Interview:
Margaret Mulley, Senior Partner, Deloitte & Touche
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• Steve Showerman, Deloitte & Touche, LLP.
  Technical reviews by Partners at Deloitte & Touche, LLP:
  • Magnus Orrell
  • Ignacio Perez
  • George Garrett

Research Papers:
Fair Value Accounting and the Credit Crisis
Patrick Casabona,
The Peter J. Tobin College of Business, St. John’s University
Victoria Shoaf
The Peter J. Tobin College of Business, St. John’s University

Fair Value and Business Combinations
Nina T. Dorata
The Peter J. Tobin College of Business, St. John’s University
Ignacio Perez Zaldívar
Deloitte & Touche LLP

Fair Value Audit Guidance of Public and Non-Public Companies in Response to the Credit Crisis
Adrian P. Fitzsimons
The Peter J. Tobin College of Business, St. John’s University
Jeffrey L. Satenstein
Queens College of the City University of New York
Benjamin R. Silliman
The Peter J. Tobin College of Business, St. John’s University

Ethics is Imperative to Effective Fair Value Reporting
Teresa M. Cortese-Danile
The Peter J. Tobin College of Business, St. John’s University
R. David Mautz, Jr.
University of North Carolina, Wilmington
Irene M. McCarthy
The Peter J. Tobin College of Business, St. John’s University

IFRS in the United States: Challenges and Opportunities
Sylwia Gornik-Tomaszewski
The Peter J. Tobin College of Business, St. John’s University
Steve Showerman, Deloitte & Touche LLP

IFRS for SMEs - An Option for U.S. Private Entities?
Eva K. Jermakowicz, Tennessee State University
Barry Jay Epstein, Russell Novak & Company LLP

TCB NEWS:
What’s Happening at the Tobin College of Business
Microfinance Program (GLOBE) One Year Later
Dr. Linda M. Sama, GLOBE Director
The Peter J. Tobin College of Business,
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# Table of Contents

**Volume 30, Number 2**

**Spring 2010**

From the Editor .............................................................................................................................................. 2
Igor M. Tomic

**From the Special Issue Editors**
Fair Value Measurements and Reporting Developments and the Continued Movement toward International Financial Reporting Standards ................................................................. 3
Patrick A. Casabona, *The Peter J. Tobin College of Business, St. John’s University*
Sylwia Gornik-Tomaszewski, *The Peter J. Tobin College of Business, St. John’s University*

Interview:
Margaret Mulley, Senior Partner, Deloitte and Touche ................................................................. 9
Interviewed by Patrick A. Casabona, *The Peter J. Tobin College of Business, St. John’s University*
Significant Contributions by:
» Sylwia Gornik-Tomaszewski, *The Peter J. Tobin College of Business, St. John’s University*
» Steve Showman, *Deloitte & Touche, LLP*
Technical reviews by Partners at *Deloitte & Touche, LLP*:
» Magnus Orrell
» Ignacio Perez
» George Garrett

Research Papers:
Fair Value Accounting and the Credit Crisis ........................................................................................ 19
Patrick Casabona, *The Peter J. Tobin College of Business, St. John’s University*
Victoria Shoaf, *The Peter J. Tobin College of Business, St. John’s University*

Fair Value and Business Combinations ............................................................................................. 31
Nina T. Dorata, *The Peter J. Tobin College of Business, St. John’s University*
Ignacio Perez Zaldivar, *Deloitte & Touche LLP*

Fair Value Audit Guidance of Public and Non-Public Companies in Response to the Credit Crisis .................................................................................................................. 40
Adrian P. Fitzsimons, *The Peter J. Tobin College of Business, St. John’s University*
Jeffrey L. Satenstein, *Queens College of the City University of New York*
Benjamin R. Silliman, *The Peter J. Tobin College of Business, St. John’s University*

Ethics is Imperative to Effective Fair Value Reporting ........................................................................ 50
Teresa M. Cortese-Danile, *The Peter J. Tobin College of Business, St. John’s University*
R. David Mautz, Jr., *University of North Carolina, Wilmington*
Irene M. McCarthy, *The Peter J. Tobin College of Business, St. John’s University*

IFRS in the United States: Challenges and Opportunities ................................................................ 59
Sylwia Gornik-Tomaszewski, *The Peter J. Tobin College of Business, St. John’s University*
Steve Showman, *Deloitte & Touche LLP*

IFRS for SMEs - An Option for U.S. Private Entities? ......................................................................... 72
Eva K. Jermakowicz, *Tennessee State University*
Barry Jay Epstein, *Russell Novak & Company LLP*

**TCB NEWS: What’s Happening at the Tobin College of Business**
Microfinance Program (GLOBE) – One Year Later ........................................................................... 80
Dr. Linda M. Sama, GLOBE Director, *The Peter J. Tobin College of Business, St. John’s University*

About the Review of Business and Author Submission and Review Guidelines................................... 82
From the Editor

I am very pleased that in our journey to cover global issues, we have now been joined by an extraordinary group of corresponding editors from several countries. Their mission is to recruit interesting articles from a variety of sources. In my travels, I have discovered that many excellent written works never leave their country of origin. Even more disturbing for our business sciences is the fact that valuable material, even when translated into English, nevertheless tends to be circulated only domestically, despite the age of the internet. The Review of Business will serve to attract fine research from global colleagues, thanks to the help of our Corresponding Editors, whose names and affiliations are listed on the inside front cover.

On occasion, we publish a Special Issue regarding topics of current interest in a business area where changes are taking place. The financial crisis that has been a primary topic of discussion for business people and the general public has given rise to much interest, research and analysis as many changes in financial services are anticipated. The financial services encompass many areas, and in this issue of the Review of Business we feature a discussion about Fair Value and IFRS. I am very grateful to our two Special Issue editors, Professors Patrick Casabona and Sylwia Gornik-Tomaszewski of the Tobin College of Business, who have undertaken this role with zeal and tenacity to deliver a fine selection of papers that reveal and clarify the depth of the issues researched, and could serve as a complete source for a comprehensive lecture on the subject.

Finally, in our new section, TCB News: What’s Happening at the Tobin College of Business, Dr. Linda M. Sama, Director of GLOBE (GLOBAL LOAN OPPORTUNITIES FOR BUDDING ENTREPRENEURS), brings U.S. up to date on the progress made during the past year by St. John’s Microfinance Program.

Below, the Special Issue editors will summarize the contribution of the various articles included in this issue.

Igor M. Tomic, Ph.D.
Editor, Review of Business
Introduction

This issue of the Review of Business provides informative articles on the two most important financial accounting and reporting topics affecting the accounting profession in recent history. The first deals with the growing use of fair value measurements for assets and liabilities reported in financial statements, especially during the recent credit crisis and current economic environment. The second deals with the continued convergence of U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS), including the Security and Exchange Commission’s (SEC’s) proposed roadmap for the potential mandatory use of IFRS in financial statements prepared by U.S. issuers.

These two topics are inherently linked. Elements of fair value accounting have been used for decades in U.S. GAAP. Although the growth of fair value accounting has been incremental, its use has accelerated in recent years as a means of enhancing financial statement quality, transparency and relevance. This trend aligns with global accounting convergence, because the use of fair value measurement is equally, if not more, prevalent in IFRS, developed by the International Accounting Standards Board (IASB).

The primary U.S. GAAP rules for measuring the fair value of assets and liabilities reported in financial statements resides in the Financial Accounting Standards Board’s Accounting Standards Codification 820 (ASC 820), Fair Value Measurements and Disclosures, which was originally published as FASB Statement 157, Fair Value Measurements, in September 2006. Among other things, this guidance defines fair value, establishes a framework for measuring fair value in U.S. GAAP and expands disclosures about fair value measurements.

Supporters of fair value accounting have argued that its application allows users to see the underlying economic reality in a changing environment, while carrying assets at their original costs masks the declining values. However, there have been many complaints about the application of fair value accounting’s increased subjectivity and uncertain valuation estimates, which have called into question the reliability of such information. During the recent credit crisis, these complaints escalated significantly, and additional assertions have been made that these rules may have led to investment values reported in financial statements that were significantly underestimated for certain entities (i.e., financial institutions).

Many constituents have also expressed their concerns for the need to correct the unintended consequences of fair value accounting, especially related to determining valuations for illiquid assets in unstable markets, and the need for enhanced transparency in the form of more meaningful disclosures. A major area of concern relates to inherent subjectivity and complexity in fair value valuation techniques and assumptions used when determining the fair values of assets and liabilities that are not traded in active and orderly financial markets, and that rely on valuation inputs that are not observable in the market.

As a result of recommendations made by the SEC, the FASB’s Valuation Resource Group, Congressional House Subcommittee hearings, and the European Commission, among others, both the FASB and IASB have worked (and continue to work) arduously on improving fair value accounting and reporting guidance. Furthermore, the FASB and IASB have a joint project, Fair Value Measurement and Disclosure – Joint Project of the IASB and FASB,
to develop converged fair value measurement guidance and improve the consistency and transparency of financial statements on a global basis. The fair value project forms part of a long-term program by the FASB and IASB to achieve convergence of U.S. GAAP and IFRS.

Several of the articles presented in this Special Issue of the Review of Business describe the challenges recently experienced in applying fair value accounting rules in the current economic environment, the possible role that fair value accounting played in the recent credit crisis the procedures and complexities involved in auditing fair value measurements, and ethical considerations related to fair value accounting. Also addressed are the FASB and IASB's ongoing improvements in fair value accounting and reporting, which reflects a pursuit of one of the most challenging and important international accounting convergence objectives the Boards share with one another. These efforts have led to, among other things, additional guidance to clarify how fair value measurements for assets and liabilities reported in financial statements should be made, especially in inactive markets, and the additional disclosures required to make financial statement information more translucent and meaningful to investors and other users.

Other articles in this Special Issue of the Review of Business deal with the growing importance of IFRS and its impact on financial reporting systems worldwide. Over the last several years, the world's capital markets have undergone tremendous expansion and integration. And with that, there has been a movement away from local country financial reporting standards toward global standards. IFRS are now used for public reporting purposes in more than 100 countries with others to follow over the next couple of years.

Year 2009 also brought interesting developments regarding accounting for private companies. In July 2009, the IASB released IFRS for Small and Medium-sized Entities (IFRS for SMEs). It is a self-contained, standalone set of financial accounting and reporting standards designated for entities that publish general-purpose financial statements for external users, but do not have public accountability.

Increasing transparency in the market through a high-quality, global set of standards has been recognized as an important objective and a priority by governments, capital market regulators and standard setters. In September 2009, the Group of Twenty (G-20) summit in Pittsburgh called upon accounting standard setters to redouble their efforts to achieve a single set of global accounting standards and to complete their convergence project by June 2011. In response, on November 5, 2009, the FASB and IASB issued a joint statement reaffirming their commitment to achieving convergence of U.S. GAAP and IFRS, and announcing plans to intensify efforts to complete several major joint projects by the end of June 2011.

Moreover, U.S. policymakers are now considering whether IFRS should be used in the United States. In August 2007, the SEC issued a "concept release" asking whether U.S. public companies should be permitted to use either IFRS or U.S. GAAP as a basis of accounting in preparing their financial statements for reporting with the SEC. Following this release, in 2008 the SEC issued a proposed "IFRS roadmap" that sets forth a possible path to eventual adoption of IFRS by all U.S. public companies. Most recently, in February 2010 the SEC issued a statement endorsing a more specific plan to work toward incorporation of IFRS in the U.S. financial reporting system. Over the next year the Commission will evaluate the quality of IFRS, the independence of IASB, investors and accountants' knowledge of IFRS and the impact of IFRS on U.S. regulations and companies. The SEC plans to make the final decision on the IFRS roadmap in 2011.

In the United States, there are 29 million privately held companies, according to the U.S. Census Bureau. Many are small- and medium-sized organizations that report to a narrower range of financial statement users, such as lenders, venture capitalists and
insurers. Although U.S. private companies are not required to use a particular basis of accounting in preparing financial reports, their reporting has been largely based on what is required for public companies, that is, U.S. GAAP.

In December 2009, the American Institute of Certified Public Accountants (AICPA) and the Financial Accounting Foundation (FAF) have announced the establishment of a “blue-ribbon panel” to address how U.S. accounting standards can best meet the needs of users of private company financial statements. The panel will provide recommendations on the future of standard setting for private companies, including whether separate, standalone accounting standards for private companies are needed. Following the decision of the AICPA in May 2008 to recognize the IASB as a standard setter, IFRS for SMEs could be an acceptable accounting standard for U.S. companies that meet requirements set in the standard.

Summary of Articles Presented in this Special Issue

This issue begins with an interview featuring Margaret Mulley, Partner of Strategy & Communications and Chief Learning Officer, Deloitte & Touche LLP and Touche, LLP, who discusses the impact that fair value accounting and reporting and the movement to IFRS are having on the accounting profession and business community. This includes the impact on the preparation of financial statements, the steps accounting firms and their clients are taking to implement this new guidance, accounting and valuation processes needed to measure fair value, auditing procedures, and tools professionals need to insure the accuracy of fair value measurements and disclosures reported in financial statements, and the education requirements and other tools needed by accounting professionals.

The interview is followed by six articles dealing with various aspects of fair value accounting and reporting, auditing and ethical considerations, and the movement toward applying IFRS and its impact on the accounting profession.

In the first article, Fair Value Accounting and the Credit Crisis, Patrick A. Casabona and Victoria Shoaf discuss the impact of the increasing use of fair value accounting and reporting in financial statements and the difficulties experienced in applying fair value guidance in measuring the fair values of certain assets and liabilities, especially for investments traded in inactive markets for which reliable observable market valuation inputs are not readily available. They also discuss the criticisms made by accounting profession constituents about the complexity and weaknesses in fair value accounting rules, and their possible contribution to the financial losses incurred in the credit crisis.

This led to congressional hearings and recommendations from members of the U.S. Congress, leaders of the G-20, the SEC, and other valuation experts to improve and converge the fair value accounting and reporting requirements, especially for financial instruments. As a result, the FASB and IASB have been issuing significant new and informative guidance to improve fair value measurements and disclosures reported in financial statements to make them more informative, reliable and translucent.

The FASB and IASB have recently provided guidance to improve fair value accounting and reporting in a number of areas, including estimating the fair value of an asset or liability traded in inactive and unstable markets; improving disclosures about the fair value of financial instruments; assessing whether a debt security is other than temporarily impaired; and clarifying the guidance on the fair value measurement of liabilities, among others. In addition, the FASB and IASB have accelerated their joint project on financial instruments, which will reduce the complexity of the accounting and reporting for such instruments, make the reporting more informative and translucent and to achieve convergence in this area.
Fair Value and Business Combinations by Nina T. Dorata and Ignacio Perez Zaldivar examines implementation and application issues related to ASC 805, Business Combinations, which took effect for combinations in fiscal years after December 15, 2008. The two major concerns related to applying this guidance include the increased earnings volatility created by the business combination accounting procedures, and obtaining timely and accurate fair value measurements for assets acquired and liabilities assumed in the business combination. Both concerns directly result from the enhanced use of a fair value model required by the acquisition method, which requires most acquisition-related transaction costs to be expensed in earnings, as well as subsequent changes in fair value measurements. The two are a vast departure from the accumulated cost model that merger and acquisition specialists were accustomed to in the past.

The authors point out that the interaction between ASC 805, which expands the requirements for fair value use in business combinations, and ASC 820, Fair Value Measurements and Disclosures, which promulgates procedures for determining fair value measurements and related disclosures, creates boundless opportunities for valuation specialists and experts who thrive on the nuances of fair value measurements in the absence of active markets. The opportunities for valuation specialists come with a price, however, as explained in the article.

Adrian P. Fitzsimons, Jeffrey L. Satenstein, and Benjamin R. Silliman, point out that since the credit crisis emerged in 2008, the American Institute of CPAs (AICPA) and the Public Company Accounting Oversight Board (PCAOB) have issued a variety of guidance dealing with the auditing of fair value reporting. This article, Fair Value Audit Guidance of Public and Non-Public Companies in Response to the Credit Crisis, examines and discusses this recent guidance for both non-public corporations and public corporations. The paper includes an audit case that illustrates an auditor’s testing for fair value of debt securities using level-2 valuation inputs, as defined in ASC 820.

Under the new auditing guidance, the objective is to obtain sufficient appropriate evidence about whether the recognition or disclosure of any accounting estimates are reasonable and whether the related disclosures in the financial statements are adequate in the context of the applicable financial reporting framework. In addition, the auditor would need to exercise professional judgment to determine whether any estimates that have been identified as having high estimation uncertainty give rise to significant risks. The paper also examines PCAOB’s new fair value auditing guidance for public corporations. The objectives of the new guidance are to inform auditors about potential implications of the FASB’s new standard on reviews of interim financial information and annual audits. It also addresses audit procedures for financial statements, including integrated audits, disclosures, and auditor reporting considerations.

Ethics is Imperative to Effective Fair Value Reporting, by Teresa M. Cortese-Danile, R. David Mautz, Jr., and Irene M. McCarthy, points out that the growing use of fair value measurements in accounting has been a source of concern for accountants and auditors, legislators, regulators and market participants. The role of “mark to market” accounting in possibly precipitating the near-collapse of financial markets in 2008 has been debated by Congress, the SEC and the PCAOB, among others. Despite recent efforts by the FASB and IASB to improve fair value accounting and reporting, significant concern remains about the extent to which judgment is permitted in the estimation of fair value estimates for assets and liabilities that are traded in inactive and disorderly markets, and where reliable market-based valuation inputs are not available.
The authors indicate that the latitude afforded entities to assign fair values to assets and liabilities means that the most important “principles” in mark-to-market accounting are the ethical principles of preparers and auditors who estimate and attest to the fair values reported in financial statements. Thus, a high level of ethical diligence is essential to counter managers’ natural inclination to report overly optimistic fair values when markets are inactive or disorderly, and when observable market value inputs are not available to estimate fair values (i.e., level-3 fair value measurements). Therefore, the authors suggest that there must be structural changes in ethics education and corporate culture to help mitigate the temptation to manipulate fair values so that confidence in financial reporting is restored.

In the fifth article, *IFRS in the United States: Challenges and Opportunities*, Sylvia Gornik-Tomaszewski and Steve Shownerman discuss the need for a single set of high quality global accounting standards to achieve comparability and transparency of financial reporting worldwide. To address the growing demand for such standards, FASB and IASB have been pursuing improvement and convergence of U.S. GAAP and IFRS. In the meantime, a global movement to IFRS has developed with well over 100 countries worldwide requiring or permitting the use of IFRS for reporting purposes.

In the United States, important rules adopted by the SEC with respect to foreign private issuers went into effect on March 4, 2008. They eliminate the need for foreign private issuers who prepare financial statements in accordance with IFRS, as issued by the IASB, to reconcile their financial statements to U.S. GAAP. This significant change was a major step towards the SEC’s goal of having a single, global accounting standard. Furthermore, in 2008, the Commission proposed a roadmap that will lay out a schedule and appropriate milestones for continuing progress toward acceptance of IFRS in the United States. In a statement issued on February 24, 2010, the Commission articulated its continued belief that a single set of high-quality globally accepted accounting standards would benefit U.S. investors. The statement is a commitment from the SEC to assess the impact of IFRS on the U.S. reporting environment. Although no final decisions have been made in this regard, adoption or expected adoption of IFRS in almost all developed economies around the world have a real impact on a growing number of U.S. companies, and on the accounting profession itself. The article overviews current status of IFRS worldwide and in the United States, and discusses challenges as well as opportunities of potential U.S. GAAP to IFRS conversion from the perspectives of preparers of financial statements, the accounting profession and the academia.

In the final article, *IFRS for SMEs – An Option for U.S. Private Entities?* Eva K. Jermakowicz and Barry Jay Epstein evaluate the IASB’s new IFRS for Small and Medium-sized Entities (IFRS for SMEs). The stated goal of this IFRS is to provide a simplified, self-contained global accounting and financial reporting standard designed to meet the financial statement needs of smaller, non-listed entities. In the United States, FASB is also weighing development of such a streamlined group of financial reporting requirements. The advent of this standard follows by about a decade a similar undertaking in the United Kingdom, where Financial Reporting Standard for Smaller Entities (FRSSE) has been successfully implemented.

The support for the IASB’s project from national accounting standard setters throughout the world stems mostly from the widely perceived complexity of the full IFRS, and from the compulsory statutory requirements for financial reporting by non-public entities in many countries, which contrasts with the absence of such requirements in the United States. The complexity of the full IFRS (or, for that matter, full U.S. GAAP) arguably imposes a high cost on implementing and applying these standards. In addition, in most
countries — in contrast with the United States — SMEs are legally required to file statutory financial statements prepared in accordance with national GAAP (or IFRS), and to make them available to all users. Additionally, many believe that the IFRS for SMEs may ease the transition to full IFRS for listed companies, provide improved comparability for users of accounts, and enhance the overall confidence in the accounts of SMEs.

This volume would not have been possible without the support and collaboration of numerous individuals. First of all, as the guest editors of this special issue, we would like to express our sincere appreciation to Igor Tomic, Editor of the Review of Business, for his support during the publication process. In addition, we would like to thank all the reviewers for their insightful comments. All manuscripts were technically reviewed (blind review) by academics and technical experts in the area of fair value accounting and IFRS. Each manuscript was revised at least twice before final acceptance.

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Significant contributions dealing with International Financial Reporting Standards (IFRS) were also made by:

- **Sylwia Gornik-Tomaszewski**, The Peter J. Tobin College of Business, St. John's University
- **Steve Showerman**, Deloitte & Touche, LLP.

In addition, technical reviews and guidance were provided by the following Partners at Deloitte & Touche, LLP:

- Fair value accounting Q & A: Magnus Orrell
- IFRS Q & A: Ignacio Perez
- The audit Q & A: George Garrett

*The views expressed by the people involved in this interview are theirs alone and do not represent positions of Deloitte & Touche LLP*

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**Margaret V. Mulley** currently serves as the Deputy Managing Partner for Strategy and Innovation and Chief Learning Officer for Deloitte & Touche LLP. In this role, she is responsible for helping to implement strategy and for assuring that the strategy for the audit and advisory businesses are aligned with U.S. and global functional strategies. She is also responsible for evolving the strategy in response to the complex environment in which we operate. Ms. Mulley works closely with various national office technical functions, including work on technical consultation policies and protocols. She has more than 30 years experience serving clients primarily in the Media and Consumer Products industries. Margaret is a member of the American Institute of Certified Public Accountants and the Massachusetts Society of Certified Public Accountants. She received her B.A. in
Mathematics from Wellesley College, and M.S. degrees from the Massachusetts Institute of Technology Sloan School of Management and Simmons College.

This interview took place on February 2, 2010.

Introduction

Hi, Margaret. We are delighted that you will be providing your thoughts on two of the most important accounting topics affecting the accounting profession in recent history:

- Fair value measurement and reporting developments in the current economic environment
- Convergence of U.S. GAAP and international financial reporting standards (IFRS), including the SEC's proposed roadmap for the potential mandatory use of IFRS in financial statements prepared by U.S. issuers

Q: Margaret, I would like to start by asking you some questions related to the increasing use of fair value measurement and reporting applications in companies’ financial statements, especially in the current economic environment.

A: I do not believe that fair value accounting caused or contributed in any large extent to the recent credit crisis; rather it revealed important information about the extent and depth of the crisis as entities experienced significant declines in the value of their investment portfolios. Carrying these investments at cost would have masked these declining values. This is not to say, however, that there was no need to improve the guidance around fair value accounting. Many steps have and will continue to be taken by the profession to achieve that goal.

