of compliance with debt covenants – in particular.

Changes to accounting rules, even when positive overall, can play havoc with obligations under already-completed transactions. Post-transaction changes in reporting standards can impact the continuing duties of the parties (e.g., under earn-out arrangements), in ways that may prove deleterious to one or the other. For this reason, a primary objective for parties engaging (and attorneys assisting) in acquisitions, joint ventures, or other transactions requiring ongoing involvements among multiple parties should be reaching explicit understanding of current GAAP, and how recent and forthcoming changes may affect the contractual provisions.

Some of the new pronouncements and other important developments over the past year are addressed below. Attorneys involved in any area of corporate or transactional law should be aware of these developments and how they affect their client's financial statements and recently completed or contemplated business transactions.

1. Variable Interest Entities – The use of these "off balance sheet" structures has grown exponentially in recent decades, primarily to isolate certain financing transactions (e.g., for securitizations of mortgage and other loans), but occasionally also to accomplish only financial reporting objectives. Abuses – both of the Enronesque variety and, recently, perceived problems flowing from the mortgage market melt down – have led to calls for reform. In response, the US standard setter, FASB, has recently released two major new standards that will alter past practices significantly. Most importantly, the concept of qualified special purpose entities has been deleted, which will bring billions of dollars of securitized assets and related debt back onto bank and other balance sheets, quite possibly chilling enthusiasm for such devices and altering market demand for such instruments. The full impact won't occur until 2010, at which time retrospective application may be needed; and future recognition of "gains on sale" will be constrained. These are likely to cause confusion among investors and other users of financial statements, and will alter the behavior of investors, lenders and others. The changes will require that financial structures be reevaluated, at least for all new transactions. Attorneys advising financial institutions and others need to quickly become familiar with these rules, in order to serve their clients' interests.

2. Fair Value Accounting – Issues surrounding fair value accounting continue to make headlines. Over the years, required use of fair value has expanded in financial reporting, in recognition of the relevance of such information for decision-making, and as information technology has made current fair value data more available and reliable. Accounting standards have evolved to include a so-called "fair value hierarchy," which contemplates the usage of subjective information when market data is unavailable or unreliable. The recent market conditions have contributed to volatility in such measures, which has been reflected in wide swings in reported earnings, particularly of financial institutions, which in turn has, in the public mind at least, resulted in an unwillingness to lend and consequential contraction of business activities. FASB was pressured by Congress, in particular, to relax some of its fair value requirements, which if fully responded to could have impaired the future utility of financial reporting. Wisely, FASB responded with modest changes while preserving key underlying principles. However, the changes will alter the extent to which fair value declines (e.g., on portfolios of securitized

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loans) are to be currently reflected in earnings, with a greater portion of losses likely to be reported directly in shareholders' equity (via so-called "other comprehensive income" adjustments), so users must be educated about them in order to fully appreciate the economic impacts of market conditions. Attorneys and their accounting advisors should assist clients – in both the issuer and user communities – about these modifications, which have now gone into effect.

3. Other changes - There have been a multitude of other changes to accounting standards in the past year. Most notable for CPAs, and others who must rely on accounting standards research, is the codification system introduced in July. Attorneys who have a familiarity with the previous, chronologically numbered system of FASB statements should be aware of this codification.

Most recently, there have been some changes to revenue recognition for arrangements that include certain software elements. These changes specifically apply to companies such as Apple and Palm, which can now account for revenue from hardware and software bundles all at once, as opposed to previously being required to use subscription accounting for nominally free software upgrades.

There have also been recent changes to accounting for business combinations. This has clarified initial recognition and measurement and subsequent accounting for assets acquired and liabilities assumed in a business combination arising from pre-acquisition contingencies of the acquiree.

Also, at the very beginning of this year, guidance was introduced to achieve more consistent determination of whether an other-than-temporary impairment of an asset has occurred. Issues surrounding asset impairment testing include topics ripe for manipulation by parties who desire a specific outcome in earnings calculations for reasons including surpassing or falling below earn-out requirements or compliance with debt covenants.

Perhaps the biggest financial reporting news of 2009 is the rapidly growing acceptance of IFRS, soon to be the norm in as many as 150 countries, and increasingly acknowledged even in the US. The SEC now permits foreign registrants to file under IFRS and has extended that right to large US companies, and is contemplating a complete adoption of IFRS perhaps as soon as 2014. Internationalization of business is the major impetus, and changes in CPA's ethical standards in 2008 make it now acceptable to opine upon IFRS-based financial statements.

1. IFRS – The plan for convergence with international accounting standards, initiated under former SEC Chair Cox, is still on the horizon. The new Chair, Mary Schapiro, has expressed some hesitation over the roadmap as currently prescribed, but the momentum seems unstoppable, and the importance of having a single set of global accounting standards was most recently stressed at the recent G-20 summit. Even absent explicit adoption, the ongoing convergence efforts of FASB and IASB have already resulted in the replacement of a number of older rules, in order to conform to IFRS (and a few older IFRS have been modified to embrace U.S. GAAP). In other words, whether IFRS are formally imposed or not, U.S. GAAP is in the process of becoming indistinguishable from IFRS.

2. IFRS for SMEs – In a major development, the IFRS standard setter, IASB, published an "all in one" standard for non-publicly accountable (e.g., privately held) entities this past summer (confusingly labeled as "small and medium-sized entities, or SMEs), with reduced complexity and simplified disclosures. This has received wide notice and may actually serve as the springboard for IFRS adoption in the US, as many smaller preparers have longed for decades for streamlined "small business GAAP." With the aforementioned change to AICPA ethical rules, IFRS for SMEs can be implemented by US businesses right now, and attorneys advising their clients should be aware of this, which could have implications for contractual provisions (e.g., bank loan covenants; purchase and sale agreements) as well as for ongoing reporting.

An awareness of recent and impending changes in financial reporting requirements can alleviate or avert future contention, underscoring the need for a detailed inventory of accounting methods being applied at the time of agreement drafting. The informed practitioner can minimize the risk of future misunderstandings and litigation by bringing a complement of skills to bear; the inclusion of GAAP analyses can enhance the likelihood of successful outcomes. ■

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