As you know, the Financial Accounting Standards Board (FASB) issued Statement 157 in September 2006, [now codified in ASC 820], which defines fair value, establishes a consistent framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. It does not expand the use of fair value accounting under GAAP.

During the crisis, many of the complaints about fair value accounting have focused on the problems in determining valuations for illiquid assets in inactive and illiquid markets, and the need for enhanced transparency in the form of more meaningful disclosures. There were also perceived problems with accounting rules on impairment of debt and equity securities, which contributed to big write-downs of certain assets even in circumstances where entities expected to recover the contractual cash flows. To address these issues, the FASB issued several pieces of new and revised guidance to improve the application of fair value accounting under GAAP.

Q: What do you believe were some significant governmental and regulatory actions aimed at addressing fair value accounting rules, since the credit crisis began in 2008?

A: There have been several significant actions taken by Congress and the SEC and others during this period. I will only mention some that I deem most significant.

For example, on October 3, 2008, the U.S. Congress enacted H.R. 1424, the Emergency Economic Stabilization Act (EESA) of 2008. Among other things, the EESA grants authority to the SEC to suspend FAS 157 [ASC 820] and also required it to conduct a study of mark-to-market accounting, which would consider, among other things, the impact of accounting standards on bank failures; the process used by FASB in developing accounting standards; and potential modifications or alternatives to existing standards.

The SEC completed its study in December 2008 by issuing its Report and Recommendations Pursuant to Section 133 of the EESA of 2008: Study on Mark-to-Market Accounting, which addressed several key issues, including: the
effect of fair value accounting on bank failures in 2008, the effect of fair value accounting on the quality of financial information available to investors, alternatives to fair value accounting standards, and the advisability and feasibility of modifications to fair value accounting standards. The report concluded that existing mark-to-market accounting should not be suspended and noted that because fair value accounting provides transparent and timely information that is useful in making informed decisions, its removal would erode investor confidence in financial reporting. However, the report made several important recommendations, including recommendations for the FASB to improve fair value accounting standards, improve the application of existing fair value requirements and readdress the accounting for financial asset impairments, among others.

The reliability of fair value estimates will depend on the quality of the processes used, the appropriateness of the models and assumptions applied, the soundness of the related internal controls over financial reporting, and the technical competency of those involved.

Despite initial efforts made by the SEC and FASB to clarify application and the recommendations made in the SEC study to improve fair value accounting, criticisms of this practice continued to emerge as the credit crisis deepened in early 2009 and the economy headed into a severe recession. For example, during a hearing held on March 12, 2009, on mark-to-market accounting, certain members of the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises demanded that the FASB “fix” mark-to-market accounting soon or they would propose legislation to “fix” it themselves.

Q: What do you feel are some important actions taken by the FASB to improve fair value accounting and reporting during the crisis?

A: The FASB has worked (and continues to work) arduously on the credit crisis accounting and disclosure projects it added to its agenda during 2008 and 2009, several of which were joint projects with the International Accounting Standards Board (IASB). It completed many of its fair value credit crisis projects during 2009, as discussed in more detail in the articles presented in this Journal. For example, the FASB issued guidance on recognition and presentation of other-than-temporary impairments for investments in debt securities, determining fair value when the volume and level of activity for an asset or liability have significantly decreased, and identifying transactions that are not orderly.

While I do not have time to discuss these projects or to address the importance of all of them in detail, I would like to point out that both the FASB and IASB have made significant progress in providing new guidance on estimating the fair value of assets or liabilities, including impairments, especially in inactive markets, and in requiring that the related disclosures are much more translucent.

However, the new guidance will still require significant management judgment in many circumstances, and each valuation estimate will require careful analysis of all existing facts and circumstances. In addition, the reliability of fair value estimates will depend on the quality of the processes used, the appropriateness of the models and assumptions applied, the soundness of the related internal controls over financial reporting, and the technical competency of those involved. There will still exist inherent subjectivity and complexity in fair value valuation techniques and assumptions used by preparers, especially when determining the fair values of assets and liabilities that are not traded in active and orderly financial markets and which rely on valuation inputs that are not observable in the market. As you can imagine, the subjectivity in these accounting estimates will have to be carefully considered by auditors, as I will discuss soon.

Q: How did the SEC and PCAOB address fair value estimates and disclosures reported in financial statements during the current economic environment?
Both the SEC and PCAOB have focused a great deal of attention on fair value estimates and disclosures reported in financial statements and have issued a significant amount of related accounting disclosure and audit guidance for both auditors and their audit clients. These alerts highlight certain requirements in the auditing standards related to fair value measurements and disclosures in the financial statements and certain aspects of generally accepted accounting principles (GAAP) that are particularly relevant to the current economic environment and that have significantly affected audit practice. For example, they discuss:

- Considerations for the auditor in determining whether a specialist is needed, and the requirement that the auditor should evaluate assumptions used in fair value measurements developed by a company's specialist in accordance with the PCAOB standard on auditing fair value measurements

- Identification of matters related to the current economic environment that might affect audit risk and require additional emphasis in a number of areas, such as auditing fair value measurements and other accounting estimates in the current environment and the auditor's consideration of a company's ability to continue as a going concern

- The need to obtain an understanding of the entity's process for determining fair value measurements and disclosures and of the relevant controls sufficient to assess the risk of material misstatement

- The need for performing planned audit procedures which may vary significantly in nature, timing and extent due to the wide range of possible fair value measurements

- The need for testing management's significant assumptions, the valuation model used and the underlying data

- The importance of developing independent fair value estimates for corroborative purposes

- Ascertaining that amounts and disclosures included in MD&A are consistent with financial statements

- The need for reviewing subsequent events and transactions

In addition, the SEC has focused on additional fair value reporting issues, such as MD&A disclosures they wish to see in financial reports filed with them, including:

- Explanations of Managements' process and valuation methodologies for establishing fair value estimates

- Detailed disclosures about unobservable inputs

- Significant judgments used in fair value hierarchy classifications

- Material amounts transferred into Level 3 fair value measurements

- To what extent and reasons why management has adjusted its assumptions used to determine a fair value estimate from the assumptions used in the immediately preceding period

- Procedures for goodwill and other than-temporary impairments impairment tests

- Explanation of how credit risk is incorporated in valuation criteria to determine if the market for financial instruments is illiquid

- Impact of lack of market liquidity on valuation of financial instruments

- How illiquidity is factored into fair value determination of impacted financial instruments

- Where brokers and or pricing services were used to determine fair value, details of how these measurements were attained
Q: How does the growing use of fair value measurements and disclosures in financial statements, continuing new guidance from FASB, SEC and PCAOB, affect related client audit engagements?

A: This has significantly affected audit engagements involved with extensive and complex fair value measurements in several ways. One area impacting audit engagements is the complexity of the valuation models, and the subjectivity of the assumptions utilized in valuation models, to arrive at fair value measurements, especially for assets and liabilities that are not traded in active and orderly financial markets and those which utilize valuation inputs that are not observable in the market. These types of circumstances influence the audit procedures performed and the level of involvement of valuation specialists to assist audit engagement teams. As a result, given these circumstances and the growing use of fair value measurements and disclosure in financial statements, we take a comprehensive and integrated approach to auditing fair value measurements and disclosures.

The strategy of our audit practice involves the transformation of audit delivery; ensuring quality, providing superior value to clients, and building operational excellence into the practice. This strategy will drive to achieve the highest levels of professional excellence and quality in all activities. Transforming the audit practice requires everyone, regardless of role, to bring a mindset to their work which is anchored in quality, innovation, and value, and to demonstrate a commitment to continually improve processes, tools, and services to clients.

An essential objective of these activities is to increase focus on professional skepticism, particularly in how it intersects with exercising professional judgment. This, among other things, requires that the audit engagement team apply a professional judgment process that allows our professionals to reach well-reasoned and well-documented professional judgments within the context of an audit engagement, and to maintain an attitude of professional skepticism throughout the audit.

As part of our understanding of the entity and its environment, including its internal control, we obtain an understanding of the entity's process for determining fair value measurements and disclosures. Through this process, we identify risks of material misstatement related to fair value measurements and disclosures, and identify control activities in place that sufficiently address the risks of material misstatements. We also design and perform substantive audit procedures to address the risks of material misstatements. In doing so, we seek to obtain sufficient appropriate audit evidence as to whether the fair value measurement and disclosure is reasonable in the circumstances and appropriately disclosed. When planning and performing procedures to evaluate fair value measurements and disclosures, we consider, with an attitude of professional skepticism, both subjective and objective factors.

In conducting audits, our audit professionals obtain an understanding of the processes that management utilizes to develop fair value estimates, including use of third party valuation firms, valuation methods, assumptions (e.g., valuation assumptions, business assumptions, accounting assumptions, etc.) and other inputs, such as underlying data, used in such valuations. In addition, our audit professionals refer to internal guidance that suggests circumstances that may prompt the need to consult and seek the services of our valuation specialists. Our valuation specialists are generally specially-trained audit partners and senior managers who assist the auditors in assessing the qualifications of the fair value preparer, and in determining the reasonableness of the valuation method and valuation assumptions used in fair value measurements and disclosures. Additionally, we have specialists available at a national securities pricing center who are available to assist auditors with financial instruments.
pricing and other valuation services. Our national securities pricing center uses standard valuation techniques to assist auditors in pricing non-listed securities, securities not priced by third party pricing vendors (e.g., illiquid bonds) and over the counter securities (e.g., derivatives, structured bonds/notes, etc.)

An essential objective of these activities is to increase focus on professional skepticism, particularly in how it intersects with exercising professional judgment.

Audit professionals are also assisted by firm-developed fair value guidance, consultation networks, various instructor-led and e-learning training programs specific to fair value and a dedicated fair value Web site containing fair value accounting and auditing tools including specific guidance on valuation concepts, methodologies, assumptions, and other inputs used in various types of complex fair value measurements. Additionally, our audit professionals utilize tailored audit programs which include procedures that may be conducted in auditing various fair value measurements and disclosures, depending on the entity’s facts and circumstances.

Q: How should accounting programs at universities around the world appropriately prepare students for the fair value accounting measurements and disclosures they will inevitably deal with when they enter the business world?

A: I certainly believe that accountants — both those serving an entity and those serving as independent auditors — financial analysts and others planning to perform audits or use financial statement information, certainly need much more fair value training than ever before, and this trend will continue in the future.

Therefore, accounting programs are going to have to ensure that there is a focus on teaching valuation approaches, models, assumptions and other inputs used to determine fair value measurements of both financial and nonfinancial assets and liabilities as well as advanced financial statement analysis tools. Specific areas of concentration could include:

- GAAP and other methodologies used to value nonfinancial business assets and liabilities, including assets acquired in business combinations, investments, derivatives, loans, goodwill and other intangibles, impaired assets, etc.
- Basic Types and uses of Financial Instruments, and Valuation Concepts and methodologies
- Interest Rates and Term Structure Concepts Used in Valuation Techniques
- Interest Rate Mechanics and Basic Application to Valuation of Debt Instruments
- Determining expected future cash flows, growth rates and required rates of return to be used in valuations of Private and Publicly Traded Equity Securities, and
- Methodologies for discounting future cash flows in the various valuation methods

These courses could be developed and taught jointly by the departments of accounting, economics and finance.

In addition, auditing courses could contain additional training on procedures used to audit fair value measurements, and the processes used to arrive at such measurements. In addition, they should include training on applying a focused professional judgment process and professional skepticism in high risk audit areas, such as fair value. These courses may also include case studies in which the students can practice applying a professional judgment process and professional skepticism.
Financial reporting in the United States is being influenced by IFRS. IFRS reporting considerations are already impacting business decisions, and not simply through foreign subsidiaries. The effects of global reporting standards on U.S. companies will accelerate over the next few years. What is IFRS and how widespread is the adoption of IFRS around the world?

A: International Financial Reporting Standards (IFRS) are a set of accounting standards developed by the International Accounting Standards Board (IASB) based in London, UK, that is becoming the global standard for the preparation of public company financial statements. As of 2010, listed companies in over 100 jurisdictions use IFRS, including all European Union countries, Australia and New Zealand. In addition, private (unlisted) companies in over 90 jurisdictions use IFRS. Furthermore, all the remaining significant economies and capital markets outside of the United States have declared conversion of their financial reporting standards to IFRS in the near future. These include Japan, Canada, India and South Korea.

Accounting programs are going to have to ensure that there is a focus on teaching valuation approaches, models, assumptions, and other inputs used to determine fair value measurements...as well as advanced financial statement analysis tools.

Q: Most European companies converted to IFRS between 2003 and 2005. A lesson learned from the European experience is that the time expended to make the necessary changes to financial data and IT processes were significantly underestimated by most organizations. This experience indicates that the average IFRS IT conversion project may span up to 24 months. Has Deloitte been helping clients to assess their IT needs and to develop a conversion strategy?

A: Yes, one of the primary objectives of an IFRS readiness project is to assess the IT readiness of an organization and identify all of the areas where changes will be needed. In fact, all aspects of a business are considered in an IFRS readiness assessment, as it is often underestimated how extensive the effects and requirements of an IFRS implementation can be for an organization. Deloitte & Touche brings in experts from many disciplines to ensure that its clients are in a position to succeed once conversion becomes a reality.

Q: And what about the United States? In November 2008 the Securities and Exchange Commission (SEC) released for public comment a proposed roadmap for the potential mandatory use of IFRS by U.S. public companies. The roadmap sets out milestones that, if achieved, could lead to the required adoption of IFRS by U.S. issuers in their filings with the SEC. Comment letters were due April 20, 2009. While many respondents expressed support for the goal of high-quality globally accepted accounting standards, the request for comments also produced numerous critics. In addition, the financial crisis has prompted the Commission to delay making its decision on the IFRS roadmap. Most recently, the SEC Commissioners voted unanimously to issue a statement of cautious support for IFRS, contingent upon convergence of U.S. GAAP and IFRS and improved governance of the IASB. In your opinion, where will the SEC take the IFRS roadmap?

A: For many years, the SEC has supported and led efforts to develop a single set of high quality accounting standards to be used by investors worldwide. For example, in 2007, the Commission eliminated the requirement that foreign private
issuers that file in IFRS, as issued by the International Accounting Standards Board (IASB), reconcile their financial statements to U.S. GAAP. As reflected in the most recent cautionary statements made by the Commission, the SEC is still a supporter of IFRS. However, not enough developments have occurred for the SEC to make a decision on use of IFRS by U.S. issuers.

I believe the Commission would move forward to IFRS only if it is beneficial to U.S. investors. Therefore it will be monitoring progress on the milestones set out in the IFRS roadmap. The SEC staff has actually developed a detailed work plan to evaluate IFRS and the impact that the use of IFRS by U.S. companies would have on U.S. capital market. Definitely, some standards will have to be improved through the ongoing convergence process. For example, the FASB and IASB are continuing to work on projects to comprehensively address the accounting for financial instruments, which has been the subject of much controversy throughout the credit crisis. Also, the SEC wants to be sure that the IASB’s independence should be strengthened through a well developed, reliable, and consistent funding mechanism.

I hope that over the next year the Commission will collect all necessary information to make an informed decision regarding IFRS. I believe at that time it would be important that the Commission explicitly lay out a time table if the eventual transition of all U.S. issuers to IFRS is confirmed. This will help alleviate the significant uncertainty regarding the status of IFRS in the United States.

Q: What potential advantages and disadvantages of converting to IFRS should the Commission weigh?

A: Transition to IFRS is an important policy decision. The Commission will need to consider and weigh various factors in deciding whether to mandate IFRS for all U.S. issuers. More specifically, the Commission will need to consider recent developments relating to the financial crisis, the continued development of capital market alternatives outside the United States, and the impact on global competitiveness. Also, there have been ongoing questions about U.S. financial reporting, including the complexity of U.S. GAAP and the need to have standards that are less reliant on detailed rules and bright lines. While some may argue that, in light of recent events, this is not the time to make fundamental changes in financial reporting requirements, I believe that these very events reinforce the need to rethink the approach to financial reporting. Such benefits as global comparability of financial statements, increased transparency, and decreased cost of global financial reporting should be weight against the cost of adopting IFRS and the difficulties of implementing a principles-based system.

Q: One of the major differences between U.S. GAAP and IFRS lies in the conceptual approach each applies: U.S. GAAP is rule-based, whereas IFRS is principles-based. Fears that a move toward the application of a principles-based approach, which will require the use of more professional judgment, could make accounting standards overly vague and subject preparers and auditors to greater legal liability. This is one of the reasons the adoption of IFRS has been held up in the United States. Do you agree with this concern?

A: The difference between these two approaches lies in the methodology used to assess an accounting treatment. Under U.S. GAAP, the research is more focused on the literature, whereas under IFRS, the review of the facts pattern is more thorough. The inherent characteristic of a principles-based framework is the potential of different interpretations for similar transactions. However, professional judgment is not a new concept in the U.S. environment. The SEC is addressing this topic in order to find the right balance between the acceptable “educated” professional judgment, based on reliable facts and circumstances, and the “guessed” professional judgment, which is not. Also, the FASB and IASB are developing
an improved, complete, and internally consistent common conceptual framework that would serve as a point of reference in judgment formation.

**Auditing courses could contain additional training on procedures used to audit fair value measurements, and the processes used to arrive at such measurements. [And they] should include training on applying a focused professional judgment process and professional skepticism in high risk audit areas, such as fair value.**

**Q:** If adopted, what areas of the profession will IFRS affect?

**A:** Most CPAs will be affected to some extent because IFRS adoption will have an impact far beyond just financial reports. It will affect many aspects of a U.S. company’s operations, from information technology systems, to tax reporting requirements, to the tracking of stock-based compensation. As IFRS grows in acceptance, most CPAs, financial statement preparers, and auditors will have to become knowledgeable about the new rules. Others, such as actuaries and valuation experts who are engaged by management to assist in measuring certain assets and liabilities, will also have to become familiar with IFRS.

**Q:** What internal and external training efforts has Deloitte undertaken in light of worldwide adoption of IFRS and in anticipation of the SEC decision on the IFRS roadmap?

**A:** Deloitte Touche Tohmatsu established an internal global IFRS Accreditation training program to prepare our professionals to serve the ever-expanding list of clients with IFRS reporting requirements, and to better prepare engagement teams for eventual adoption in the United States. This rigorous program consists of learning delivered using multiple methods, including live classroom seminars, e-learning courses and virtual classroom courses.

On a smaller scale, Deloitte & Touche has created smaller-scale sessions focused on specific non-audit areas, such as accounting for income taxes, and has held a number of informational seminars and webcasts to increase awareness. IFRS is also in the process of being integrated into regular U.S. GAAP seminars, in a manner that focuses on the differences between the two.

Externally, Deloitte & Touche has delivered training to the corporate world using a number of well-attended courses, including ‘Navigating IFRS”, a two-day executive seminar covering global views and IFRS technical topics as well as deep-dive, topic-specific sessions of our Debriefs series of webcasts for financial executives. We have also developed and delivered industry-specific sessions tailored to the needs of our clients that are delivered to a broader base of company and industry personnel. Our firm recently delivered an IFRS Boot Camp for financial executives and sponsored the Audit Committee Symposium.

**Q:** The AICPA governing Council in May 2008 approved amending Rules 202 and 203 of the Code of Professional Conduct to recognize the IASB as an international accounting standard setter. That removed a potential barrier and gives U.S. private companies and not-for-profit organizations the choice whether or not to follow IFRS. The IASB released IFRS for Small and Medium-sized Entities on July 9, 2009. Do you think that these events would motivate private companies in the United States to adopt IFRS?

**A:** Yes, it is possible. Current rules allow private companies in the United States to prepare their financial statements in accordance with U.S. GAAP as issued by the FASB; another comprehensive basis of accounting (OCBOA), such as cash- or tax-basis; or full IFRS, among others. Now, with the issuance of IFRS for SMEs, U.S. private companies have another alternative. There does not appear to be any reason
why private companies in the United States could not use IFRS for SMEs. So it is certainly possible that IFRS implementation in the United States could be actually driven by private entities, which would be a different dynamic than that exhibited in other jurisdictions.

IFRS adoption will have an impact far beyond just financial reports. It will affect many aspects of a U.S. company’s operations, from information technology systems, to tax reporting requirements, to the tracking of stock-based compensation.

Q: Should the AICPA Board of Examiners incorporate IFRS into the Uniform CPA Exam, and if yes, when should it be done?

A: Given the globalization of the world’s capital markets as well as the continuing transition of companies around the globe to IFRS, there is a growing demand for the IFRS expertise. Therefore the AICPA should incorporate IFRS into the Uniform CPA Exam in the near future. And actually the Institute has already undertaken some steps towards this goal. Although IFRS are not part of the Uniform CPA Examination right now, the AICPA plans to have IFRS questions on the CPA exam in 2011. Under the new “Content and Skill Specifications for the Uniform CPA Examination” CPA exam candidates will be expected to identify and understand the differences between financial statements prepared on the basis of U.S. GAAP and IFRS. Candidates will also be required to demonstrate proficiency in first-time adoption of IFRS. To help the candidates prepare, professional associations and industry groups should integrate IFRS into their training materials, publications, testing, and certification programs, and colleges and universities should include IFRS in their curricula.

Q: How does Deloitte help academia to integrate IFRS into the college accounting curriculum?

A: Deloitte is addressing the need to bring IFRS education into college classrooms. Through the formation of Deloitte’s IFRS University Consortium, Deloitte is contributing essential IFRS resources and materials to help prepare and develop future accounting professionals. By contributing resources to academic institutions, such as Ohio State University and Virginia Tech, the Consortium is assisting in the enhancement of IFRS education for students.

Through intellectual and financial support, the Deloitte IFRS University Consortium hopes to accelerate the integration of IFRS into school curricula. This involves offering course materials, classroom guides and case studies, as well as providing access to other Deloitte resources. Participating schools have the opportunity to provide input in the direction, goals and resources of the program, including:

- Participation in periodic Webcasts to share leading practices in the classroom
- Involvement in defining the academic needs that need to be addressed
- Access to Deloitte IFRS information resources, publications and training sessions – including support and guidance from experienced Deloitte professionals

Universities that wish to participate in the Consortium will be asked to provide feedback and input about the program. (There is no cost for institutions to participate in the Deloitte IFRS University Consortium.) IFRS teaching materials and resources will be made available to all colleges and universities.

The IFRS University Consortium continues Deloitte’s longstanding practice of assisting higher education in activities that benefit students, business and society.
Fair Value Accounting and the Credit Crisis

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Executive Summary

A number of criticisms have been made to the U.S. Congress about the Financial Accounting Standards Board’s (FASB’s) fair value accounting rules and their possible contribution to the financial losses incurred in the credit crisis. In conjunction with an investigation by the Securities Exchange Commission (SEC), “Report and Recommendations Pursuant to Section 133 of the EESA of 2008: Study on Mark-to-Market Accounting,” which reaffirmed the soundness of fair value reporting, the FASB issued new pronouncements to clarify the application of fair value measurement in unstable markets. They provide guidance on:

- estimating the fair value of an asset or liability when the volume and level of activity for the asset or liability have significantly decreased and transactions are not orderly
- improving disclosures about the fair value of financial instruments for interim and annual financial statements
- assessing whether a debt security is other than temporarily impaired and measuring the amount of the other than temporary impairment that is recorded in earnings;
- clarifying the guidance on the fair value measurement of liabilities
- amending the guidance to investors in certain alternative investments (e.g., hedge funds, private equity funds, real estate funds, venture capital funds, offshore fund vehicles) that provide their investors with a net asset value per share

The FASB and the International Accounting Standards Board (IASB) have accelerated their joint projects on fair value measurement of financial instruments and on financial statement presentation and disclosure, currently scheduled for completion by 2011.

Introduction

The Financial Accounting Standards Board (FASB) has been moving toward fair value accounting for a number of years. Indeed, an extremely large and increasing number of Financial Accounting Standards (FAS) and other pronouncements include some requirement for the determination of fair value in reporting or disclosure. The issuance in September 2006 of FAS 157 (under the recent FASB Accounting Standards Codification, ASC 820) was merely intended to provide assistance to implementation of previous rules, as it tells how to measure fair value when applying standards that already require or permit fair value measurements or disclosures, but does not add any new requirements as to when fair value measures or disclosures are required. However, the coincidence of the implementation of FAS 157 during 2007 and 2008 and the financial crisis tended to focus public outrage on the fair value accounting rather than the underlying reality of inferior investments.

The ongoing crisis in the credit and financial markets which began mid-2007 has been characterized as the most severe economic crisis since the Great Depression. Recent criticisms
about the FASB’s fair value accounting rules and their possible contribution to the financial losses incurred in the credit crisis have been provided to the U.S. Congress and various politicians during 2009 by the U.S. Chamber of Commerce, American Bankers Association, American Council of Life Insurers, Financial Services Roundtable, real estate and home builders groups, and the Council of Federal Home Loan Banks, among other organizations. They believe that the inability of businesses, investors, and government to properly value assets — especially in increasingly inactive and disorderly markets — has created uncertainty, resulted in the fair values of certain assets being underestimated, and caused a loss of confidence by many market participants. They have expressed their concerns for the need to correct the unintended consequences of mark-to-market accounting, especially related to determining fair value for illiquid assets in unstable markets, and the need for enhanced transparency in the form of more meaningful disclosures.

The Role of Fair Value Accounting in the Credit Crisis

Supporters of fair value accounting argue that its application allows users to see the underlying economic reality in a changing environment, whereas carrying assets at their original costs masks the unpleasant truth of declining values. In a 2007 interview, KPMG Partner Theresa Ahlstrom notes that fair value accounting “provides users of financial statements with a clearer picture of the current economic state of a company, making a company’s financial statements more useful or ‘relevant’ in the marketplace” (Casabona 2007). Mary Barth reflects the position of the International Accounting Standards Board (IASB) toward fair value accounting: “Fair values are relevant because they reflect present economic conditions, i.e., the conditions under which the users will make their decisions” (Barth 2006). Even those who oppose fair value accounting recognize that it is not the cause of the credit crisis (see, for instance, Gingrich 2008); however, they contend that its application in a declining economy creates a domino effect that accelerates the decline, and that the determination of market value in an unstable market is problematic. Gingrich (2008), for instance, observes that in distress sales, “the market-bottom prices…become the new standard for the valuation of all similar securities held by other companies under mark-to-market” and, he points out, the result is “a downward death spiral for financial companies large and small.”

In addressing the role of fair value accounting in the credit crisis, it is important to understand its magnitude and its application. First of all, a large number of assets and liabilities reported in the balance sheet are measured and either reported or disclosed at fair value, and are within the scope of FAS 157. The following are examples of these items, whose fair values were most impacted by current economic environment: investments in debt and equity investments, loans and receivables, derivatives, pension fund assets, auction rate securities, asset-backed securities, goodwill and other intangible assets as well as financial liabilities...
Fair Value Accounting and the Credit Crisis

Supporters of fair value accounting argue that its application allows users to see the underlying economic reality in a changing environment, whereas carrying assets at their original costs masks the unpleasant truth of declining values.

While there are a large number of assets and liabilities reported or disclosed in financial statements, the percentages of these items and the dollar impact on earnings may not have been exorbitant for most companies, except for financial institutions. In 2008, only 27% of the total assets of the S&P 500 companies that had adopted FAS 157 were actually reported at fair value (Zion et al. 2009). While this represents about $6.6 trillion in assets, it is still a relatively small percentage of the assets. Because of the mixed attribute model used in U.S. Generally Accepted Accounting Principles (GAAP), some assets are measured using fair values while others — even very similar assets — are measured at cost, or amortized cost, or by some other measure. The nature of the assets held by these companies determined, to a large extent, their exposure to risk in the credit crisis. Companies in the financial sector had a much larger number of fair valued assets (39%) than did, for instance, companies in consumer staples (2%).

Although the average percentage of assets subject to fair value accounting was relatively small, the effect of marking these assets to a declining market value was enormous, especially in some sectors. Some financial services companies carried up to 80% of their assets in 2008 at fair value (Zion et al. 2009). Even companies closer to the industry average were greatly impacted. For example, in its 10-K of December 31, 2008, BNY Mellon reported securities losses of $1.6 billion for 2008, compared to $201 million in 2007.

BNY Mellon adopted FAS 157 on January 1, 2008, but in its MD&A, BNY Mellon clearly attributes these losses to the failing economy:

The ongoing disruption in the fixed income securities market has resulted in additional impairment charges, as well as an increase in unrealized securities losses. In 2008, we recorded impairment charges on our securities portfolio of $1.6 billion, pre-tax, or $0.85 per common share. These losses were primarily driven by lower market values of Alt-A, home equity lines of credit (“HELOC”) and asset-backed collateralized debt obligations (“CDO”) securities. The market value of these securities was severely impacted by the depressed housing market and deterioration in the broader economy. The unrealized loss on the securities portfolio, which is recorded in other comprehensive income, was $4.1 billion at Dec. 31, 2008, compared with $342 million at Dec. 31, 2007.

The sharp difference between its 2007 and 2008 losses raises the question of the efficacy of BNY Mellon adopting FAS 157 at this time, despite its attribution of loss to economic conditions.

The Initial Response

In view of the loss of confidence caused by the inability of businesses, investors and government to properly value assets in inactive and disorderly markets, and the need to correct the unintended consequences of mark-to-market accounting, the Office of the Chief Accountant of the SEC and the FASB staff jointly issued a press release on September 30, 2008 — SEC Release 2008-234: SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting, September — that provided financial statement users, preparers, and auditors with...
clarification on the application of fair value accounting. They emphasized the need for preparers and auditors to be less conservative in assessments and for preparers to use more judgment in valuing assets, including their own financial models, if no market exists or if assets are being sold only at “fire-sale” prices (Scannell 2008).

The FASB followed up on October 10, 2008, with the posting of FASB Staff Position (FSP) FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active [ASC 820-10-35-55A-51. The information included in this pronouncement was consistent with, and amplified, the guidance contained in the press release. However, since it did not provide users with sufficient direction in measuring fair value in illiquid and unstable markets, this guidance was replaced by FSP FSA 157-4 (ASC 820-10), Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, in April 2009, as discussed below.

At almost the same time, on October 3, 2008, the U.S. Congress enacted H.R. 1424, the Emergency Economic Stabilization Act (EESA) of 2008. The EESA of 2008, commonly referred to as a bailout of the U.S. financial system, is a law enacted in response to the global financial crisis of 2008, authorizing the United States Secretary of the Treasury to spend up to $700 billion to purchase distressed assets, especially mortgage-backed securities, and to make capital injections into banks. Asset purchases are to be made through the Troubled Asset Relief Program (TARP), which is administered by the newly formed Office of Financial Stability. The goals of TARP include: (a) stabilization of the economy, (b) homeownership preservation, (c) tax payer protection, (d) elimination of windfalls for executives and (e) strong oversight.

The EESA grants authority to the SEC to suspend FAS 157 [ASC 820]. It also required the SEC to conduct a study of mark-to-market accounting, which would consider:

- the impact of accounting standards on bank failures
- the process used by FASB in developing accounting standards
- modifications or alternatives to existing standards

The SEC held Roundtable meetings on mark-to-market accounting and current market conditions to provide input to this study, and in December 2008 it completed the study, “Report and Recommendations Pursuant to Section 133 of the EESA of 2008: Study on Mark-to-Market Accounting,” in accordance with the EESA requirements. The SEC delivered the results to Congress on December 30, 2008. The report addresses six key issues:

1. The effect of fair value accounting standards on financial institutions’ balance sheets.
3. Fair value accounting on the quality of financial information available to investors.
4. The process the FASB follows to develop accounting standards.
5. Alternatives to fair value accounting standards.
6. The advisability and feasibility of modifications to fair value accounting standards.

The report concludes that existing mark-to-market accounting should not be suspended; noting that because investors have indicated that fair value accounting provides transparent and timely information that is useful in making informed decisions, an abrupt removal of fair value accounting would erode investor confidence in financial reporting.

The SEC report makes several important recommendations, which are expected to impact the FASB’s future activities, including:

- improve fair value accounting standards
- improve the application of existing fair value requirements
- readdress the accounting for financial asset impairments
- establish formal measures to address the operation of existing accounting standards in practice
implement further guidance to foster the use of sound judgment of practitioners

address the need to simplify the accounting for investments in financial assets

The SEC report also recommends that the FASB and International Accounting Standards Board (IASB) fast-track their joint projects on financial statement presentation and disclosure, which is currently scheduled for completion by 2011.

Increased Pressure to Improve Fair Value Accounting

Despite the efforts made by the SEC and FASB to clarify application and the recommendations made in the SEC study to improve fair value accounting, criticisms of this practice continued to emerge as the credit crisis deepened in early 2009, the financial markets deteriorated further, and the economy headed for a deep recession. This unrest led to the introduction on March 5, 2009, of a House bill, HR 1349, the Federal Accounting Oversight Board Act, which was drafted by Colorado Democrat Ed Perlmutter and Oklahoma Republican Frank Lucas. Its provisions would significantly increase the government’s oversight over how accounting rules are applied. The SEC would cede its accounting-oversight powers to a newly created Federal Accounting Oversight Board (FAOB). The FAOB would consist of five top regulators: the Secretary of the Treasury, the chairman of the Federal Reserve, the chairman of the SEC, the chairman of the Federal Deposit Insurance Corp., and the chairman of the Public Company Accounting Oversight Board. The bill states that if another federal financial regulatory agency determines that an accounting rule has an adverse effect on the safety and soundness of the entities it regulates, the health of the United States financial system, or the economy, it may request authorization from the FAOB to review such standard. The FAOB would have the power to determine whether the rule should continue to be applied or be removed on either a temporary or permanent basis, which could strip FASB of its rulemaking and rule revising role.

During a hearing held on March 12, 2009, on mark-to-market accounting, certain members of the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises demanded that the FASB fix mark-to-market accounting or they would propose legislation to fix it themselves. Since many of the complaints about mark-to-market accounting have focused on the problem of determining fair value for illiquid assets in inactive and unstable markets, the FASB and SEC had previously tried to highlight the flexibility that exists in FAS 157 [ASC 820] for estimating a fair value when markets are not active. Despite these efforts, the House Subcommittee gave the FASB three weeks from March 12 to come up with additional fair value guidance.

As a result of recommendations made in the SEC’s December 2008 fair value study, recommendations from their Valuation Resource Group, Congressional House Subcommittee hearings and an increasing convergence of U.S. Accounting standards with those of the IASB, FASB immediately completed several of its “credit crisis” projects on fair value accounting and disclosure guidance:

- FSP FAS 157-4 (ASC 820-10), Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly
- FSP FAS 107-1 and APB 28-1(ASC 825-10), Interim Disclosures about Fair Value of Financial Instruments
- FSP No. FAS 115-2 and FAS 124-2 (ASC 320-10), Recognition and Presentation of Other-Than-Temporary Impairment
- ASU 2009-05, Measuring Liabilities under FASB Statement 157
- ASU 2009-12, Investment in Certain Entities that Calculate Net Asset Value per Share (or Its Equivalent), exposed for comment in June 2009 and adopted in September 2009
Despite all of this effort from the FASB, during November 2009, Congress still considered the idea of making FASB subject to a new oversight body as the House Financial Services Committee worked to pass a proposed amendment to a sweeping financial regulatory bill (H.R. 3996). An original draft of the amendment, co-sponsored by Reps. Ed Perlmutter (D-Colo.) and Frank Lucas (R-Okla.), would have significantly impinged on the independence of the FASB by allowing a new federal council of risk regulators to override accounting standards during times of extreme financial stress. However, because of concerns by the accounting profession and others, the House committee subsequently modified the bill on November 19 to allow the new Financial Services Oversight Council (that would be created by H.R. 3996) to only make recommendations to the SEC about new and proposed accounting standards they feel may adversely affect the U.S. financial system.

... many of the complaints about mark-to-market accounting have focused on the problem of determining fair value for illiquid assets in inactive and unstable markets

The New Pronouncements and their Effects

FSP FAS 157-4 [ASC 820-10-35-51A-51H] provides additional guidance on estimating the fair value of an asset or liability when the volume and level of activity for the asset or liability have significantly decreased, and identifying transactions that are not orderly. It applies to all assets and liabilities (financial and non-financial) within the scope of accounting pronouncements that require or permit fair value measurements in accordance with FAS 157 [ASC 820], but it does not apply to quoted prices for an identical asset or liability in an active market (that is, a Level 1 input). For example, although the volume and level of activity for an asset or liability may significantly decrease, transactions for the asset or liability may still occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

It is important to note that the FSP does not change the objective of fair value measurements when market activity declines. Instead, the FSP emphasizes that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. This reinforces FASB 157 (ASC 820) guidance that fair value is a current market-based measurement and not an entity-specific or hypothetical future market-based measurement. The FSP also includes an example that provides additional explanation on estimating fair value when the market activity for an asset has declined significantly, which is consistent with the newly stated objectives.

FSP FAS 157-4 provides application guidance to assess whether the volume and level of activity for the asset or liability have significantly decreased when compared with normal market conditions. This assessment should consider whether there are factors present that indicate that the market for the asset is not active at the measurement date, such as:

- There are few recent transactions based on volume and level of activity in the market
- Price quotations are not based on current information
- Price quotations vary substantially either over time or among market makers (for example, some brokered markets)
- There is a significant increase in implied liquidity risk premiums, yields, or performance indicators (such as delinquency rates or loss severities)
- There is a significant decline or absence of a market for new issuances

These factors are not all inclusive. Refer to paragraph 12 of ASC 820 [FSP 157-4] for a listing of factors an entity should consider. Note that preparers will need to use judgment in determining whether the market is active.
If, based on analysis, it is judged that there has been a significant decrease in the volume and level of activity, the quoted price may not be determinative of fair value and may require a significant adjustment.

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FASB 157 does not prescribe a specific approach in calculating the adjustment to the quoted price, but it does recommend three valuation techniques (that is, market, income and/or cost approach) that may be used to estimate fair value. FSP FAS 157-4 clarifies that the valuation technique may be changed or multiple valuation techniques may be used in determining fair value when there has been a significant decline in the volume and level of activity. According to paragraph ASC 820-10-35-51A-51C:

If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate (for example, the use of a market approach and a present value technique). When weighting indications of fair value resulting from the use of multiple valuation techniques, the reporting entity shall consider the reasonableness of the range of fair value estimates. The objective is to determine the point within that range that is most representative of fair value under current market conditions. A wide range of fair value estimates may be an indication that further analysis is needed.

Note, however, that even if there has been a significant decrease in the volume and level of activity for an asset or liability, it is not appropriate to conclude that all transactions are not orderly (that is, distressed or forced). Therefore, it must be determined whether or not a quoted price (that is, a recent transaction or broker price quotation) is orderly or not (i.e., associated with a distressed transaction) by considering the available evidence (events and circumstances) for the given quoted price. For example, you must assess whether factors such as the following exist, to determine if a transaction is not orderly:

- There was not an adequate exposure to market (before the measurement date) to allow for marketing activities for the asset that are usual and customary under current conditions
- The seller marketed the asset to only a single buyer
- The seller is in or near bankruptcy or receivership, or required to sell the asset to meet regulatory requirements (that is, a forced transaction)
- The transaction price is an outlier when compared with other recent transactions (for same or similar assets or liabilities)

Note that entities may consider additional factors in addition to those explained in FSP FAS 157-4. But the evaluation of the circumstances to determine whether the transaction is orderly is based on the weight of the evidence, which may be more difficult if there has been a significant decrease in the volume and level of activity for the asset or liability. However, if based on the weight of evidence an entity concludes that the transaction is not orderly, little if any weight should be given to the transaction in estimating fair value. If the transaction is considered orderly, then it should be considered in determining fair value, although it may not be used as the “sole” or “primary” basis for determining fair value in an inactive market. Also note that the fair value measurement should include appropriate risk adjustments (market participant view), including a premium for liquidity risk.

FSP FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments, amends FAS 107, Disclosures about Fair Value of Financial Instruments, to require disclosures
about fair value of financial instruments for interim reporting periods of publicly traded companies, as well as in annual financial statements. It also amends APB Opinion No. 28, *Interim Financial Reporting*, to require those disclosures in summarized financial information at interim reporting periods. The requirement is to disclose in the body or in the accompanying notes of its summarized financial information for interim reporting periods and in its financial statements for annual reporting periods the fair value of all financial instruments for which it is practicable to estimate that value, whether recognized or not recognized in the statement of financial position, as required by FAS 107. Fair value information disclosed in the notes should be presented together with the related carrying amount, in a form that makes it clear whether the fair value and carrying amount represent assets or liabilities, and how the carrying amount relates to what is reported in the statement of financial position. It requires the disclosure of the methods and valuation techniques used to measure fair value, and a discussion of any changes in valuation techniques and related inputs, if any, during the period. The disclosure must include the major categories of equity and debt securities, based on the nature and risks of the security. For financial institutions, the categories would include, at a minimum:

- Equity securities (seggregated by industry type, company size, or investment objective)

- Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies

- Debt securities issued by states of the United States and political subdivisions of the states

- Debt securities issued by foreign governments

- Corporate debt securities

- Residential mortgage-backed securities

- Commercial mortgage-backed securities

Collateralized debt obligations

Also note that FASB Accounting Standards Update (ASU) 2010-06, *Improving Disclosures About Fair Value Measurements*, was issued in January 2010. ASU 2010-06 amends ASC 820 (formerly Statement 157) to add new requirements for disclosures about transfers into and out of Levels 1 and 2, and separate disclosures about purchases, sales, issuances, and settlements relating to Level 3 measurements. It also clarifies existing fair value disclosures about the level of disaggregation and about inputs and valuation techniques used to measure fair value.

The third FSP issued in April 2009, FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other Than Temporary Impairments*, provides guidance on how to determine whether the holder of an investment in a debt security for which changes in fair value are not regularly recognized in earnings (such as securities classified as held-to-maturity or available-for-sale) should recognize a loss in earnings when the investment is impaired. An investment is impaired if the fair value of the investment is less than its amortized cost basis. FSP FAS 115-2 and FAS 124-2 eliminates the old requirement for the preparer to assert the intent and ability to hold a debt investment (whose fair value is less than its amortized cost basis) until forecasted recovery to avoid recognizing an impairment loss. Instead, it turns the intent and ability assertion around. If the preparer either (a) intends to sell the security, or (b) more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss (e.g., for working capital requirements or contractual or regulatory obligations), the OTTI will be recognized in earnings equal to the entire difference between the investment’s amortized cost basis and its fair value at the balance sheet date. When a credit loss exists, but there is little likelihood of sale of the security, the total impairment is separated into (a) the amount of the total impairment related to the credit loss and (b) the amount of the total impairment related to all other factors, and the OTTI related to the credit loss is recognized in earnings. The amount of OTTI related to all other factors (e.g., illiquidity, change in interest rates) is recognized in a new component of other comprehensive income, reported separately from other unrealized gains and losses on available-
for-sale securities, net of taxes. The total OTTI is presented in the statement of earnings with an offset for the amount recognized in other comprehensive income.

FSP FAS 115-2 and FAS 124-2 does not explain exactly how to determine the amount of credit loss; instead, it refers to FAS 114 [ASC 310-10-35], Accounting by Creditors for Impairment of a Loan. Under these rules, the loss is measured by taking the expected future cash flows from the instrument (as determined by the preparer), discounted at the instrument’s original effective yield, and comparing it with the current value on the balance sheet (i.e., amortized cost). The difference is the credit loss (i.e., the present value of the expected future cash shortfalls). Clearly, this process is highly subjective. On the other hand, FSP FAS 115-2 and FAS 124-2 does not require that the methodology in FAS 114 [ASC 310-10-35] is used, so in theory different preparers could arrive at different credit losses on the same security (as presently occurs with the asset fair values). For certain interests in securitized assets, the reference is made to EITF 99-20 [ASC 325-40-35-4 and 35-5], Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transfer in Securitized Financial Assets, for guidance on determining credit losses. As with the guidance in FAS 114 [ASC 310-10-35], preparers would use the present value of expected cash flows to estimate credit losses.

For both available-for-sale and held-to-maturity securities, if recovery subsequently occurs, the portion of the credit loss that was reported in earnings is treated as a prospective yield adjustment and is recovered over time (not all in one period) through higher interest income, as the discount that was created on the balance sheet by the impairment charge to the asset is accreted back into earnings over the remaining life of the asset (as in current practice). On held-to-maturity securities, the noncredit losses that are reported in other comprehensive income (“OCI”) will also be reversed over time, but will not result in higher earnings. Instead, the debt discount will be accreted back through accumulated OCI. That is, the noncredit portion for held-to-maturity securities recorded in OCI will be amortized prospectively over the remaining life of the security as an increase to OCI and an increase to the investment balance. This new standard also enhances the disclosure requirements in FAS 115 [ASC 320], Accounting for Certain Investments in Debt and Equity Securities, and FSP FAS 115-1 and FAS 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, which are now required for both annual and interim periods.

ASU 2009-05, Measuring Liabilities at Fair Value, finalized in August 2009, clarifies FAS 157’s (ASC 820’s) guidance on the fair value measurement of liabilities. This standard indicates that if an identical liability is traded in an active market, the quoted price of that liability represents a Level 1 fair value measurement. If a quoted price for an identical liability traded in an active market is not available, an entity must use one of the following approaches to maximize the use of relevant observable inputs and minimize the use of unobservable inputs:

1. The “quoted price of the identical liability when traded as an asset in an active market.”
2. The “quoted price of the identical liability or the identical liability when traded as an asset” in an inactive market.
3. The “quoted price for similar liabilities or similar liabilities when traded as assets” in an inactive market.
4. “Another valuation technique that is consistent with the principles of Statement 157,” such as an income approach or a market approach.

The ASU emphasizes the importance of maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs, regardless of the method employed. It specifies that restrictions on the transfer of the liability — unlike restrictions on the sale of an asset — should not result in a separate adjustment in estimating fair value, as the restriction is already factored into the price of the liability at inception.

ASU 2009-12, Investment in Certain Entities that Calculate Net Asset Value per Share (or Its Equivalent), issued in September 2009 provides guidance to investors in certain alternative
investments (e.g., hedge funds, private equity funds, real estate funds, venture capital funds, offshore fund vehicles) that provide their investors with a net asset value per share that has been calculated in a manner consistent with U.S. GAAP for investment companies [Topic 946 in the Codification]. Because of the complexities and practical difficulties in estimating fair value for these investments, this ASU permits using the net asset value per share of the investment if it has been calculated in a manner consistent with the measurement principles in Topic 946 (incorporated from the AICPA Audit and Accounting Guide, Investment Companies). Disclosures are required by major category of investment about the attributes of applicable investments, including the nature of any restrictions on redemption, any unfunded commitment, and the investment strategy of the investee.

It is possible that the SEC’s continued support of fair value accounting, and the FASB’s recent pronouncements and IASB converging standards guiding preparers to properly value assets during the credit crisis in inactive and disorderly markets, have restored some confidence in financial reporting, if not in the economy.

The FASB and the IASB

Pursuant to the SEC’s mark-to-market report (2008), in March 2009, the FASB and IASB announced that they will fast-track their efforts to reduce complexity in the accounting for financial instruments by replacing existing requirements with a simplified and improved approach. While it is a joint project, the Boards will continue to work separately and then reconcile their approaches as they develop.

In July 2009, the IASB issued an Exposure Draft (ED), Financial Instruments: Classification and Measurement, which was finalized as IFRS 9 on November 12, 2009. This standard is part of IASB’s ongoing project to replace IAS 39, which includes an ED on derecognition (issued March 2009) and EDs on impairment and hedge accounting (forthcoming at the time this article was written).

IFRS 9 replaces the existing classification and measurement requirements in IAS 39, Financial Instruments: Recognition and Measurement, for financial assets. It changes the manner in which entities classify and measure investments in debt and equity securities, loan assets, trade receivables and derivative financial assets by requiring entities to classify financial assets as being measured at either amortized cost or fair value, depending on the entity’s business model and the contractual cash flow characteristics of the asset.

The issuance of IFRS 9 represents the completion of the first phase of the IASB’s project to replace IAS 39. The project addresses classification and measurement of financial assets as well as the accounting for financial liabilities, recognition and measurement of impairments, hedge accounting, and derecognition. The IASB expects to replace the remaining portions of IAS 39 during 2010.

At the same time, the FASB is developing proposals to replace the current accounting requirements for financial instruments under U.S. GAAP. The FASB plans to issue a comprehensive exposure draft (ED) in the first quarter of 2010 that will address classification and measurement of financial instruments, as well as impairments and hedge accounting. In a Joint Statement issued by the FASB and the IASB on November 5, 2009, the two boards indicated that they are committed to working together on this project, and to issuing standards by the end of 2010 “that provide international comparability.”

While there is similarity in many of the decisions reached by the FASB and the IASB on simplifying the classification and measurement of financial instruments, including the preference for income statement reporting of changes in fair value and disclosure requirements, the issue of applying fair value
measurement consistently remains at the center of the difference. Both Boards are continuing their work in this area.

**Conclusion**

It is possible that the SEC’s continued support of fair value accounting, and the FASB’s recent pronouncements and IASB converging standards guiding preparers to properly value assets during the credit crisis in inactive and disorderly markets, have restored some confidence in financial reporting, if not in the economy. Some firms in the financial services sector already seem to have benefited from the new guidance. For instance, BNY Mellon, in its first quarter 10-Q for 2009, indicates that its early adoption of FSP FAS 157-4 has significantly reduced the amount of fair value losses reported. The securities losses reported on BNY Mellon’s income statement for the first quarter of 2009 were $295 million, contrasted to losses of $1,241 million in the fourth quarter of 2008.

The SEC’s and FASB’s call for companies to use judgment in estimating fair value apparently needed to be institutionalized in the pronouncements for preparers to overcome their fear of being second-guessed.

The FASB continues to work to improve fair value accounting. In 2008, it formed a group of valuation practitioners and accountants, representing a cross section of industry representatives including financial statement preparers, auditors, and valuation experts, to provide input to the FASB staff on valuation guidance. The Valuation Resource Group (VRG) does not make any authoritative decisions; rather the VRG provides the FASB staff with information on the existing implementation issues surrounding fair value measurements used for financial statement reporting purposes and the alternative viewpoints associated with those implementation issues. Also in 2008, the IASB and FASB established a Financial Crisis Advisory Group, made up of current and former regulators and financial services executives, and co-chaired by Harvey Goldschmid, a former commissioner for the Securities and Exchange Commission, and Hans Hoogervorst, a regulator from the Netherlands.

The 18-member board has been given the mission of staving off undue interferences in accounting rulemaking. Their initial objective is to address both how financial reporting helped uncover the current problems and how it helped hide them as the crisis unfolded in the U.S. and abroad. The group will also explore the ties that mark-to-market accounting and off-balance-sheet accounting had to the collapses on Wall Street.

FASB Chairman Robert Herz has said, regarding the setting of standards, that “the emphasis should be on providing useful information to those who read financial statements, including those who use them to make investment and credit decisions” (Kranacher and Morris 2007). Hopefully, the additional implementation guidance and continued efforts of the FASB, IASB, SEC, and others, to improve the application of fair value accounting will further this end.

**References**


Endnote

1 BNY Mellon is a financial services company in the S&P 500. On October 1, 2006, The Bank of New York acquired JPMorgan Chase’s Corporate Trust business in exchange for its retail and regional middle market banking businesses; on July 1, 2007, it then merged with Mellon Financial Corporation into The Bank of New York Mellon Corporation, with BNY Mellon being the surviving entity.
Executive Summary

Merger and acquisition specialists are very concerned about the implications of Accounting Standards Codification (ASC) 805, Business Combinations, which took effect for business combinations in fiscal years after December 15, 2008. Specifically, there are two major concerns: first, the earnings volatility the business combination accounting procedures create, and second, obtaining timely and accurate fair value measurements for assets acquired and liabilities assumed in the business combination. Both concerns directly result from the enhanced use of a fair value model required by the acquisition method that is used in the cost accumulation model, once heralded by the demised purchase method treatment. The acquisition method model requires most acquisition-related transaction costs to be recognized directly in earnings. In addition, subsequent changes in fair value measurements of most assets acquired and liabilities assumed are included in earnings, which is a vast departure from the accumulated cost model to which merger and acquisition specialists were accustomed.

The interaction between ASC 805, which expands the requirements for fair value use in business combinations, and ASC 820, Fair Value Measurements and Disclosures, which promulgates procedures for determining fair value measurements and related disclosures, creates boundless opportunities for valuation specialists and experts who thrive on the nuances of fair value measurements in the absence of active markets. The opportunities for valuation specialists come with a price, as they create havoc and add transactional and reporting costs for the combining entities, while business combination accounting procedures simultaneously contribute to earnings volatility, in particular when contingent consideration exists.

The implications of fair value measurement are not limited to acquisition-date measurements; they also create need for valuation specialists in periods after the business combination. Contingent consideration classified as assets or liabilities are revalued at each reporting date, with changes in their fair value included in earnings. ASC 350, Intangible-Goodwill and Other, requires at least annual impairment testing for all intangible assets with indefinite lives, including goodwill, which may necessitate fair value measurements for reporting units or units of accounting within the acquired entity. Subsequent accounting guidance for most other acquired assets and liabilities necessitate fair value estimations inherent in impairment testing and balance sheet reporting.

The Measurement Principle

ASC 805 requires that the acquirer measures assets acquired and liabilities assumed, and any noncontrolling interest at its acquisition date fair value. There are limited exceptions to the fair value measurement principle, including measurements for deferred tax assets and liabilities, income tax uncertainties, tax carryforwards, employee benefits, indemnification assets, reacquired rights, share-
based payment awards, and assets held for sale. Unlike International Financial Reporting Standard (IFRS) No. 3, Business Combinations, which allows for a choice in measurement of non-controlling interest at either the minority interest’s proportionate share of the acquiree’s identifiable net assets or at its fair value at the date of acquisition, ASC 810, Consolidation only permits use of acquisition date fair value measurement for any non-controlling interest in the acquired entity.

**Fair value measurements for share replacement awards may be simple if the acquiree’s shares are actively traded, yet cumbersome if thinly traded or if considered private equity.**

### Contingent Consideration

Contingent consideration is an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree, if specific future events occur or conditions are met. Contingent consideration may also give the acquirer the right to the return of previously transferred consideration if specific conditions are met. All contingent consideration is included in the business combination accounting and is measured at its acquisition date fair value. Classification of an obligation to pay contingent consideration as a liability or as equity in done in accordance with ASC 480, Distinguishing Liabilities From Equity or other applicable guidance. Contingent consideration classified as an asset or a liability is remeasured to fair value at each reporting date, until the contingency is resolved with changes in fair value recognized in earnings.

Contingent consideration classified as equity is not remeasured, and its subsequent settlement is accounted for within equity. Changes in the fair value of contingent consideration result from events subsequent to the acquisition date. Examples include: meeting an earnings target, reaching a specified share price, or reaching a milestone on a research and development project. Remeasurement of the contingent consideration, which is classified as an asset or liability on the acquisition date, is required at each reporting period. Probability-weighted income approach models for valuing contingent consideration are commonly used, which require evaluating the likelihood of achieving future events and the estimated cash flows for each possible outcome.

Consideration that includes share-based payment awards resulting from the acquirer’s obligation to replace share-based payment awards of the acquiree is measured at the fair value of the acquirer’s replacement award. Fair value measurements for share replacement awards may be simple if the acquiree’s shares are actively traded, yet cumbersome if thinly traded or if considered private equity. In acquisition accounting, it is necessary to apportion the fair value of replacement share-based payment awards between the acquisition consideration and those awards that require expense treatment. The portion of the replacement award that is attributable to services rendered by the acquiree’s employees prior to the business combination would be included as part of the consideration transferred in the business combination, increasing goodwill. Yet, the portions of the replacement award that relates to the post-combination service would be recognized as compensation cost in the post-combination financial statements, thus contributing to earnings volatility.

An acquirer is obligated to replace the acquiree’s awards if the replacement is required by either (1) the terms of the acquisition agreement, (2) the terms of the acquiree’s awards, or (3) applicable laws or regulations. If an acquirer was not obligated to replace the acquiree’s awards, but did so anyway, none of the replacement awards can be included in the consideration transferred in the business combination: that is, all of the fair value based measure of the replacement awards shall be recognized as compensation cost in the post-combination financial statements. The allocation procedures for share-based payments compound the effects of fair value measurements that the acquirer cannot ignore.
Noncontrolling interest

ASC 805 requires the acquirer to measure a noncontrolling interest in the acquiree at its fair value at the acquisition date. The fair value of noncontrolling interest could be measured on the basis of market prices for the equity shares, if they are traded in an active market. However, if an active market price for the equity shares does not exist, then the acquirer would measure the fair value of the noncontrolling interest using other valuation techniques described in ASC 820 (such as an income approach). The fair values of the acquirer’s interest in the acquiree and the noncontrolling interest on a per-share basis might not be proportional. The main difference is likely to be the inclusion of a control premium in the acquirer’s interest in the acquired company. Conversely, the inclusion of a discount for lack of control may be included in the fair value of the noncontrolling interest.

In acquisition accounting, it is necessary to apportion the fair value of replacement share-based payment awards between the acquisition consideration and those awards that require expense treatment.

Contingent Assets and Liabilities

ASC 805 requires that acquisition-date fair value of assets or liabilities arising from a contingency be recognized at the acquisition date. For example, the acquisition-date fair value of a warranty obligation often can be determined. A contingent asset or a liability under ASC 805 mimics ASC 450, Contingencies, and requires that at the acquisition date, recognition occurs if both of the following criteria are met:

1. Information available before the end of the measurement period indicates that it is probable that an asset existed or that a liability had been incurred at the acquisition date. It is implicit in this condition that it must be probable at the acquisition date that one or more future events confirming the existence of the asset or liability will occur.
2. The amount of the asset or liability can be reasonably estimated.

The accounting guidance for contingent assets and liabilities arising from business combinations described above reflects revisions to guidance initially promulgated by the FASB. The FASB cited application issues with the initial guidance that were expressed by preparers, auditors, and members of the legal profession and thus led to revised procedures.

Intangibles

Intangibles Other than Goodwill

Intangible assets acquired apart from goodwill require fair value measurement. The inherent nature of intangible assets makes it difficult to directly estimate their fair value, because the valuation process requires indirect measures of fair value from other tangible assets. ASC 350 classifies intangibles other than goodwill into five categories:

1. Marketing-related intangible assets.
2. Customer-related intangible assets.
3. Artistic-related intangible assets.
5. Technology-based intangible assets.

Specifically excluded from the list above, as under the purchase method treatment, is assembled workforce, because it fails the separability and transferability test. Therefore, because assembled workforce cannot be exchanged in a sale, its fair value, if any, will be subsumed or included in any acquired goodwill recognized from the acquisition.

Measuring the fair value of intangible assets other than goodwill typically relies upon the income approach. Although the cost or market approaches could be used as measurement alternatives, Lev (2001) asserts that risk and returns are necessary contributors to intangible asset valuation. Present value considerations would include the estimate of future cash flows, their variations and timing, risk-free rate of return, premiums for bearing uncertainty and other unidentifiable factors,
including new product launches, response of competitors and regulators.

In a departure from past and current accounting guidance, ASC 805 requires that acquired “in-process research and development (IPR&D)” be recognized as an intangible asset with an indefinite life, and measured at its acquisition-date fair value, which is subsequently subject to impairment testing. The acquisition method treatment of IPR&D departs from the former purchase method of accounting for business combinations, which required expensing acquired in-process research and development costs. It is subject to subsequent impairment testing that will require continual remeasurement of its fair value as necessary. However ASC 730, Research and Development, requires expense treatment of research and development costs as they are incurred outside of a business combination. This is because at the time most research and development costs are incurred, the future benefits to be derived from them are at best uncertain and there is generally no indication that an economic resource has been created. Because future benefits from IPR&D costs are difficult to see and measure, research and development costs as incurred fail to satisfy the suggested measurability test for accounting recognition as an asset. Therefore, internally generated IPR&D requires no fair value measurement, which is inconsistent with recognition and measurement requirements under ASC 805.

In spite of the inconsistent treatment between acquired research and development costs and those costs that are incurred internally, fair value measurements at acquisition date and beyond are necessary. Therefore, to maintain a reasonable and reliable estimate of the future cash flows, market participants should consider the following elements:

1. Market for the product.
2. Time to bring the product to market, including necessary promotion.
3. Customers, market penetration and entity’s share of market.
4. Effects of competition and competing products.

5. Selling price and costs of production (Mard et al. 2007).

Additionally, ASC 805 further reinforces the fair value measurement concepts regarding using the “market participant perspective and the highest and best use of the asset fair value measurement guidance” explained in ASC 820. In a business combination or an asset acquisition, an entity may acquire an intangible asset, other than IPR&D described above, that it does not intend to put to its highest and best use. For example, an entity may acquire a competitor, including its trade name, in a business combination. In such situations, the acquirer may decide not to use the acquired entity’s trade name because it directly competes with its own trade name. If the acquirer intends to prevent others from using the acquired trade name, the asset still has value because it enhances the value of the acquirer’s own trade name. (Such assets are commonly referred to as “defensive value assets.”)

Measuring the fair value of intangible assets other than goodwill typically relies upon the income approach.

Under prior guidance, the practice was not to recognize this so-called “defensive value” for these assets, and from the acquirer’s perspective, their value was considered to be zero. The new guidance would provide for additional valuation considerations as well as how to consider its subsequent fair value accounting. It is also worth noting that ASC 830 provides relevant guidance on the subsequent accounting for defensive value assets, and it requires that such assets be assigned a useful life, which represents the entity’s expected consumption period of the future benefits expected from the asset. However, we believe it would be rare for a defensive intangible asset to have an indefinite life because the fair value of the defensive intangible asset will generally diminish over time as a result of a lack of market exposure or as a result of competitive or other factors. In addition, if an acquired
intangible asset meets the definition of a defensive intangible asset, at acquisition, it cannot be considered immediately abandoned and expensed.

According to ASC 350, the fair value of a reporting unit refers to the price that would be received to sell the unit as a whole in an orderly transaction between market participants at the measurement date.

Goodwill

For accounting purposes, the measurement of goodwill is considered a residual amount. ASC 805 defines goodwill as the difference between the sum of items (one to three below) over the net fair value of the acquisition-date amounts of the identifiable assets acquired, and the liabilities assumed in the acquisition:

1. The consideration transferred by the acquirer, measured in accordance with ASC 805, which generally requires acquisition-date fair value.
2. The fair value of any noncontrolling interest in the acquiree.
3. In a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

The fair value of goodwill may be derived from an income valuation approach, such as the capitalization of a multi-period stream of expected free cash flows expected to be received by the acquiring entity over the fair value of the identifiable assets acquired. The estimated goodwill would therefore include goodwill plus the fair value of those other intangibles that do not have separate recognition under ASC 350, and therefore were not included in the determination of the fair value of the identifiable assets.

ASC 350 requires that the aggregate amount of goodwill be allocated to reporting unit(s), based on expected benefits that reporting unit(s) expect to receive from the business combination. This process often is not easy to accomplish. In addition, this process may result in allocating goodwill to reporting units that may not have been allocated any of the identified assets acquired or liabilities assumed, if those reporting units would benefit from expected synergies of the combination that contributed to the value of the goodwill. This allocation requirement affects the subsequent impairment testing for goodwill, which is performed at the reporting unit level.

According to ASC 350, the fair value of a reporting unit refers to the price that would be received to sell the unit as a whole in an orderly transaction between market participants at the measurement date. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. However, the market price of an individual equity security (and thus the market capitalization of a reporting unit with publicly traded equity securities) may not be representative of the fair value of the reporting unit as a whole. ASC 350 suggests that a valuation technique based on multiples of earnings or revenue, or a similar performance measure, may be used if that technique is consistent with the objective of measuring fair value for that reporting unit. Although ASC 350 permits that a detailed determination of fair value be carried forward from one year to the next, subsequent redetermination of reporting unit fair values necessary for goodwill impairment testing is required unless all of the following are met:

1. The assets and liabilities that make up the reporting unit have not changed significantly since the most recent fair value determination. (A recent significant acquisition, or a reorganization of an entity's segment reporting structure, is an example of an event that might significantly change the composition of a reporting unit.)
2. The most recent fair value determination resulted in an amount that exceeded the carrying amount of the reporting unit by a substantial margin.
3. Based on an analysis of events that have occurred and circumstances that have changed since the most recent fair value determination, the likelihood that a current
fair value determination would be less than the current carrying amount of the reporting unit is remote.

However, the impairment testing for reporting unit level goodwill could be accelerated if events warrant that the carrying value of a reporting unit is more likely than not greater than its fair value.

Illustrations

The exhibits below present measurement alternatives that exist at acquisition date. Exhibit 1 presents information for measurement methodologies of acquired assets and liabilities assumed at the acquisition date, and Exhibit 2 presents the required measurements under ASC 805. Exhibit 3 presents measurements included in the consolidated balance immediately following the business combination.

Summary and Conclusions

The benefits from extended fair value use in business combination reporting are not yet evident, but managers of combining entities and analysts should concede that a fair value model produces more relevant information for evaluation. The question remains: are the measurements reliable? Recent criticisms of fair value measurements and subsequent guidance revisions in the securitization markets provide a history of lessons to learn from. The jury is still out for extensive reliance on fair value measurements in business combination accounting.

Exhibit 1. Measurements

<table>
<thead>
<tr>
<th>Asset or Liability</th>
<th>Measurement Method</th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marketable securities that are classified as trading securities</td>
<td>Cost</td>
<td>1,500,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fair value</td>
<td>2,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Tax basis</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td>Marketable securities that are classified as available-for-sale securities</td>
<td>Cost</td>
<td>5,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fair value</td>
<td>3,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Tax basis</td>
<td>2,000,000</td>
<td></td>
</tr>
<tr>
<td>Food, beverages, etc. to be sold (considered finished goods or merchandise)</td>
<td>Selling price</td>
<td>6,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fair value</td>
<td>3,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cost</td>
<td>2,500,000</td>
<td></td>
</tr>
<tr>
<td>Fixed assets (tables, chairs, silverware, etc.) to be used in the business</td>
<td>Cost</td>
<td>20,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Accumulated depreciation</td>
<td>-6,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Carrying value</td>
<td>14,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fair value</td>
<td>16,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Tax basis</td>
<td>4,000,000</td>
<td></td>
</tr>
<tr>
<td>Intangible assets that meet either the contractual-legal or the separability criterion</td>
<td>Cost</td>
<td>9,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Accumulated depreciation</td>
<td>-1,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>=Carrying value</td>
<td>8,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fair Value</td>
<td>7,500,000</td>
<td></td>
</tr>
<tr>
<td>Intangible assets related to the special skills and talents of several individuals in the acquired company's workforce</td>
<td>Carrying value</td>
<td>$0</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fair value</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td>Acquired Company's goodwill (from a prior acquisition)</td>
<td>Carrying value</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fair value</td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td>Bonds payable</td>
<td>Amount to be paid</td>
<td>4,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fair value</td>
<td>3,200,000</td>
<td></td>
</tr>
<tr>
<td>Agreed Purchase price excluding contingent consideration</td>
<td>Fair value</td>
<td>39,000,000</td>
<td></td>
</tr>
<tr>
<td>Contingent consideration</td>
<td>Maximum amount to be paid</td>
<td>7,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fair value</td>
<td>4,200,000</td>
<td></td>
</tr>
</tbody>
</table>
### Exhibit 2. Measurement Guidance

<table>
<thead>
<tr>
<th>Asset or Liability</th>
<th>Acquisition-date Amount to be Assigned Based on</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marketable securities classified as trading securities</td>
<td>Fair value</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Marketable securities classified as available-for-sale securities</td>
<td>Fair value</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Food, beverages, etc., to be sold (considered finished goods or merchandise)</td>
<td>Fair value</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Fixed equipment assets to be used in the business</td>
<td>Fair value</td>
<td>$16,000,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>N/A — not separately recognized</td>
<td>N/A</td>
</tr>
<tr>
<td>Acquired company's goodwill (from a prior acquisition)</td>
<td>N/A — goodwill of an acquired entity is not carried forward</td>
<td>N/A</td>
</tr>
<tr>
<td>Goodwill created on acquisition (Purchase price + Fair Value Contingent consideration)</td>
<td>$39,000,000 + $4,200,000</td>
<td>$6,300,000</td>
</tr>
<tr>
<td>Fair value of Net Assets acquired)</td>
<td>-$36,900,000</td>
<td></td>
</tr>
<tr>
<td>Intangible assets that meet either the contractual legal or the separability criteria are assigned a portion of the acquisition cost, based on fair value</td>
<td>Fair value</td>
<td>$7,500,000</td>
</tr>
<tr>
<td>Intangible asset related to the special skills and talents of the acquired company's workforce do not meet either the contractual legal or the separability criteria — ASC 805-20-55-6 states: “...the assembled workforce is not an identifiable asset to be recognized separately from goodwill, any value attributed to it is subsumed in goodwill”</td>
<td>Fair value of $1,000,000 is not recognized</td>
<td>N/A</td>
</tr>
<tr>
<td>Bonds payable</td>
<td>Fair Value</td>
<td>$(3,200,000)</td>
</tr>
<tr>
<td>Contingent consideration</td>
<td>Fair Value</td>
<td>$(7,200,000)</td>
</tr>
</tbody>
</table>

*Required measurements under ASC 805*
Exhibit 3. Measurements included in the consolidated balance immediately following the business combination

<table>
<thead>
<tr>
<th>Post-combination Balance Sheet</th>
<th>Acquirer General Ledger Balances</th>
<th>Target General Ledger Balances</th>
<th>Amounts Under ASC 805</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>BALANCE SHEET — AT 11/30/20X9</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$13,700,000</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Accounts Receivable (net)</td>
<td>56,000,000</td>
<td>600,000</td>
<td>600,000</td>
</tr>
<tr>
<td>Marketable securities</td>
<td>—</td>
<td>6,500,000</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>48,000,000</td>
<td>2,500,000</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Other current assets</td>
<td>4,500,000</td>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Land</td>
<td>15,300,000</td>
<td>2,000,000</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Building</td>
<td>102,800,000</td>
<td>8,000,000</td>
<td>7,050,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>159,200,000</td>
<td>20,000,000</td>
<td>16,000,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(69,700,000)</td>
<td>(7,000,000)</td>
<td>—</td>
</tr>
<tr>
<td>Goodwill</td>
<td>10,000,000</td>
<td>100,000</td>
<td>6,300,000</td>
</tr>
<tr>
<td>Intangible assets</td>
<td></td>
<td>8,000,000</td>
<td>7,500,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$339,800,000</td>
<td>$41,750,000</td>
<td>$48,500,000</td>
</tr>
<tr>
<td>Accounts and notes payable</td>
<td>$47,000,000</td>
<td>$2,100,000</td>
<td>$2,100,000</td>
</tr>
<tr>
<td>Other current liabilities</td>
<td>19,700,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonds payable</td>
<td>120,000,000</td>
<td>3,400,000</td>
<td>3,200,000</td>
</tr>
<tr>
<td>Contingent Consideration</td>
<td>—</td>
<td></td>
<td>4,200,000</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>$186,700,000</td>
<td>$5,500,000</td>
<td>$9,500,000</td>
</tr>
<tr>
<td>Common stock</td>
<td>5,000,000</td>
<td>3,000,000</td>
<td></td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>17,500,000</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>130,600,000</td>
<td>32,250,000</td>
<td></td>
</tr>
<tr>
<td>Total stockholders’ equity</td>
<td>153,100,000</td>
<td>36,250,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total liabilities and SE</strong></td>
<td>$339,800,000</td>
<td>$41,750,000</td>
<td></td>
</tr>
</tbody>
</table>
References


Accounting Standards Codification Topic 450, *Contingencies*. Financial Accounting Standards Board, Norwalk, CT

Accounting Standards Codification Topic 730, *Research and Development*. Financial Accounting Standards Board, Norwalk, CT


Accounting Standards Codification Topic 820, *Fair Value Measurements and Disclosures*. Financial Accounting Standards Board, Norwalk, CT


Executive Summary

Since the credit crisis emerged in 2008, the reliability of fair value estimates has become a major concern to investors and other interested financial statement users. The accounting profession reacted swiftly to improve the reliability of fair value estimates. The first section of this paper examines fair value auditing of non-public corporations and the recent guidance proposed by the Auditing Standards Board on the auditing of accounting estimates.

In auditing non-public corporations, the AICPA issued an exposure draft of a proposed Statement on Auditing Standards (SAS), titled Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures. If adopted, the proposed SAS would supersede SAS No. 57, Auditing Accounting Estimates, and SAS No. 101, Auditing Fair Value Measurements and Disclosures. In the proposed auditing standard, the auditor’s objective is to obtain sufficient appropriate audit evidence about whether the recognition or disclosure of any accounting estimates are reasonable, and whether the related disclosures in the financial statements are adequate in the context of the applicable financial reporting framework. In addition, the auditor would need to exercise judgment to determine whether any estimates that have been identified as having high estimation uncertainty give rise to significant risks.

The second half of the paper examines fair value auditing guidance of public corporations, in particular the PCAOB’s issuance of Staff Audit Practice Alert No. 4, Audit Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments. The objectives of the staff audit practice alert (Alert 4) are to inform auditors about potential implications of the FASB Staff Positions 157-4 and 115-2 on reviews of interim financial information and annual audits. Alert 4 addresses the following topics: (1) audits of financial statements, including integrated audits, (2) disclosures, and (3) auditor reporting considerations.

I. Introduction

Since the credit crisis emerged in 2008, the reliability of fair value estimates has become a major concern to investors and other interested financial statement users. The accounting profession reacted swiftly to improve the reliability of fair value estimates. The first section of this paper examines fair value auditing of non-public corporations and the recent guidance proposed by the Auditing Standards Board on the auditing of accounting estimates.

The second portion of the paper examines fair value auditing of public corporations. In that section, the recent audit guidance issued by the Public Company Oversight Board, Staff Audit Practice Alert No. 4, Audit Considerations Regarding Fair Value
Measurements, Disclosures, and Other-Than-Temporary Impairments will be examined.

Lastly, the paper concludes with an audit case to illustrate an auditor’s testing for fair value of debt securities with Level 2 input.

The ASB … has made changes to the language of the ISA to use terms or phrases that are more common in the United States and to tailor examples and guidance to the U.S. environment.

II. Fair Value Audits of Non-Public Corporations

The American Institute of Certified Public Accountants (AICPA) recently issued an exposure draft of a proposed Statement on Auditing Standards (SAS), titled Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures. If adopted, the proposed SAS would supersede SAS No. 57, Auditing Accounting Estimates, and SAS No. 101, Auditing Fair Value Measurements and Disclosures, and would become effective for audits of financial statements for periods beginning on or after December 15, 2010. Specifically, SAS 57 and SAS 101 would be redrafted to:

- Converge their guidance with Topic 540 of the International Standards on Auditing (ISAs), which are standards issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC), and

- Apply the Auditing Standards Board’s (ASB’s) clarity drafting conventions.

The proposal would expand on how the redrafted SAS, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement, and the redrafted SAS Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained, and other relevant SASs would be applied in relation to accounting estimates. The proposed SAS would also include requirements and guidance on misstatements of individual accounting estimates and indicators of possible management bias.

AICPA Fair Value Guidance

Consistent with the ASB strategy to converge its standards with those of the IAASB, the proposed SAS on auditing accounting estimates, including fair value accounting estimates and related disclosures, was drafted using ISA 540, Auditing Accounting Estimates, Including Fair Value Estimates and Related Disclosures, as a base. The ASB clarifies that no differences exist between the proposed SAS and ISA 540 other than the omission from the proposed SAS of two paragraphs of ISA 540 that contain requirements dealing with management representations and communications with those charged with governance, respectively. The ASB states that those requirements are or will be addressed in the proposed SAS, Written Representations, and in the recently redrafted SAS, The Auditor’s Communication With Those Charged With Governance. The ASB also states that it has made changes to the language of the ISA to use terms or phrases that are more common in the United States and to tailor examples and guidance to the U.S. environment. The ASB believes that such changes will not create differences between the application of ISA 540 and the application of the proposed SAS.

Clarity of ASB Auditing Guidance. The ASB states that it is currently making a significant effort to clarify audit guidance to address concerns over the clarity, length, and complexity of the auditing standards. The ASB has established clarity drafting conventions and will revise all existing SASs, including the proposed SAS, in accordance with those conventions. The clarity drafting conventions of the ASB include:

- Establishing objectives for each of the standards

- Including a definitions section, if relevant, in each standard
Separating requirements from application and other explanatory material

Numbering application and other explanatory material paragraphs using an A-prefix and presenting them in a section following the requirements section

Using formatting techniques, such as bulleted lists, to enhance readability

Including, where appropriate, special considerations relevant to audits of smaller, less complex entities within the text of the standards

Including, where appropriate, special considerations relevant to audits of governmental entities within the text of the standard

Changes from Existing Standards. The ASB notes that the proposed SAS would not change or expand the guidance in SAS 57 or SAS 101 in any significant respect. Consistent with ISA 540 and to reflect a more principles-based approach to standard setting, the ASB moved to application and other explanatory material, certain requirements that are duplicative of broader requirements in SAS No. 57 and SAS 101.

In the proposed standard, the AICPA notes that the auditor’s objective is to obtain sufficient appropriate audit evidence about whether the recognition or disclosure of the accounting estimates are reasonable; and whether the related disclosures in the financial statements are adequate in the context of the applicable financial reporting framework.

Risk Assessment Procedures and Related Activities.

In the proposed redraft of the SAS, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement, the proposed SAS would require the auditor to obtain an understanding of the following to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:

- The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures
- How management identifies those transactions, events, and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements. In obtaining this understanding, the auditor should make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates
- How management makes the accounting estimates and an understanding of the data on which they are based, including: (a) the method, including where applicable, the model, used in making the accounting estimate; (b) relevant controls; (c) whether management has used a specialist; (d) the assumptions underlying the accounting estimates; (e) whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates and, if so, why; and (f) whether, and if so how, management has assessed the effect of estimation uncertainty.

The proposed SAS would also require the auditor to review the outcome of accounting estimates included in the prior period financial statements or, where applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor’s review would take account of the nature of the accounting estimates and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements.

Identifying and Assessing the Risks of Material Misstatement.

In identifying and assessing the risks of material misstatement, the proposed SAS would require the auditor to evaluate the degree of estimation uncertainty associated
with an accounting estimate. The proposed SAS would require the auditor to determine whether, in the auditor’s judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks.

In responding to the assessed risks of material misstatement, the proposed SAS would require the auditor to consider whether specialized skills or knowledge...are required to obtain sufficient appropriate audit evidence.

Responses to the Assessed Risks of Material Misstatement

The proposed SAS would require the auditor to determine (a) whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate; and (b) whether the methods for making the accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances.

In responding to the assessed risks of material misstatement, the proposed SAS would require the auditor to undertake one or more of the following, taking account of the nature of the accounting estimate:

- Determine whether events occurring up to the date of the auditor’s report provide audit evidence regarding the accounting estimate
- Test how management made the accounting estimate and the data on which it is based. In doing so, the proposed SAS would require the auditor to evaluate whether (a) the method of measurement used is appropriate in the circumstances; and (b) the assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework
- Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures
- Develop a point estimate or a range to evaluate management’s point estimate. For this purpose:
  (a) if the auditor uses assumptions or methods that differ from management’s, the proposed SAS would require the auditor to obtain an understanding of management’s assumptions or methods sufficient to establish that the auditor’s point estimate or range takes into account relevant variables and to evaluate any significant differences from management’s point estimate; and
  (b) if the auditor concludes that it is appropriate to use a range, the proposed SAS would require the auditor to narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.

In determining the matters identified above or in responding to the assessed risks of material misstatement, the proposed SAS would require the auditor to consider whether specialized skills or knowledge in relation to one or more aspects of the accounting estimates are required to obtain sufficient appropriate audit evidence.

Substantive Procedures to Respond to Significant Risks

Estimation Uncertainty. For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of proposed SAS 110 Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained, the auditor would evaluate the following:

- How management has considered alternative assumptions or outcomes, and why it has
rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.

- Whether the significant assumptions used by management are reasonable.
- Management’s intent to carry out specific courses of action where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, and its ability to do so.

If the auditor believes that management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the proposed SAS would require the auditor, if considered necessary, to develop a range with which to evaluate the reasonableness of the accounting estimate.

**Recognition and Measurement Criteria.**

For accounting estimates that give rise to significant risks, the proposed SAS would require the auditor to obtain sufficient appropriate audit evidence about whether management’s decision to recognize, or to not recognize, the accounting estimates in the financial statements and the selected measurement basis for the accounting estimates are in accordance with the requirements of the applicable financial reporting framework.

**Evaluating the Reasonableness of Accounting Estimates and Determining Misstatements.**

The proposed SAS would require the auditor to evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated.

**Disclosures Related to Accounting Estimates.**

The proposed SAS would require the auditor to obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework. The ASB notes that for accounting estimates that give rise to significant risks, the proposed SAS would require the auditor to evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework.

**The proposed SAS would require the auditor to evaluate whether... the method of measurement used is appropriate in the circumstances.**

**Indicators of Possible Management Bias.**

The proposed SAS would require the auditor to review the judgments and decisions made by management in the making of accounting estimates in order to identify whether indicators of possible management bias exist. The ASB notes that indicators of possible management bias do not, themselves, constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates.

**Documentation.**

The proposed SAS would require the auditor to include in the audit documentation:

- (a) the basis for the auditor’s conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and
- (b) indicators of possible management bias, if any.

**III. Guidance for Auditing of Fair Value Reporting and Disclosure of Public Companies.**

The FASB issued SFAS No. 157, Fair Value Measurements, [ASC 820], which applies to all standards requiring or permitting fair value measurement, either on a recurring or nonrecurring basis. ASC 820 was intended...
to provide guidance on how to measure fair value, but the standard lacks guidance on when to measure fair value. ASC 820 provides a three-level disclosure hierarchy based on the reliability of the inputs used in fair value measurements.

Exhibit 1 below provides a brief summary with examples of the fair value hierarchy to underscore, in particular, Level 2 and Level 3 measurements that have occurred during the recent inactive and disorderly markets since the Credit Crisis.

### Exhibit 1. Fair Value Levels

<table>
<thead>
<tr>
<th>Level Description</th>
<th>Example(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level 1: Quoted prices in active markets for identical assets or liabilities</td>
<td>A corporation’s common stock actively traded and quoted on the NYS Exchange.</td>
</tr>
<tr>
<td>Level 2: Directly or indirectly observable (market-based) information</td>
<td>An over-the-counter interest rate swap, valued based on a model of observable inputs (LIBOR forward interest rate curves)</td>
</tr>
<tr>
<td></td>
<td>A quoted price in a market that is not active for the identical asset or liability (e.g., debt securities traded in an over-the market when the market for the security is inactive)</td>
</tr>
<tr>
<td>Level 3: Unobservable inputs (no market data, inputs not correlated with market data)</td>
<td>Goodwill or fixed asset impairments based on discounted cash flows projections.</td>
</tr>
</tbody>
</table>

### Criticisms of Fair Value

Since ASC 820 was issued, the Credit Crisis that emerged in 2008 was partly due to unreliable or faulty asset valuations. (http://www.cfo.com/printable/article.cfm/10902771) This has resulted in the investing community, businesses and government officials questioning the reliability of valuations of the fair value of assets. In particular, many complaints centered on the use of mark-to-market accounting due to the problems in determining fair value for illiquid assets in inactive and unstable markets. In addition, there were also perceived problems with accounting rules on impairment of debt and equity securities, particularly with the treatment of “other-than-temporary impairment” (OTTI), which may have contributed to massive asset write-downs that may not have been warranted.

These concerns have caused the profession to move toward correcting the unintended consequences of mark-to-market accounting. There are several criticisms of the weak and unclear guidance in ASC 820, as originally promulgated, especially with respect to level three measurements which allowed a great deal of judgment, as well as obtaining reliable Level 2 inputs for fair value measurements during a time like the recent Credit Crisis, a time of inactive and disorderly markets. Before discussing the recent audit guidance surrounding the auditing of fair value and required disclosures, some of the recent amendments to fair value accounting treatments will be examined along with a few illustrations of the auditing of fair value.

After the impact of the Credit Crisis, the FASB made significant amendments to FASB 157 (ASC 820), especially in the area of measuring fair value involving the use of observable level-2 inputs during inactive and disorderly markets. Therefore, during April 2009, the Board issued FASB Staff Position 157-4 (ASC 820-10), Determining Fair Value When the Volume and Level for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly. This guidance addressed concerns that ASC 820 lacked sufficient guidance on how to measure...
fair value where markets for financial assets that were previously active were no longer active. A great deal of concern focused on the extent that too great an emphasis was being placed on last transaction prices or quoted prices as the sole determinant of fair value. As such, these observable inputs may not be the most reliable estimate of fair value if such inputs are not current, relevant, require significant costs to obtain. FSP 157-4 does not alter the objective of fair value measurement. It states that “fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced sale or distressed sale) between market participants at the measurement date under current market conditions.”

The guidance in FSP 157-4 emphasizes the determination of fair value when the volume and level of market activity has significantly declined, identifying transactions that are not orderly and the use of significant judgment by management. However, FSP 157-4 provides additional guidance by allowing entities to look beyond the last transaction or sale price previously used to develop a fair value measurement by enabling management to exercise judgment in considering those market factors that may warrant adjustment to the transaction or quoted price of the asset or liability. Also, ASC 820-10 does not provide a specific methodology for making a fair value estimate but allows three valuation approaches discussed in FASB 157: market, income and cost approaches. FSP 157-4 indicates that when there is a significant decrease in volume or level of activity, the valuation method used may need to be changed or multiple methodologies may be required.

The guidance for measuring fair value under FASB 157 as amended by FSP 157-4 allows for the use of even more refined management judgment in the measurement process, which of course raises additional auditing issues. Therefore, the PCAOB continues to issue audit guidance to help clarify how fair value measurements should be presented and audited.

**PCAOB Staff Audit Practice Alert No. 4: Fair Value Audit Considerations**

On April 21, 2009, the PCAOB issued Staff Audit Practice Alert No. 4, Audit Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments, which was issued immediately following FSP 157-4 and highlights new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws.” The practice alert addressed the implications of FSP 157-4 as well as re-emphasized existing requirements. The objectives of the staff audit practice alert (Alert 4) are to inform auditors about potential implications of the FSPs on reviews of interim financial information and annual audits. Alert 4 addresses the following topics discussed below: (1) audits of financial statements, including integrated audits, (2) disclosures and (3) auditor reporting considerations.

**Audits of Financial Statements**

As mentioned above, FSP 157-4 provides additional guidance for estimating fair value in situations where the volume and level of activity for an asset or liability have significantly decreased. Therefore, in performing audit engagements involving fair value determination, auditors must perform the following:

1. Obtain an understanding of the company’s process for determining fair value measurements and disclosures and of the relevant controls sufficient to assess the risk of material misstatement (AU §§ 328.09 and 328.13).

2. Perform planned audit procedures (depending on the nature, timing and extent of the wide range of possible fair value possibilities and varying levels of risk of material misstatement), the auditor’s substantive tests of the fair value may involve:

   a. Testing management’s significant assumptions, the valuation model the
underlying data, b. Developing independent fair value estimates for corroborative purposes, or c. Reviewing subsequent events and transactions.

If the auditor concludes the existence of a material inconsistency, or becomes aware of a material misstatement of fact, the auditor should determine if the financial statements, the audit report, or both require revision.

Note that in April 2009 FSP Nos. FSP 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments, was also issued to amend the guidance for recognizing an “other-than-temporary impairment” (OTTI) of a debt security investment. Alert 4 requires the auditor to evaluate a company’s conclusions concerning the need to recognize an impairment loss. If a company records an impairment loss, the auditor should gather evidence supporting the amount of the impairment recorded to determine if the company has appropriately followed GAAP. In addition, if a company is required to separate the amount of the OTTI that represents credit losses from the amount representing other factors, Alert 4 indicates that the auditor should obtain sufficient competent evidence to provide a reasonable assurance that the estimates are reasonable in the circumstances and are properly presented and disclosed in conformity with GAAP. In addition, the auditor should obtain an understanding of how such estimates were developed.

Disclosures

FSP 157-4 requires additional disclosures regarding fair value measurements. Specifically, the Staff Position requires companies to disclose changes in valuation techniques and related inputs for fair value measurements in interim and annual periods and to provide additional disclosures required under ASC 820. FSP 115-2 requires companies to disclose any information that assists users to understand the reasons for the portion of OTTI that was not recognized in earnings, as well as the methodology and significant inputs used to determine the portion of OTTI recognized in earnings. Auditors should evaluate such disclosures to insure they are in accordance with FAS 115-2.

In Alert 4, the auditor should read the other information accompanying interim and annual financial statements contained in reports filed with the SEC. Specifically, the auditor should determine if the Management’s Discussion and Analysis of Financial Condition and Results of Operations section of annual reports and other filings that include discussions regarding fair value measurements and OTTI are materially inconsistent with the financial statement. If the auditor concludes the existence of a material inconsistency, or becomes aware of a material misstatement of fact, the auditor should determine if the financial statements, the audit report, or both require revision. However, if the auditor concludes that the financial statements or audit report do not require revision, the auditor should request the company to revise the other information.

Auditor Reporting Consideration

FSP 157-4 states that revisions resulting from a change in a valuation technique or its application are required to be accounted for as a change in accounting estimate. In the period of adoption, entities are required to disclose any change in valuation technique and related inputs, and to quantify the total effect by major category. In addition, FSP 115-2 requires the company to recognize the cumulative effect of initially applying the Staff Position as an adjustment to the opening balance of retained earnings, as of the beginning of the period in which FSP 115-2 is adopted, with a corresponding adjustment to accumulated other comprehensive income.
The auditor should evaluate whether the company's accounting for and disclosure of the changes are in accordance with the Staff Positions. Alert 4 also indicates the need to identify consistency matters that might affect the auditor's report. Moreover, the auditor should evaluate whether the comparability of the financial statements between periods has been materially affected by changes in accounting principles. If a change in accounting principle has a material effect on the financial statements, it should be recognized in the auditor's report through the addition of an explanatory paragraph following the opinion paragraph.

IV. Illustration of Fair Value Auditing

In this last section, an illustration of fair value auditing is provided. This illustration provides an audit example of fair value of available-for-sale debt securities.

**Illustration: Auditor Testing For Fair Value of Debt Securities (with Level 2 Input)**

**Example:** On December 31, 2009, your client holds in its Investment Securities Available-for-Sale (A-F-S) account, $30 million face value of a publicly issued corporate bond maturing in 20 years. The security was purchased at par through an underwriting that took place on October 1, 2009. The bond issuer has a debt rating of Baa from Moody's and BBB from Standard & Poors, the minimum investment rating to qualify as investment grade. The client reports the fair value of the security at $31 million along with a credit to Other Comprehensive Income of $1 million. There have been no trades in the preceding 20 days by any holder of this bond ($1.2 billion of these bonds are outstanding). As support for its fair value determination, the client has stated that:

1. Last sale of this bond by another holder was 20 days ago at the same price your client proposes to use at December 31.
2. There has been no change in the credit rating of the issuer since the offering date.
3. The amount of the bond held by your client represents only 1% of total client assets of $3 billion.

**Auditor’s Concerns:**

1. Client holding represents 2.5% (30 million/1.2 billion) of the entire bond issue outstanding. There is liquidity risk of whether the client can receive the same price for all shares in a forced sale.
2. There could have been a change in market conditions over the last 20 days of the month, resulting in either an increase or decline in the value of this bond.
3. Client has not been able to identify a more recent sale of another security of similar credit rating and maturity to substantiate its pricing.
4. Client is unable to identify either a broker or market maker who can independently verify client’s calculation of fair value.

**Audit Procedures:**

1. This is a “Level 2” valuation under SFAS 157. The auditor identifies three other securities with similar maturity, credit rating, issue date and coupon interest rate, which it uses as “proxy securities.” Each of these securities had been actively traded on December 31, 2009.
2. For those proxy securities, the auditor identifies:
   a. Prices at December 31, 2009 based on actual trades (an average of the three prices is used)
   b. The amount of price change in the proxy securities in the last 20 business days (assume here that the percentage of price change is consistent with the price change in the client bond from last trade date to December 31, 2009)

3. Since average daily volume for the bond during the first three months of trading is less than the client’s holdings, a liquidity reserve of 3% of face value is agreed with the client to be appropriate. This reserve is also agreed to by the client’s independent Market Risk Group that reports to the corporate CFO.

4. Auditor researches the change in the last 20 days in December in spreads between U.S. Treasury securities of similar maturity and corporate bonds of similar credit
rating, and concludes there has not been significant movement. 5. Auditor determines that there is minimal concentration risk in the client’s holding as other investments in the Available-for-Sale account are well diversified across asset classes, so no pricing reserve for concentration risk is necessary.

**Conclusion:** The client reduces the fair value amount by $900 thousand (3% of $30 million) to reflect the liquidity risk in holding such a significant portion of the security issue. This reduces the carrying value to $30,100,000, and the credit to Other Comprehensive Income becomes $100,000. Auditor is now able to conclude that the balance carried at fair value in the A-F-S account is fairly stated at December 31, 2009.

### V. Conclusion

The credit crisis has placed a higher burden on fair value reporting in financial statements, particularly Level 2 and Level 3 transactions. The FASB issued guidance for using judgment in estimating fair value (FSP 157-4 and FSP 115-2) and in response, both auditing standards boards issued audit guidance dealing with the auditing of accounting estimates. For non-public corporations, in the AICPA’s exposure draft of a proposed Statement on Auditing Standards (SAS), Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures, the auditor’s objective is to obtain sufficient appropriate audit evidence about whether the recognition or disclosure of the accounting estimates are reasonable; and whether the related disclosures in the financial statements are adequate in the context of the applicable financial reporting framework. For public corporations, the Public Company Accounting Oversight Board issued Staff Audit Practice Alert No. 4, Audit Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments, and addressed the implications of FSP 157-4, which informs auditors about potential implications of the FSPs on reviews of interim financial information and annual audits. These additional steps taken by the accounting profession and the guidance to enhance the attestation function will hopefully improve fair value reporting.

### References


----------. 2006. Statement of Auditing Standards No. 110, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained. Jersey City, NJ.


----------. 2009. FASB Staff Position FAS 115-2, Recognition and Presentation of Other-Than-Temporary Impairments. FASB, Norwalk, CT.

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Ethics is Imperative to Effective Fair Value Reporting: Weaving Ethics into Fair Value

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Executive Summary

The use of fair value measurement in accounting has been a source of concern for accountants and auditors, legislators, regulators and market participants. The role of fair value measurement (also known as “mark to market” accounting) in precipitating the near-collapse of financial markets in 2008 has been debated by Congress, the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB), among others.

Congress explicitly considered the impact of fair value accounting in the Emergency Economic Stabilization Act of 2008. Although the SEC concluded, in its report to Congress, that fair value accounting did not contribute to the failures of major financial institutions, the PCAOB has been actively issuing Staff Audit Practice Alerts to assist auditors in identifying matters that could affect audit risk. The ethical application of fair value measurement remains a critical concern.

The issuance of Financial Accounting Standard (FAS) 157, Fair Value Measurements, and the subsequent clarifications provided in FASB Staff Position (FSP) 157-4 are part of the Financial Accounting Standards Board’s (FASB’s) effort to promote consistency and comparability in fair value measurement. Despite these efforts, significant concern remains about the extent to which judgment is permitted in the application of fair value in inactive and disorderly markets. In short, the latitude afforded entities to assign fair values to assets and liabilities means that the most important “principles” in mark-to-market accounting are the ethical principles of preparers and auditors who estimate and attest to the fair values reported in financial statements. Thus, a high level of ethical diligence is essential to counter managers’ natural inclination to report optimistic fair values when markets are inactive or disorderly.

Background

The Conceptual Framework of Accounting identifies relevance and reliability as the primary qualitative characteristics of useful financial information. While both are theoretical ingredients of ideal information, a tension exists between relevance and reliability in practice. The accounting profession’s perennial devotion to historical cost measurement reflects an overriding concern with the reliability of financial reports. Moreover, the historical cost of an asset in an arm’s length transaction is arguably the most reliable measure of fair value at the transaction date. With the passage of time, historical costs become less and less relevant.

The Financial Accounting Standards Board’s (FASB’s) gradual embrace of fair value measurement in recent years reflects an attempt to provide more relevant information about values after the initial transaction date. However, one of the costs of this shift has been an increased threat to the reliability of financial reports. This article
The current economic environment may trigger certain risk factors associated with misstatement due to fraudulent financial reporting, including incentives, pressures and opportunities present in the reporting entity.

Prior to the issuance of Statement of Financial Accounting Standards No. 157, Fair Value Measurements, there were varying definitions of fair value. Generally accepted accounting principles (GAAP) guidance for applying those definitions was limited. Guidance related to fair value measurements was contained within the broad spectrum of existing pronouncements, and the differences in that guidance created inconsistencies in the application of GAAP.

The Financial Accounting Standards Board (FASB) addressed the need for increased consistency and comparability in fair value measurements, and in September 2006 issued Financial Accounting Standard (FAS) No. 157 to address those needs and expand disclosures related to fair value measurements. FAS No. 157 has been codified into FASB Accounting Standards Codification (ASC) Topic 820, Fair Value Measurements and Disclosure. Topic 820 defines fair value, establishes a framework for measuring fair value, and requires certain disclosures about fair value measurements, which are intended to provide clarity and consistency in the way fair values are measured.

The FASB emphasizes the notion that fair value be based on an exit price and not an entry price. There is a distinction made between observable inputs and unobservable inputs. Observable inputs are based on market data obtained from independent sources. Unobservable inputs (Level 3 measurements) emanate from the entity’s own assumptions based on the best information available.

The importance of inputs cannot be underestimated, for it is these upon which reliance is placed and these which are most susceptible to manipulation. Observable inputs, used in Level 1 and 2 fair values, include the data sources and market prices that are available and visible outside the entity. Observable inputs are external to the entity and more objective than the internal unobservable inputs of Level 3. Unobservable inputs are the data and analysis that are developed within the entity to assess the fair value. Indeed, Level 3 inputs are unobservable inputs for the asset or liability. These are inputs that reflect the reporting entity’s own assumptions about the assumptions market participants would use in pricing the asset or liability.¹

The Impact of Fair Value on the Current Economic Environment

The notion of unobservable inputs was intended to allow for situations in which there was little or no market activity for the asset or liability at the measurement date. In those situations the reporting entity need not have taken all possible efforts to obtain information about market participant assumptions. Additionally, though the reporting entity was expected not to ignore information about market participant assumptions, it was given the leeway to pursue the information if it was reasonably available without undue cost and effort.

For example, a Level 3 input would include a financial forecast developed using the reporting entity’s own data if there is no information reasonably available, without undue cost and effort, that indicates that market participants would use different assumptions.² Such latitude in professional standards clearly set the stage for the liberties taken by financial institutions in valuing the bad assets on their books. The extent to which Level 3 measurements contributed to the economic crisis was not
known until the economic crisis hit. The Level 3 overvaluations permitted to be used by financial institutions acted as a catalyst in fueling the economic crisis.

The crisis has demonstrated that markets are ineffective in controlling unethical practices driven by greed.

Consider the case of subprime mortgage-backed securities. These represent one of the instruments for which there were substantial write-downs. The fair value of financial instruments collateralized by assets, such as homes with declining values, is difficult to approximate due to the difficulty of estimating the value of the underlying homes. When there are falling house prices that may not support the value of a mortgage and the mortgage-backed security held as investments by banks and other investors, the lack of the ability to objectively measure the value of the houses that support these debt instruments creates uncertainty. This has caused a lack of confidence in investing in these securities and has resulted in an inactive market. For entities that must liquidate their holdings of these mortgage-backed securities, the prices received may be considered “forced” or “distressed” prices that are not indicative of the intrinsic fair value. When the markets are inactive, the issue is whether these market participant trades and broker quotes are reliable estimates of fair value.\(^3\)

In spite of the flagrant deception perpetrated by financial institutions, according to the Financial Crisis Advisory Group, accounting standards were not a root cause of the financial crisis. Instead, the crisis has exposed weaknesses in accounting standards and their application. The weaknesses primarily involved:

(1) the difficulty of applying fair value (“mark-to-market”) accounting in illiquid markets
(2) the delayed recognition of losses associated with loans, structured credit products, and other financial instruments by banks, insurance companies and other financial institutions
(3) issues surrounding the broad range of off-balance sheet financing structures, especially in the U.S.
(4) the complexity of accounting standards for financial instruments, including multiple approaches to recognizing asset impairment\(^4\)

The Emergency Economic Stabilization Act of 2008 took into consideration the view held by some that fair value accounting contributed to bank failures. Two sections of the Act recognize fair value as a possible influence on the degree to which financial institutions were viewed as having potential solvency problems. Section 133 of the Act required that the Securities and Exchange Commission (SEC) report to Congress on the effect of mark-to-market fair value accounting on the recent bank failures. The SEC’s report was required to include recommendations to remedy any weaknesses identified in the study.

Specifically, this study was required to evaluate the effect of fair value accounting on bank failures and bank balance sheets. It was required to: (a) address the way the FASB develops accounting standards, (b) describe alternate possible accounting methods, and (c) evaluate the quality of financial reporting information provided under Topic 820. The study was issued by the SEC staff on December 30, 2008, and concluded that Topic 820 did not contribute to the bank failures in 2008. The report does suggest the need for expanded disclosures, the need for more guidance on fair value, and other improvements in the financial reporting of fair value. (CCH Accounting research Manager, Overview and Scope of Topic 820 et al.)

Recent Efforts by Standard-Setters and Regulatory Agencies

Three FASB Staff Positions (FSPs) were issued on April 9, 2009 which revised and clarified Topic 820:

- FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (codified as Topic 820)
- FSP FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments (codified as Topic 320)
- FSP FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments (codified as Topics 825 and 270, respectively).
Topic 320 defines key classifications of securities and accounting treatment for the classifications, whereas Topics 825 and 270 extend disclosure requirements on all fair value assets and liabilities on the balance sheet and/or footnotes to interim periods. All three FSPs are tied together in concept and purpose.

Most relevant to this article is FSP FAS 157-4. It is not our intent to engage in a detailed discussion of the FSP, but instead to point out that there is no change in the underlying principles set forth in Topic 820. FSP FAS 157-4 primarily clarifies the fair value measurement process and expands the disclosure requirements. It provides a list of tests of market activity. This list of tests can be found in ASC 820-10-35-51A. The tests provide guidance to help the reporting entity evaluate factors to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability. This should help the user decide if the market volume has declined to the point where the market quotes are neither orderly nor reliable measures of fair value.

The FSP does not prescribe a methodology for making adjustments to transactions when estimating fair value, so it offers no detailed specified tests for measuring fair value. If there has been a significant decrease in the volume and level of activity, then a change in valuation technique or the use of multiple valuation techniques is considered appropriate. Determining the price at which willing market participants would transact if there has been a significant decrease in the volume and level of activity will require the use of significant judgment. What resonates from this part of the guidance is that the way each test is applied will continue to require judgment. Hence, we opine that such guidance, yet again, allows entities considerable latitude in measuring fair value.

The FASB recognizes that the determination of whether a transaction is orderly is indeed more difficult if there has been a significant decrease in the volume and level of activity. However, such circumstances do not provide conclusive evidence that transactions are not orderly (distressed or forced). ASC 820-10-35-51E provides guidance to assist in determining if a transaction is not orderly, but in 51F indicates that the entity need not undertake all possible efforts and should not ignore information available to it without undue cost and effort.

In general, fair values in the financial statements are frequently developed with the assistance of a valuation expert. Those valuations should be audited by independent CPAs. Notwithstanding, the Public Company Accounting Oversight Board (PCAOB) has expanded audit requirements and the resulting implications have become apparent in field application of Topic 820’s guidelines. (CCH Accounting Research Manager, Current Economic Crisis et al.)

On April 21, 2009, the PCAOB issued Staff Audit Practice Alert No. 4, Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments. The purpose of this staff audit practice alert is to inform auditors about potential implications of the FSPs on reviews of interim financial information and annual audits. This alert addresses the following topics: (1) reviews of interim financial information ("reviews"); (2) audits of financial statements, including integrated audits; (3) disclosures; and (4) auditor reporting considerations. This alert highlights certain areas and is not intended to serve as a substitute for the relevant auditing standards. (PCAOB Staff Audit Practice Alert No. 4 et al.)

The PCAOB also issued Staff Audit Practice Alert No. 3, Audit Considerations in the Current Economic Environment, on December 5, 2008. The purpose of this practice alert is to assist auditors in identifying matters related to the current economic environment that could affect audit risk. Several audit risk considerations are provided in the...
alert including fraud risk considerations. The practice alert points out that the current economic environment may trigger certain risk factors associated with misstatement due to fraudulent financial reporting, including incentives, pressures and opportunities present in the reporting entity. Additionally, reference is made to PCAOB Staff Audit Practice Alert No. 2, Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists, which was issued on December 10, 2007. The PCAOB reminds auditors that this practice alert and their responsibilities remain relevant, especially with regard to auditing fair value measurements, classification within the hierarchy, using the work of a specialist and use of a pricing service.7

The Need for Ethics

Rules are said to lose their bite over time because regulation-induced innovation creates and widens loopholes. Complex structured securitizations expanded as a way to respond to rules. The market and government failures that produced the crisis can be described as “de-supervision.” Consequently, agents (i.e., management) had little incentive to fulfill their fiduciary responsibility to the public and investors. Devising a way to prescribe “a goodly dose of ethics” would be a way of remedying such disregard for the rules.8 Verschoor (2009) agrees that the crisis has demonstrated that markets are ineffective in controlling unethical practices driven by greed.9

A starting point would be the cultural audit as suggested by Castellano and Lightle (2005). An independent firm would conduct the audit periodically and it would focus on the preoccupation with meeting analysts’ expectations, pressure associated with meeting targets, and compensation tied to performance. Those authors support the concept of a cultural audit by reference to the 1987 Treadway Commission report. That report outlined causal factors associated with fraudulent financial reporting, identifying tone at the top as a critical factor.10

Brooks and Dunn (2007) suggest that accountability be based on responding to shareholder and other stakeholder interests. The modern governance framework should direct corporate personnel to integrate those interests into their strategies, planning and decision-making. Discovering what those interests are is imperative, as well as understanding the risks that should be managed.11

We believe that business education is also part of the solution. Business schools should focus on integrity at the individual, company and societal levels. Waddock (2005) opines that the accounting profession seems to have failed to acknowledge that accounting is fundamentally an ethical, rather than a technical discourse. A top executive with integrity will not only be true to his or her critically examined beliefs and standards, but will develop mission statements that define the whole corporation and encourage accurate reporting. The majority of top executives are people who possess integrity but have been led astray by a lack of self-examination and by the fact that no one in their organization offers them alternatives to a profit-based style of management and they learned no different course of action during their business school education.12

When one believes it is acceptable to be dishonest or sees others acting dishonestly, then one is more likely to behave dishonestly. Behavior can be shaped by pressure from others.

The need for ethics is underscored by a 2004 survey of top Fortune 500 corporate executives conducted by co-author Cortese-Danile (2006). The results of that instrument indicate that corporate culture is considered relatively more important than financial incentives and personal values in misrepresentation of financial statements. Generally, respondents felt less strongly that companies who support unethical behavior can be remedied, but rather that those engaging in unethical behavior can be remedied.13
The response to education in ethics by the survey participants was overwhelmingly positive. Respondents supported teaching ethics at the university level and, in particular, business ethics. In particular, the executives believed that case studies should be used in teaching ethics and they felt rather strongly that improving education in professional ethics could improve corporate culture (Cortese-Danile et al.).

We argue that in conjunction with Kohlberg’s theory of moral development, intervention must take place at the collegiate level. Kohlberg’s (1976) cognitive theory of moral development states that moral reasoning develops quite naturally. It develops through a series of stages and is stimulated by social interaction. The stages reflect our progress as moral reasoners from a time when we think in egoistic terms to when we conform to societal norms to when we are able to reason morally in terms of the perspective of a rational individual. In an interim stage of this theory one develops a sense of fairness. It is at this interim stage that intervention must take place. Here education can play a significant role in mitigating the inherent threat to reliability posed by fair value accounting.

The form of intervention must be considered, and to that end we refer to a study which examined moral judgment, moral experience and the impact of a moral intervention project on adult undergraduate students. Armon (1998) concluded that education programs for adults should go beyond the emphasis on moral abstract reasoning to the application of such reasoning to real social problems. There existed no evidence that discussion of moral dilemma and conflict encourages the development of abstract reasoning. Rather, community membership and the sense of personal responsibility had a greater impact on students. If experience is to be meaningful, it must have a personal and emotional connection to the participant. This connection is of critical importance in the delivery of the intervention.

Intervention, if it is to have an impact, should be in the form of interactive case studies. Such case studies are a powerful tool in the study of ethics. They involve asserting the facts of the case, defining the ethical issues, identifying the major principles, rules and values related to the case, selecting alternative plans, comparing the values and alternatives and anticipating the consequences of the various options (Langenderfer and Rockness 1989). Kennedy and Lawton (1992) suggested that students engaged in dramatizations of business dilemmas develop greater awareness of the complexity of the ethical and moral issues than by just reading essays. The heightened realism of the circumstances provides the student with a clearer view of what the main characters are struggling with.

The conflicts that management and executives struggle with in the real world must be understood in order to successfully overcome those challenges. One study (Greene 1999) looked at the decision to behave dishonestly as a response to one’s perception of the environment. An individual’s conduct is dependent in part upon how he or she perceives the norm of the situation. Indeed, the individual looks to others for an indication of what is acceptable behavior. When one believes it is acceptable to be dishonest or sees others acting dishonestly, then one is more likely to behave dishonestly. Behavior can be shaped by pressure from others.

Personal conflicts that arise when there is a disparity between what organization members believe they ethically should do, and what they actually do. This has been the subject of some prior research. Individuals rely on the opinions of their referent groups when deciding how to behave. Organizational and environmental factors can affect one’s behavior. Moral approbation (Jones and Ryan 1997) proposes that individuals consider four factors when determining their own level of moral responsibility in a given situation. When deciding whether to behave unethically, the
factors one considers include:

1. Consequences of one’s actions.
2. The question as to whether the act is moral or immoral.
3. One’s degree of complicity in the act.
4. The extent of pressure felt.\(^{19}\)

The pressure to comply has long been considered a factor in unethical behavior. In 1987 the Treadway Commission concluded that an aggressive tone at the top was a contributing factor and that students should be trained to recognize the signs.

There must be structural changes in ethics education and corporate culture to help mitigate the temptation to manipulate fair values so that confidence in financial reporting is restored.

The Environment and Current Trends

A slowing economy may increase pressure on companies to meet and often exceed short-term performance goals or to demonstrate that shareholder value has improved due to management’s leadership. This mindset in slower economic times can contribute to increased fraudulent activity. Historical data supports this premise. The United Kingdom’s Financial Services Authority, in its 2008 Financial Risk Outlook, warned that increased financial pressures could lead to opportunities for management and employees to commit or break laws. Three common factors drive fraudulent activity: financial pressure, opportunity and rationalization. These factors, present even in a strong economy, can be exacerbated during an economic downturn.\(^{20}\)

During an economic downturn, business units potentially face increased pressure to meet or exceed financial targets. The risk for fraudulent activity increases, according to the 2007 Oversight Systems Report on Corporate Fraud. The results of that report indicate that 81% of the study participants stated that fraud occurs when employees and managers are faced with pressure to do “whatever it takes” to meet financial goals. The greater the pressure, the easier it may be to rationalize fraudulent activity.

Management may rationalize such activity believing it best serves the interests of the company, employees and shareholders. Opportunity may present itself during an economic downturn. A corporation’s risk environment can be impacted as it employs stabilization strategies such as downsizing and prioritization of revenue generating activities. Companies place revenue generating activities and expense reductions over risk management issues. The result can be that effective implementation of internal controls or fraud control policies may be neglected. (Deloitte 2008 et al.)

The Deloitte whitepaper Risk Intelligence in a downturn – Balancing risk and reward in volatile times points out that effective risk management depends on three key components: (1) risk governance, (2) risk infrastructure and management, and (3) risk ownership. Risk governance involves strategic decision-making and risk oversight, led by a Board of Directors. Risk infrastructure and management includes designing, implementing and maintaining an effective risk program. This effort should be led by executive management. Risk ownership activities include identifying, measuring, monitoring and reporting on specific risks.\(^{21}\)

Ernst & Young surveyed more than 500 senior executives, predominately those at the C-suite and board level in global companies with revenue turnover in excess of US$1 billion across multiple industry sectors. The survey was conducted for Ernst & Young by the Economist Intelligence Unit in June and July 2009. The survey revealed that ninety-six percent of global organizations today believe they have an opportunity to improve their risk management functions. Nearly half said that committing additional resources to risk management could create a competitive advantage. The survey also highlights the point that the economic downturn is
heightening awareness among companies of the need to manage risk more effectively.22

The accounting industry needs to understand how the actions of companies they audit will impact the community, not just shareholders.

Conclusion

There were and continue to be very credible supporters of fair value, noting that to use anything other than fair value would be to hide or defer recognition of the decline in value (CCH Accounting Research Manager, Current Economic Crisis et al). Recent FSPs have been issued to provide guidance in measuring fair value, and the PCAOB has recently issued audit alerts addressing risks associated with fair value measurements. Disappointingly, the most recent guidance from the FASB leaves a gap in reporting Level 3 fair values. The absence of detailed specified tests will only serve to keep the door to manipulation wide open. There must be structural changes in ethics education and corporate culture to help mitigate the temptation to manipulate fair values so that confidence in financial reporting is restored.

Waddock (2005) suggests that business schools pay more attention to fundamental questions about the meaning and consequences of economic gain and that corporate responsibility be put at the core of business and accounting education. Courses on analysis must consider implications of corporate and individual actions. Accountants must be prepared to question the system and view situations from the perspective of all stakeholders and society as a whole. The professional must assume responsibility for the welfare of others. The accounting industry as a whole needs to understand the evolution of social and environmental reporting and how the actions of companies they audit will impact the community, not just shareholders. Ethics, accuracy and transparency are an integral part of accounting, not something to consider when dilemmas arise.

The ethical implications of increased transparency and diligent oversight cannot be underestimated. Primary responsibility for reliable and relevant financial information rests with management. It is our duty as a profession to be proactive in creating and upholding the standards by which we practice — both accounting and auditing standards.

Besides the continuing diligence of CEO’s and corporate finance officers to ensure that financial statements reflect economic reality, the FASB and PCAOB must maintain an unprecedented level of thoughtful standard-setting and comprehensive oversight to protect the public.

Pressure, temptation and greed will always exist in our society. It is not only the responsibility of regulatory bodies to ensure fairness, honesty and social responsibility, but it is also our own responsibility. Despite controls that may be in place, there will always be justification and rationalization for engaging in deceitful activities. It is the responsibility of regulatory agencies to focus on reducing the value of the incentive to commit fraud, and instead increase the value of compliance while decreasing the opportunities to deviate from the rules.23

Endnotes

1www.fasb.org/summary/stsum157.shtml
5 PCAOB Staff Audit Practice Alert No. 4, “Auditor Considerations Regarding Fair Value Measurements, Disclosures and Other-Than-Temporary Impairments.”
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AssetName=subtopic_page_subsection%26nav_type=subtopic_page#d3e17774-110257

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Misaligned-and-fragmented-risk-functions-
jeopardizing-organizations-performance

IFRS in the United States: Challenges and Opportunities

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Executive Summary

The establishment of a single set of high quality global accounting standards is a matter of growing importance as the participants in the ever increasingly integrated world capital markets demand comparability and transparency of financial reporting worldwide. International Financial Reporting Standards (IFRS) is a set of accounting standards, developed by the International Accounting Standards Board (IASB) that is becoming the global standard for the preparation of public company financial statements. More than 12,000 public companies in over 100 countries have adopted IFRS, including listed companies in the European Union. Other countries, including Canada and India, are expected to transition to IFRS in 2011. In many countries, private companies also use IFRS for financial reporting.

Regulatory authorities in the United States recognize the changing needs of investors making allocation decisions in globally integrated markets. They also acknowledge a significant shift in global market capitalization with U.S. market share steadily declining. According to the September 2009 Standard & Poor report, the U.S. market is now less than 41% of global capital markets, a substantial decline from January 2004, when it was nearly 53% (Standard & Poor, 2009; 2004). More specifically, the New York Stock Exchange (NYSE) market cap at the end of 2003 was 41 times that of Bombay Stock Exchange (BSE) and 31 times that of Shanghai exchange. In July of 2009, NYSE was 9 times that of BSE and only 3.6 times that of Shanghai (Chakravarty, 2009).

The U.S. Securities and Exchange Commission (SEC) has been in favor of a core set of accounting standards suitable for financial reporting in cross-border offerings since the 1990s. Since 2002, it has supported efforts of the Financial Accounting Standards Board (FASB) and the IASB to develop a common set of high-quality global standards. In 2008, the Commission proposed a roadmap that will lay out a schedule and appropriate milestones for continuing progress toward acceptance of IFRS in the United States. In February 2010 the roadmap was revisited and the SEC staff released a statement outlining a work plan to evaluate the impact that IFRS would have on the U.S. financial reporting system. Although it is still not known what date the Commission will set, and whether it will set a date at all, for public companies to make the mandatory or voluntary switch from U.S. Generally Accepted Accounting Principles (U.S. GAAP) to IFRS, the IFRS have a real impact on an ever growing number of U.S. companies, public and private. Some companies are required to report, under IFRS, to meet the reporting requirements of an international parent or investor company. Also, U.S. companies have foreign subsidiaries that must report according to IFRS, and some have operations in jurisdictions where IFRS is mandatory. Furthermore, U.S. companies may recognize the need to voluntary supplement their U.S. GAAP-based financial statements with IFRS-based reports to allow for an accurate comparison with foreign competitors (Gannon and Ashwal, 2004). This article overviews the current status of IFRS worldwide and in the United States, and discusses challenges as well as opportunities of IFRS adoption from the perspectives of: (1) preparers of financial
statements, (2) the accounting profession and (3) the academia.

Introduction

International Financial Reporting Standards (IFRS) refer to a comprehensive, high quality set of accounting standards and interpretations used in the preparation of financial statements. IFRS are considered a principles-based set of standards in that they establish broad rules with greater emphasis on interpretation and the use of judgment, rather than reliance on specific “bright-lines.” Many of the standards forming part of IFRS are known by the older name of International Accounting Standards (IAS). IAS were issued between 1973 and 2000 by the International Accounting Standards Committee (IASC). The Standing Interpretations Committee (SIC), the IASC’s interpretive body formed in 1997, developed interpretations of IAS to be applied where the standards were silent or unclear. The interpretations were referred to as SICs.

In 2001, the International Accounting Standards Board (IASB), an independent, privately funded, full-time standard-setter and the International Financial Reporting Interpretations Committee (IFRIC), its interpretive body, replaced the IASC and the SIC, respectively. During its first meeting the new Board adopted existing IAS and SICs. The IASB has continued to develop standards calling the new standards IFRS, while IFRIC issues interpretations referred to as IFRICs.

As of today, IFRS are used by public companies in 120 jurisdictions, including 90 jurisdictions where IFRS are required for all domestic listed companies (Deloitte, IASPlus.com, 2010). These jurisdictions include all European Union countries, Australia and New Zealand. As for private industry, unlisted companies in 93 jurisdictions use IFRS. Among them there are 27 jurisdictions where IFRS are required for all domestic unlisted companies (Deloitte, IASPlus.com, 2010). Furthermore, the remaining significant economies and capital markets outside the United States have declared a date for specific conversion of their financial reporting standards to IFRS in the near future. For example, Japan is due to decide in 2012 whether it will make adoption of IFRS mandatory for Japanese companies. The country’s Financial Services Agency (FSA) took a big step in December 2009, when it decided to allow some domestic companies to start using IFRS designated by the Commissioner of the FSA in their consolidated financial statements starting from the fiscal year ending March 31, 2010. Japan’s FSA also ended the option for some Japanese listed companies to submit their consolidated financial statements prepared according to U.S. GAAP (FSA, 2009). In 2010, IFRS becomes mandatory for listed companies and banks in Brazil; 2011 will mark mandatory adoption of IFRS for listed companies in Canada, India and South Korea, while listed companies in Mexico and Singapore are required to comply with IFRS by 2012 (IASPlus.com, 2010).

A growing body of academic literature provides empirical evidence confirming the merits and quality of IFRS. For example, Beneish, Miller and Yohn (2009) find increased foreign investment by countries adopting IFRS in 2005, as well as increased foreign participation in debt markets of the adopting countries. Covrig, DeFond and Hung (2007) find increases in foreign mutual fund ownership in foreign stocks after voluntary IAS adoption between 1999 and 2002. A study by Daske, Hail, Leuz and Verdi (2008) on IFRS adoption in non-US markets indicates that it results in lower information asymmetry and greater liquidity, as compared to the domestic sets of standards used in these markets. Barth, Landsman and Lang (2008) find that firms voluntarily adopting IAS from 21 countries exhibit less earnings management, more timely loss recognition and more value-relevant information than a matched sample of firms using their domestic standards. Studies comparing quality of IAS and U.S. GAAP using data from firms that traded in Germany’s New Market, such as Leuz (2003) and Bartov, Goldberg and Kim (2005), find no significant differences between the two sets of standards, suggesting that IAS and U.S. GAAP appear to be of similar quality when applied in German capital market.

Current Status of IFRS in the United States

The Convergence Process

The movement toward IFRS in the United States gained momentum in 2002 with the Norwalk Agreement between FASB and IASB. It acknowledged the Boards’ commitment to the development of high quality, compatible
accounting standards that could be used for both domestic and cross-border financial reporting. At the time, the FASB and the IASB pledged to make their best efforts to make their existing financial reporting standards fully compatible as soon as is practicable and to co-ordinate their future activities to ensure that once achieved, compatibility is maintained (FASB, 2002). Since reaching the agreement, the Boards and their staff have been researching existing differences between U.S. GAAP and IFRS, monitoring and coordinating each others’ agenda and working on a series of joint long-term and short-term convergence projects.

In February 2006, the FASB and IASB issued a Memorandum of Understanding (MoU) to reaffirm the Boards’ shared objective of developing high quality, common accounting standards for use in the world’s capital markets (FASB, 2006). The MoU set forth the relative priorities within the FASB-IASB joint work program in the form of specific milestones to be reached by 2008, although they knew that many of the major standards level projects would not be complete by that date. Also, the Boards decided to change their original approach to convergence of standards that are in need of significant improvements on both sides. Instead of expending resources on trying to eliminate differences between such standards, the Boards decided to seek convergence by replacing them with jointly developed new standards. At their April 2008 joint meeting, the Boards reassessed their priorities again and agreed on milestones to be achieved on major joint projects by 2011. The updated MoU released on September 11, 2008, describes the priorities and milestones related to completion of major joint projects by 2011 (FASB, 2008). Exhibit 1 summarizes the ambitious agenda.

### Exhibit 1. The 2008 Memorandum of Understanding: Plans for Completion by 2011

<table>
<thead>
<tr>
<th>Topic</th>
<th>Convergence Objective</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial statement presentation</td>
<td>to develop a new format for the financial statements</td>
</tr>
<tr>
<td>Revenue recognition</td>
<td>to create a revenue recognition standard that companies can apply consistently across various industries and transactions</td>
</tr>
<tr>
<td>Leases</td>
<td>to ensure that the assets and liabilities arising from lease contracts are recognized in the statement of financial position</td>
</tr>
<tr>
<td>Financial instruments</td>
<td>to simplify hedge accounting and to reconsider recognition and measurement requirements for financial instruments</td>
</tr>
<tr>
<td>Liabilities and equity distinctions</td>
<td>to reach consensus on a preferred model</td>
</tr>
<tr>
<td>Consolidations policy and procedure</td>
<td>to improve financial reporting by enterprises involved with variable interest entities and to reconsider consolidation guidance for voting interest entities</td>
</tr>
<tr>
<td>Fair value measurement</td>
<td>IASB: to develop guidance similar to FAS 157; FASB: to improve disclosure about fair value measurements and to review FAS 157 in light of IASB’s deliberations</td>
</tr>
<tr>
<td>Derecognition</td>
<td>to develop a common standard</td>
</tr>
<tr>
<td>Post employment benefits (including pensions)</td>
<td>to place the full obligation on balance sheet and re-examine measurement</td>
</tr>
</tbody>
</table>
At the inception, the convergence process was envisioned to continue until the point when U.S. GAAP and IFRS achieve practical equivalence. Although the process produced some results, most notably in accounting for business combinations, share-based payment, and the fair value option, it turned out to be slower and more difficult than expected. Consequently, the progress on convergence has been limited. It became apparent that it would be very difficult, if not impossible, to replace about 25,000 pages of detailed rules, comprehensive implementation guidance, and industry interpretations with about 2,500 pages of broad and principles-based standards. Therefore, in 2008 the emphasis in the United States started to shift from the convergence approach to the conversion approach: that is, adoption of IFRS. Most recently, however, the SEC has reemphasized the convergence process as a necessary prerequisite for eventual incorporation of IFRS into the U.S. financial reporting system.

The leaders of the G-20 Group called on “international accounting bodies to redouble their efforts to achieve a single set of high quality, global accounting standards... by June 2011.”

The SEC’s Regulatory Decisions

In 2007, the U.S. SEC made two seminal IFRS-related decisions. In August 2007, the Commission issued the “Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with IFRS” (SEC, 2007a). The SEC issued this Concept Release to gather input on whether U.S. registrants should be permitted to use IFRS when reporting with the Commission. In December 2007, the SEC adopted a final ruling: Securities Act Release No. 8879, “Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with IFRS without Reconciliation to U.S. GAAP,” with an effective date of March 4, 2008 (SEC, 2007b). The ruling indicated the Commission’s confidence that IFRS, as issued by the IASB, were robust enough to provide investors with reliable and relevant financial data. These two decisions present a dramatic new idea with significant implications for U.S. companies, the U.S. capital markets, and the accounting profession.

Most respondents to the Concept Release supported the idea of allowing U.S. issuers to choose between IFRS and U.S. GAAP during an interim period with an eventual move toward IFRS for all issuers. Moreover, many respondents advocated a date-specific mandatory adoption of IFRS. The FASB, American Institute of Certified Public Accountants (AICPA), Big Four accounting firms, as well as the Financial Executives International (FEI)⁴, and many multinational corporations expressed their support for IFRS in their comment letters and during the following round tables, forum discussions and Congressional Hearings.

Consequently, the SEC issued the proposed roadmap for potential adoption of IFRS by all U.S. publicly traded companies (SEC, 2008). The roadmap was issued in November 2008 around the time when the G-20 Group⁵ called for the implementation of a globally consistent set of accounting standards.

The 2008 IFRS roadmap indicated that adoption of IFRS in the United States would be conditional upon achieved progress towards “milestones” including the following:

- Improvements in accounting standards: The SEC will continue to monitor the degree of progress made by the FASB and IASB regarding the development of accounting standards

- Accountability and funding of the IASC Foundation (IASCF): The IASCF must show indications of securing stable funding that supports the independent functioning of the IASB

- Improvement in the use of interactive data for IFRS reporting: The SEC mandated filings for public companies in eXtensible Business Reporting Language (XBRL) format; the mandate came into effect for the largest 500 U.S. companies for financial disclosures made after June 15, 2009

- Education and training: The SEC will consider the state of preparedness of U.S.
issuers, auditors and users, including the availability of IFRS education and training.

The milestones are intended to demonstrate improvement in the infrastructure of international standard setting as well as preparedness of U.S. capital market participants. The Commission envisioned that it would measure progress against these milestones in 2011 and, based on the evaluation results, make a final decision on whether and when to go ahead with adoption of IFRS in the United States. The SEC proposed a phased-in mandatory use of IFRS beginning with fiscal years ending on or after December 15, 2014, for large accelerated filers, 2015 for accelerated filers and 2016 for other filers (SEC, 2008).

Given the time it takes to fully implement IFRS...sufficient up front planning of resource needs and allocation will be vital to a successful adoption.

The Private Sector

In the meantime, the AICPA has also made a seminal IFRS-related decision. In May 2008, the Institute amended Appendix A to Rules 202 and 203 of the AICPA’s Code of Ethics, giving its members the option to use IFRS as an alternative to U.S. GAAP (AICPA, 2008). The decision established IFRS as an alternative to U.S. GAAP or other consistent basis of accounting to be used by private companies. This development is especially significant in light of the IASB issuing in July 2009 “International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs).” The standard is designed to meet financial reporting needs of entities that do not have public accountability and publish general-purpose financial statements for external users (IASB, 2009). Taking into consideration the long-term dissatisfaction with U.S. GAAP expressed by many private companies, some observers believe that adoption of IFRS in the United States may actually happen through the private sector, where entities are interested in meeting user needs of assessing shorter-term cash flows, liquidity and solvency while balancing costs and benefits of compliance (Deloitte, 2009). This would be a different dynamic than in most other jurisdictions around the world, where adoption of IFRS by unlisted companies has been hindered by statutory reporting requirements.

Recently, the AICPA and the Financial Accounting Foundation (FAF) established a “blue-ribbon panel” to provide recommendations on the future of standard setting for private companies. The panel will address the question whether separate, standalone accounting standards for private companies are needed (AICPA, 2009).

The Most Recent Regulatory Developments

The SEC consistently identifies comparability of financial information to investors as a key benefit of moving to IFRS (e.g., SEC, 2007a, 2007b, 2008). In April 2009, at the inaugural meeting of the IASCF’s Monitoring Board, SEC Chairman Mary L. Schapiro reiterated her support for a single set of global standards. More recently, Chairman Schapiro spoke about reforming the global financial system and the regulatory framework that governs it at a conference sponsored by the International Organization of Securities Commissions’ (IOSCO) Technical Committee in Basel, Switzerland, on October 8, 2009. She said that financial reports prepared in accordance with high-quality, consistent accounting standards are one of the most effective tools for providing transparency to the markets and instilling confidence in investors. Yet the financial crisis has demonstrated that some standards must be improved. She reiterated the Commission’s commitment to a global set of accounting standards.

In addition, the SEC has recently published its Draft Strategic Plan for fiscal years 2010 through 2015. The document includes drafts of the SEC’s mission, vision, values, strategic goals, major initiatives, and performance metrics. In the plan, the SEC proposes an objective of promoting high-
quality financial reporting worldwide through, among other things, support for a single set of high-quality global accounting standards and promotion of the ongoing convergence initiatives between the FASB and the IASB (SEC, 2009a). This is in line with the statement issued at the G-20 Summit held from September 24 – 25, 2009, in Pittsburgh, Pennsylvania. In an agreement reached at the Summit to make numerous changes to the regulation of financial markets, systems and institutions, the leaders of the G-20 Group called on “international accounting bodies to redouble their efforts to achieve a single set of high quality, global accounting standards within the context of their independent standard setting process, and complete their convergence project by June 2011” (Lamoreaux, 2009). In response, the IASB and the FASB have issued yet another joint statement reaffirming their commitment to improve IFRS and U.S. GAAP and to bring about their convergence. The Boards also express their agreement to intensify their efforts to complete the major joint projects described in their 2006 MoU, as updated in 2008. In the interest of timely and continued progress, the two Boards also committed to monthly joint meetings and to provide transparency and accountability by providing quarterly updates on their progress on convergence projects.

In the meantime, the SEC staff reviewed over 200 comment letters received in response to the 2008 IFRS roadmap. Responders expressed widespread support for the goal of having a single set of high-quality globally accepted accounting standards, but differed in their view how to achieve this goal. After careful deliberation the Commission met on February 24, 2010, to discuss the IFRS roadmap, and unanimously approved the 71-page Commission statement that provides an overview of the IFRS activities, summarizes some of the public feedback on the 2008 IFRS roadmap and outlines an approach going forward (SEC, 2010). The Commission statement directs the SEC staff to carry out a work plan prior to an SEC decision on IFRS. The key issues to be addressed in the work plan include:

- Sufficient development and consistent application of IFRS globally
- Independence of standard setting process
- Transition issues, such as:
  - Investor understanding and education
  - Impact on U.S. regulatory environment
  - Impact on issuers, and
  - Human capital readiness

According to the SEC statement, the decision about incorporating IFRS in the U.S. financial reporting system will be made in 2011. The document does not provide any details of potential transition dates or approaches, but the staff stated that 2015 or 2016 seemed reasonable based on comments received on the 2008 IFRS roadmap. The Commission also indicated that an early adoption is a viable option if the SEC decides to require the use of IFRS.

**Challenges of IFRS Adoption Under the Proposed SEC Roadmap**

**The Preparers**

Preparers of financial statements face significant challenges in adopting IFRS. The challenges run the risk of being underestimated by management, who may focus solely on direct changes occurring on the financial statements. Preparers can learn from those in jurisdictions that have already adopted IFRS.

In the current economic environment, the sheer cost of conversion is at the top of many executives’ minds. Estimates vary depending on size and other factors, but in some cases entities can expect to incur up to nearly 1% of revenue on the effort. It can be difficult to justify the short-term costs of converting to a new set of standards when the benefits of the conversion tend to be more long-term in nature. If adoption is mandated by the SEC, difficult decisions regarding resource allocation will be necessary.
Further, depending on the timeline ultimately decided upon by the SEC, considerable time pressure could result in further escalation of costs necessary to meet the timing. Ultimately, given the time it takes to fully implement IFRS, taking two years from the date of transition to the end of the first IFRS reporting period, sufficient up front planning of resource needs and allocation will be vital to a successful adoption and to keeping the costs of adoption under control.

A sizeable challenge of adoption is the need for skilled personnel. Training existing staff and management is a time consuming process, and there will also be a need for personnel with relevant experience in the application of IFRS to ensure a satisfactory transition. Availability of an appropriately trained and experienced workforce will be limited until educational programs, both at the collegiate and professional levels, can catch up to the need.

Information systems are another area where substantial changes will be necessary during the adoption of IFRS, especially for entities with global operations. Multiple systems running with multiple charts of accounts and consolidation methods will need to be brought in sync with each other. Further, during the two-year period of transition to IFRS, entities will need to run IFRS and local GAAP simultaneously, putting additional strain on already limited resources. Standardization of policies and procedures will be necessary to consistently apply the standards across borders. The impact to those outside of accounting should also be considered. The information necessary to support many accounting and reporting functions often comes from outside of the accounting department, and responsible parties will need to be educated as to the changes that will need to take place in their arena.

### The Accounting Profession

As is the case with preparers, a significant challenge to the accounting profession will be the availability of sufficiently educated and experienced professionals. Audit professionals will need to demonstrate sufficient knowledge of IFRS in order to render an opinion on IFRS financial statements. Those who support auditors, such as tax professionals and
information systems consultants, will also need to ensure that their understanding of IFRS is sufficient to adequately provide audit support. An example of this need is in the area of tax provision auditing. Tax professionals supporting IFRS audits will need to have a sufficient understanding of IAS 12, Income Taxes, in order to properly evaluate the tax provision.

In addition to sharing the challenge of resource constraints, accounting professionals will be facing an ever-increasing use of judgment in the application of IFRS, due to the principles-based nature of the standards, as opposed to the generally rules-based standards of U.S. GAAP. Convergence efforts have increased the use of judgment-based standards in recent years, in particular the recently adopted fair value and business combination standards, which require a much greater amount of professional judgment in their application than earlier standards. But still, changing the rules-based way of thinking of U.S. GAAP to the principles-based mindset of IFRS will take considerable effort on the part of accounting professionals.

**Accounting professionals will be facing an ever-increasing use of judgment in the application of IFRS, due to the principles-based nature of the standards...**

**Academia**

IFRS knowledge in the United States is currently limited to expert groups mostly among financial analysts and institutional investors, credit-rating agents, Big Four accountants, actuaries, preparers reporting under IFRS to their foreign parent companies and regulators and standard-setters dealing with IFRS issues. Current accounting curricula at most U.S. colleges and universities include only limited IFRS content.

The 2008 survey conducted by the accounting firm KPMG in cooperation with the American Accounting Association (AAA) on the subject of IFRS education found that only five % of the surveyed professors expected the Class of 2009 to have a substantial knowledge of IFRS. The responses revealed that 62% of professors have not taken any significant steps to incorporate IFRS into the accounting curriculum. They believed that although the first class of graduating seniors likely to have a substantial amount of IFRS education will be the class of 2011, it would take many years for graduating seniors to be sufficiently knowledgeable about IFRS. Although publishers have started to gradually add IFRS content to U.S. GAAP–based accounting textbooks and IFRS textbooks in English are readily available abroad, about 42% of the professors surveyed felt that IFRS-based textbooks would not be ready until the 2010-2011 academic year (KPMG-AAA, 2008).

The survey reflected the state of IFRS readiness in academia as of the 2008-2009 academic year, but the findings are still quite relevant today. The inherent uncertainty of the SEC roadmap, augmented by the recent financial crisis and economic recession, hindered any significant progress towards IFRS education in U.S. academic institutions. The Financial Accounting and Reporting Section and the Financial Reporting Policy Committee of the AAA, in their response to the SEC roadmap, concluded that U.S. colleges and universities are not equipped to teach IFRS at the level necessary for near term adoption of the Standards (AAA, 2009).

The Uniform CPA Examination, however, will be transformed beginning in 2011, with a new structure, format and content, and supported by enhanced technology. The improvements, designated CBT-e for Computer-Based Testing evolution, will be launched January 1, 2011, simultaneously with exam content updates that include, for the first time, testing on IFRS. Under the new Content and Skill Specification Outlines (CSOs/SSOs), CPA exam candidates will be expected to identify and understand the differences between financial statements prepared on the basis of U.S. GAAP and IFRS. Candidates will also be required to demonstrate proficiency in first-time adoption of IFRS (AICPA, 2009).

This reality puts significant pressure on academic units providing accounting education. The current uncertainty as to if and when the U.S. financial reporting system transitions to IFRS does not help in developing strategic and
tactical plans. The possibility of a prolonged parallel accounting education system, where students would be required to obtain proficiency in both U.S. GAAP and IFRS, seems to loom on the horizon as the worst possible scenario. Curriculum overload and faculty shortages are almost certain to occur if parallel accounting education is to be delivered at the undergraduate level. Recent survey of Accounting Departments at two hundred universities throughout the United States indicated significant change to the intermediate accounting course sequence as a result of information overload. Twenty % of respondents indicated that they had made the change from a two to three course sequence. The remaining 20% are in the process of making the change or have made another change such as changing the intermediate accounting courses from 3 credit hours to 4-credit hours (Davidson and Francisco, 2009)

Opportunities in IFRS reporting

The Preparers

Preparers adopting IFRS will have the opportunity to take a critical look at their accounting policies to ensure that the economic substance of transactions is faithfully represented. IFRS allow the preparer to use a considerable amount of judgment in applying standards so as to achieve this goal. Extensive disclosure requirements are required to ensure that the judgments used in applying IFRS are clearly understood by users of financial statements.

The adoption of IFRS also presents a unique opportunity for preparers to streamline internal and external reporting structures. Using the same set of standards across borders can reduce or eliminate the need for reconciliations between subsidiaries and follow-up during the consolidation process. A consistent understanding of the accounting policies of entities should result in more reliable application of those policies entity-wide.

As the majority of global business is or may be using IFRS, a distinct advantage exists for those operating under IFRS. Users of IFRS financial statements may have the opportunity to have a more in-depth understanding of an entity through more informative disclosures and can hopefully make more knowledgeable decisions based on that understanding.

Exhibit 3. Benefits to adopting IFRS as perceived by potential early adopters

Source: November 2008 Deloitte survey of over 200 respondents
The Accounting Profession

There are significant opportunities in the marketplace for accounting professionals who are prepared to take advantage of them. Organizations will most likely need a substantial amount of guidance from experienced, well-trained professionals on adopting and applying IFRS, whether in working through an implementation of IFRS on a consulting basis or through providing training opportunities for an entity’s accounting and executive personnel.

Further, the adoption of IFRS can act as a catalyst to improve interaction between cross-border audit teams. Speaking the same accounting language can help to streamline the audit process, from identifying risks to concluding on consolidation. Once teams are properly trained and experienced in the application of IFRS, teams will be in better positions to serve their clients in a more effective and efficient manner.

U.S. colleges and universities are not equipped to teach IFRS at the level necessary for near term adoption of the Standards.

Academia

The possible move to IFRS in the United States could be seen as an opportunity for a much needed overhaul of the accounting curriculum. Members of academia should analyze current undergraduate and graduate accounting curricula in light of the upcoming changes. The current accounting education model emphasizing memorization of rules and journal entries would no longer be sufficient. The transition to IFRS creates a great opportunity to restructure the accounting curriculum to meet the requirements of the new global financial reporting environment.

The top accounting firms are currently trying to bridge the gap between demand and supply of IFRS skills by developing IFRS curriculum materials for students and faculty. Members of academia should foster further cooperation by working closely with leading accounting firms in developing the most relevant contemporary content of accounting courses. Cooperation between Deloitte’s University Consortium and the faculty of Virginia Polytechnic Institute on incorporating IFRS content into intermediate accounting could serve as an example (Fay, et al. 2009).

Furthermore, IFRS would not affect financial accounting alone. The conversion would impact a wide range of business functions beyond financial reporting. These may include changes to management’s internal reporting, data gathering and IT systems, the use of key performance indicators, the content of employee and executive compensation plans, the activities of investor relations, changes to policies and procedures, and the resultant impacts on internal control documentation and certification requirements. IFRS also carries tax implications arising from a major change in how companies will measure the pre-tax income. Issues such as transfer pricing, international tax planning, and local taxes will come up if the conversion takes place. To respond, the revision of the accounting curriculum should take an inter-disciplinary approach. To succeed in the profession, students ought to be well educated not only in the IFRS-based financial, managerial and tax accounting, but also in finance and economics, with special emphasis on valuation and determination of the economic substance of transactions. Emphasis should be placed on statistics, logic and judgment formation, as well as proficiency in accounting information systems. Selected programs offered at leading universities located in IFRS jurisdictions could serve as models. For example, members of academia and practitioners in Germany observed that IFRS enforce a trend toward integration of financial and managerial accounting systems. Some German universities offer courses in IFRS-based managerial accounting and integrated accounting systems.

The perfect storm of financial reporting changes hovering over academia at this time
may prompt a value-adding cooperation among accounting, finance and economics departments. But this would be a complex process of change rather than an immediate shift in education. Mary Barth, long time academic member of the IASB, suggests that in the meantime educators should start changing the way in which they teach in order to prepare for IFRS. In particular, a greater emphasis should be placed on the conceptual framework, foundational theories upon which financial reporting is based and valuation theory. Accounting faculty should teach how to audit estimates of asset and liability values and provide opportunities for students to exercise professional judgment (Barth, 2008). Larson and Brady (2009) offer useful suggestions for incorporating IFRS into the accounting curriculum and provide a list of numerous IFRS resources.

Higher education institutions are likely to face significant challenges to implement the new accounting curriculum, especially due to the well-publicized shortage of accounting faculty, especially with doctoral degrees. But this time of change offers a unique opportunity to reassess the priorities of accounting education, redefine the objectives and develop an accounting curriculum that reflects current market developments and equips students with a globally portable set of skills.

Concluding Remarks

The potential adoption of IFRS in the United States would be much more than a technical accounting exercise. The principles-based approach reflected in IFRS, if adopted, will require future accountants and auditors to exercise professional judgment more often and to a greater degree than before. IFRS also have tax, internal reporting, and systems implications. This change is profound, especially when seen in the broader context of the current financial reporting environment, including an ever-intensifying movement towards fair value accounting, the implementation of the FASB Accounting Standards Codification and the mandatory use of XBRL by publicly listed companies.

Many are wondering about future of IFRS in the United States. The SEC indicated that the execution of the staff work plan and the completion of the convergence projects would position the Commission to make the informed decision in 2011 (SEC, 2010). Whatever the Commission’s decision, given the globalization of capital markets and continuing transition of companies worldwide to IFRS, there is a rising need for financial reporting constituencies to educate themselves about IFRS.

References


Endnotes

1 The IASC issued standards IAS 1 through IAS 41, of which 29 are still in effect. The SIC issued 33 interpretations, of which only 11 are still in effect; others have been incorporated into standards.

2 Designated IFRS include all IFRS and Interpretations issued on or before December 31, 2009.

3 The authors used metrics for earnings management based on the variance of the change in net income, the ratio of the variance of the change in net income to the variance of the change in cash flows, the correlation between accruals and cash flows and the frequency of small positive net income.

4 FEI is the preeminent association for CFOs and other senior finance executives.

5 G-20 is the Group of Twenty Finance Ministers and Central Bank Governors from 20 world’s largest economies: 19 countries, plus the European Union (EU). It has also met three times at heads-of-government level: Washington, DC in November 2008, London in April 2009, and Pittsburgh in September 2009. Collectively, the G-20 economies comprise 85% of global gross national product, 80% of world trade (including EU intra-trade) and two-thirds of the world population.

6 In January 2010 the Trustees of the IASC Foundation approved changes to the Foundation’s Constitution. As a result, the IASC Foundation has been renamed the IFRS Foundation, effective March 1, 2010.
**Executive Summary**

In July 2009, the International Accounting Standards Board issued a new International Financial Reporting Standard (IFRS) designed for use by small and medium-sized entities (SMEs). This self-contained standard is a result of a five-year development process, with extensive consultation with SMEs worldwide. It was issued in response to strong international demand from both developed and emerging economies for “little IFRS,” that is, much simpler than full IFRS. This article examines IFRS for SMEs, its simplifications of full IFRS, major differences between the IFRS for SMEs and U.S. Generally Accepted Accounting Principles (US GAAP), first-time adoption requirements and potential implications for U.S. private entities.

The IFRS for SMEs is intended for entities that do not have public accountability. The modifications to the content of the full IFRS that respond to both the needs of users of SMEs’ financial statements and to cost-benefit concerns include the following broad types: a) omitted topics; b) only the simpler option included; c) recognition and measurement simplifications; d) reduced disclosures; and e) simplified drafting.

With the issuance of IFRS for SMEs, U.S. private entities have another option for financial reporting, in addition to U.S. GAAP and full IFRS. Many believe that the IFRS for SMEs can provide stakeholders with improved comparability of accounts as well as with transparent, reliable financial information to guide effective decision-making.

**Introduction**

On July 9, 2009, the International Accounting Standards Board (IASB) issued International Financial Reporting Standard (IFRS®) for Small and Medium-sized Entities (SMEs). The stated goal of this IFRS is to provide a simplified, self-contained global accounting and financial reporting standard designed to meet the financial statement needs of smaller, non-listed entities.

The perceived need for a stand-alone set of simplified standards has become increasingly manifest in recent years. In the United States, FASB is also weighing development of such a streamlined group of financial reporting requirements. The advent of this standard follows by about a decade a similar undertaking in the United Kingdom, where Financial Reporting Standard for Smaller Entities (FRSSE) have been successfully implemented.

The support for the IASB’s project from national accounting standard setters throughout the world stems mostly from the widely perceived complexity of the full IFRS, and from the compulsory statutory requirements for financial reporting by non-public entities in many countries, which contrasts with the absence of such requirements in the United States. The complexity of the full IFRS (or, for that matter, full U.S. GAAP) arguably imposes a high cost on implementing and applying these standards. In addition, in most countries – in contrast with the United States – SMEs are legally required to file statutory financial statements prepared in accordance with national GAAP (or IFRS), and to make them available to all users. Statutory financial statement requirements affect a large number of entities: for example, in the European Union (EU) about 7,000 listed companies implemented IFRS in 2005, but another seven million SMEs were required to prepare their financial statements in accordance with various national GAAP, resulting in a lack
of comparability. Additionally, many believe that the IFRS for SMEs may ease the transition to full IFRS for listed companies, provide improved comparability for users of accounts and enhance the overall confidence in the accounts of SMEs.


With the issuance of IFRS for SMEs, U.S. private entities have another option for financial reporting, in addition to U.S. GAAP and full IFRS.

Opponents of a separate set of standards for SMEs believe that all entities should follow the same basic accounting principles and detailed requirements for the preparation of general purpose financial statements, whether IFRS or U.S. GAAP. Some have noted that complexity in accounting is merely a symptom — the inevitable result of the ever-increasing complexity of transactional structures, such as the widespread use of “engineered” financial products. Based on observations of the difficulties faced by companies implementing and applying the full IFRS, others have concluded that the problem is not that SMEs need simpler accounting, but that all entities need reporting requirements that are less complex and more principles-based. Also, some believe that the use of IFRS for SMEs may produce non-comparable information. SMEs may not be comparable with each other and will not be comparable with publicly accountable entities using full IFRS.

Because the IASB lacks the power to compel any company to use its standards, the adoption of the IFRS for SMEs is a matter for each country to decide. The issue must be resolved by a country’s government legislators and regulators, an independent standards setter, or a professional accountancy body. Each country will have to set criteria to determine the eligibility of a company as a “small or medium-sized” entity.

Definition of SMEs

IFRS for SMEs is intended for entities that do not have public accountability and that are required, or choose, to publish general purpose financial statements for external users. An entity has public accountability — and therefore should use the full IFRS — if it meets either of the following conditions: 1) it has issued debt or equity instruments in a public market; or 2) it holds assets in a fiduciary capacity, as its primary purpose of business, for a broad group of outsiders. The latter category of entity would include banks, credit unions, insurance companies, securities broker/dealers, pension funds, mutual funds and investment banks. The standard does not impose a size test in defining SMEs, notwithstanding the nomenclature used. Over 99% of private entities around the world are expected to be eligible to use this standard. A subsidiary of a listed company can use this standard if it is not listed, itself, on the stock exchange.

Concepts and Pervasive Principles

IFRS for SMEs states that “the objective of financial statements of a small or medium-sized entity is to provide information about the financial position, performance and cash flows of the entity that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs.” Providing information about the results of the stewardship of management — the accountability of management for the resources entrusted to it — is also an important part of that objective.

The qualitative characteristics of financial statements that make financial information useful are understandability, relevance, materiality, reliability, substance over form, prudence, completeness, comparability, timeliness and balance between benefit and cost. Financial statements are prepared using the accrual basis of accounting, which means that the financial statement items such as assets, liabilities, equity, income and expenses are recognized when they satisfy the definition and recognition criteria for those items.

IFRS for SMEs provides the definition, recognition criteria and measurement concepts for assets, liabilities, equity, income and expenses and the pervasive principles that are derived from the IASB Framework for the Preparation and Presentation of Financial Statements and from full IFRS. In the absence of a requirement in IFRS for SMEs, management making the judgment
may also consider the requirements and guidance in full IFRS dealing with similar and related issues. The application of the qualitative characteristics, as well as definitions and pervasive principles set out in this standard, is presumed to result in fair presentation of the financial statements.

The IASB has made significant simplifications to the recognition and measurement principles included in full IFRS.

Measurement of assets and liabilities at initial recognition is at historical cost, unless IFRS for SMEs requires initial measurement on another basis, such as fair value. In subsequent periods, an entity measures basic financial instruments at amortized cost less impairment (except for certain investments in non-convertible and non-puttable preference shares and non-puttable ordinary shares that are measured at fair value). All other financial assets and financial liabilities are generally measured at fair value, with changes in fair value recognized in profit or loss, unless IFRS for SMEs requires or permits measurement on another basis, such as cost or amortized cost.

Simplifications of Full IFRS

Compared to the full IFRS, the length of the standards has been reduced by more than 90%. This was achieved by omitting topics deemed to not be generally relevant to SMEs, by eliminating certain choices of accounting treatments, by simplifying methods for recognition and measurement, and by reducing disclosure requirements. These modifications to the content of the full IFRS, discussed below, respond to both the needs of users of SMEs’ financial statements and to cost-benefit concerns.

Omitted topics. Certain topics covered in the full IFRS were viewed as not relevant to typical SMEs (e.g., pertaining to transactions thought unlikely to occur in an SME context), and have accordingly been omitted from the standard. Previously — when the exposure draft for IFRS for SMEs was released — there were cross-references to the full IFRS that would not preclude SMEs from applying any of the financial reporting standards and methods currently found in IFRS, essentially making the IFRS for SMEs standard optional. Upon issuance of the final IFRS for SMEs standard, all of these cross-references were removed, with the only ‘fallback’ option being to use IAS 39, Financial Instruments: Recognition and Measurement, instead of the financial instruments sections of IFRS for SMEs. It is expected that most SMEs will not apply IAS 39 due to the additional complexity. Consequently, IFRS for SMEs is a fully stand-alone document, not to be used in conjunction with the full IFRS.

Topics addressed in the full IFRS that are omitted from the IFRS for SMEs standard are as follows:

- Earnings per share
- Interim financial reporting
- Segment reporting
- Insurance (since insurance entities will not be eligible to use IFRS for SMEs)
- Special accounting for assets held for sale

Only the simpler option included. Where full IFRS provide an accounting policy choice, generally only the simpler option is included in IFRS for SMEs. SMEs will no longer be permitted to use the other option(s) provided by the full IFRS.

Examples of options in full IFRS that are not available for SMEs include:

- For financial instruments, the ‘available-for-sale’ and ‘held-to-maturity’ categories of IAS 39 and fair value option are eliminated
- The revaluation model in IAS 16, Property, Plant and Equipment and IAS 38, Intangible Assets
- Proportionate consolidation for investments in jointly controlled entities
- For investment property, measurement is driven by circumstances rather than a choice between the cost and fair value models. If the fair value of investment property can be measured reliably without undue cost or effort, the fair value model must be used. Otherwise, the cost method is allowed.

Deferral of actuarial gains and losses of deferred benefit pension plans

There are more than 3,000 items in the disclosure checklist in the full IFRS, but roughly 300 disclosures in the IFRS for SMEs.

**Recognition and measurement simplifications.** The IASB has made significant simplifications to the recognition and measurement principles included in full IFRS. Examples of the simplifications to the recognition and measurement principles found in IFRS are as follows:

- **Financial instruments:** Only two categories of financial instruments are provided, rather than the four found in full IFRS. Financial instruments meeting specified criteria are measured at cost or amortized cost; all others are measured at fair value through profit or loss. Since available-for-sale and held-to-maturity classifications under IAS 39 would not be available, there would be no need to deal with all of the ‘intent-driven’ held-to-maturity rules, or related ‘tainting’ concerns, with no need for an available-for-sale option, among other simplifications. Also, simplified hedge accounting and derecognition requirements are provided. (The ‘pass-through’ and ‘continuing involvement approach’ for derecognition have been dropped.)

- **Goodwill and other indefinite-life intangible assets:** An indicator approach has been adopted to supersede the mandatory annual goodwill impairment calculations in IFRS 3, *Business Combinations*. Additionally, goodwill and other indefinite-lived assets are considered to have finite lives, thus reducing the difficulty of assessing impairment. If the useful life cannot be estimated, then the assets are amortized over 10 years. An impairment test is performed only if there is an indication of impairment.

- **All research and development costs are expensed as incurred** (IAS 38, *Intangible Assets* requires capitalization after commercial viability has been assessed).

- **All borrowing costs are expensed when incurred** (IAS 23, *Borrowing Costs*, requires capitalization of borrowing costs associated with qualifying assets).

- **The cost method of accounting for associates and joint ventures may be used** unless there is a published price quotation (in which case fair value must be used).

- **Less use of fair value for agriculture** (required only if fair value is readily determinable without undue cost or effort). Otherwise, the cost-depreciation-impairment model is used.

- **Defined benefit plans.** All actuarial gains and losses must be recognized immediately in full either in profit and loss or in other comprehensive income when they occur. Thus, only two of the four options available under IAS 19, *Employee Benefits*, are allowed (the complex ‘corridor approach’ has been dropped). All past service cost must be recognized immediately in profit or loss. An entity is not required to use the projected unit credit method to measure its defined benefit obligation and the related expense, if impracticable.

- **Share-based payment:** Equity-settled share-based payments should always be recognized as an expense and the expense should be measured on the basis of observable market prices, if available (IFRS 2, *Share-based Payment*). The directors’ best estimate of the fair value of the equity-settled share-based payment is used to measure the expense if observable market prices are not available, rather than the intrinsic value method.

- **Exchange differences recognized initially in other comprehensive income** are not reclassified to profit or loss on disposal of the related investment (and thus there is no need for tracking such exchange gains and losses after initial recognition).
Reduced disclosures. The disclosure requirements in IFRS for SMEs are substantially reduced when compared with those in full IFRS. There are more than 3,000 items in the disclosure checklist in the full IFRS, but roughly 300 disclosures in the IFRS for SMEs. Some disclosure requirements have been omitted for SMEs for the following two main reasons: (1) they relate to recognition and measurement principles in full IFRS that have been replaced by simplifications in the IFRS for SMEs; and (2) they are not considered appropriate based on users’ needs and/or cost-benefit considerations (e.g., some disclosures are more relevant to investment decisions in public capital markets).

Simplified drafting. The standard is drafted in a simplified language without details that are incorporated in full IFRS.

Differences between the IFRS for SMEs and U.S. GAAP

A number of significant differences and minor differences between IFRS for SMEs and U.S. GAAP exist with regard to recognition, presentation, and measurement as well as disclosure. The adoption of IFRS for SMEs would require understanding how this standard differs from U.S. GAAP as well as the legal, financial and other implications of these differences. Exhibit 1 presents comparison of the IFRS for SMEs with U.S. GAAP in selected areas.

In general, the requirements in IFRS for SMEs are simpler than those in U.S. GAAP and these simplifications might make the standard attractive to financial-statement preparers. However, entities should consider how financial-statement users

Exhibit 1. Major differences between the IFRS for SMEs and U.S. GAAP in selected areas.

<table>
<thead>
<tr>
<th>Topic</th>
<th>Differences from U.S. GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Presentation of financial statement</td>
<td>A combined statement of comprehensive income and retained earnings allowed</td>
</tr>
<tr>
<td></td>
<td>At least one year of comparative information required</td>
</tr>
<tr>
<td>Consolidation policy</td>
<td>Consolidation based on a control model; potential voting rights are considered (e.g., options)</td>
</tr>
<tr>
<td>Business combinations</td>
<td>Business combinations accounted for using the purchase method</td>
</tr>
<tr>
<td></td>
<td>Noncontrolling interests measured at the proportionate share of the value of identifiable assets and liabilities</td>
</tr>
<tr>
<td>Revenue recognition</td>
<td>Based on general principles versus complex detailed guidance</td>
</tr>
<tr>
<td>Financial assets and liabilities</td>
<td>Cost measurements used more often for financial assets and liabilities</td>
</tr>
<tr>
<td></td>
<td>Simplified classification (two categories: amortized cost and fair value through profit or loss and derecognition criteria</td>
</tr>
<tr>
<td>Inventory</td>
<td>LIFO prohibited</td>
</tr>
<tr>
<td></td>
<td>Inventories measured at the lower of cost and net realizable value</td>
</tr>
<tr>
<td></td>
<td>Impairment losses are subsequently reversed</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>A ‘components’ approach required for depreciation of an asset with differing patterns of benefits</td>
</tr>
<tr>
<td>Goodwill and indefinite life intangibles</td>
<td>Amortized over useful lives not to exceed 10 years</td>
</tr>
<tr>
<td></td>
<td>Impairment testing required only when there is an indicator of impairment</td>
</tr>
<tr>
<td>Asset impairment</td>
<td>An assessment of impairment indicators at each reporting date required</td>
</tr>
<tr>
<td></td>
<td>Impairment based on the difference between the asset’s “recoverable amount” versus carrying value</td>
</tr>
<tr>
<td></td>
<td>Reversals of impairment recognized, other than in respect of goodwill</td>
</tr>
<tr>
<td>Employee benefits</td>
<td>Immediate recognition of actuarial gains/losses</td>
</tr>
<tr>
<td>Leases</td>
<td>Indicators are used to determine lease classification at inception</td>
</tr>
<tr>
<td>Borrowing costs</td>
<td>Capitalization of borrowing costs not permitted</td>
</tr>
<tr>
<td>Income taxes</td>
<td>A simplified approach to recognize deferred tax liabilities and assets</td>
</tr>
<tr>
<td>Disclosures</td>
<td>Simplified disclosures required in several areas, including financial instruments, share-based payments, leases and pensions</td>
</tr>
</tbody>
</table>
will react to a perceived reduction of information versus what would be required under U.S. GAAP (KPMG, 2009).

Like full IFRS, IFRS for SMEs is more principles-based than U.S. GAAP, emphasizing the use of judgment over prescribed “bright-line” rules. The intent is to allow preparers to focus on the economic substance of a transaction or event and analyze business objectives rather than sort through detailed rules and guidelines.

Other companies may [also] find the IFRS for SMEs an attractive alternative to the more complex and voluminous U.S. GAAP (AICPA, 2009).

Maintenance of the IFRS for SMEs

SMEs have expressed concerns not only over the complexity of IFRS, but also about the frequency of changes to standards. To respond to these issues, IASB intends to update the IFRS for SMEs approximately once every three years via an ‘omnibus’ standard. Users are thus being assured of having a moderately stable set of financial reporting requirements.

Transition to IFRS for SMEs

The new standard contains a section on transition, which provides all of the exemptions in IFRS 1, First-time Adoption of IFRS — with additional simplifications concerning comparative information. The first-time adoption exemptions, which permit prospective application of certain requirements, facilitate a cost-effective transition to IFRS for SMEs for entities that decide to adopt. Entities in transition to the IFRS for SMEs would have to select accounting policies based on choices provided in the standard, and prepare at least two years financial statements and opening balance sheet for the earliest year, applying those policies.

On first-time adoption, accounting policy choices permitted include the following:

- Single statement of comprehensive income (or separate income statement and statement of comprehensive income) vs. combined statement of income and retained earnings allowed in some circumstances

  - Direct or indirect method for operating cash flows
  - Investments in associates and joint ventures at cost, equity method, or fair value through Profit and Loss (P&L)
  - All actuarial gains/losses reported currently as part of P&L or as other comprehensive income (but no deferrals would be allowed)
  - In separate company financial statements, account for investment in subsidiary at cost or at fair value through P&L

This list of accounting policy choices on first-time adoption is small compared with that under full IFRS. In addition, as with first-time adoption of full IFRS, first-time adopters potentially would need to make four kinds of adjustments from national GAAP or full IFRS to IFRS for SMEs: (1) Derecognize some old assets and liabilities; (2) Recognize some new assets and liabilities; (3) Reclassifications; and (4) Measurement changes.

The IFRS for SMEs provides some relief from the requirement in IFRS 1 to present at least one year of comparable information restated in accordance with IFRS by including an ‘impracticability’ exemption. If it is impracticable to restate one or more items, the standard allows an exception, with disclosure of the resulting non-comparabilities. In addition, it provides an impracticability exception with respect to restating the opening statement of financial position.

Implications of the IFRS for SMEs

The IFRS for SMEs is a significant development that may have real impact on the future accounting and auditing standards issued by organizations participating in the standard-setting process.

The effective date of IFRS for SMEs will be determined for each jurisdiction by its national regulatory authorities and standard-setters, not by the IASB. South Africa was the first country that adopted this standard, since it reduces the cost of maintaining standards on a national basis.
The EU member states will decide whether to permit or require it, and for which entities. Today there are reportedly as many as 55 different SMEs GAAP in the EU (Pacter, 2009). In many Continental European countries, a close link exists between the statutory financial statements and the results reported for income tax purposes. The successful implementation of the SME Standard will require breaking the traditional bond between the financial statements and the income tax return, and may well trigger a need to amend company laws.

In 2005, the AICPA task force, comprised of key constituents of private company financial reporting and led by former AICPA chair James Castellano, unanimously recommended that a process be established to evaluate potential changes to U.S. GAAP in order to improve the usefulness of private company financial reporting. On March 6, 2007, the FASB and the American Institute of Certified Public Accountants (AICPA) announced that the newly established Private Company Financial Reporting Committee (PCFRC) would address the financial reporting needs of private companies and of the users of their financial statements. The primary objective of PCFRC was to help the FASB determine whether and where there should be specific differences in prospective and existing accounting standards for application by private companies. The PCFRC is discussing some possible models for private company accounting in the U.S., assuming that public companies will be required to comply with IFRS, which are presented in Exhibit 2.

Exhibit 2. Possible Future Models for Private Entity Accounting in the U.S.

<table>
<thead>
<tr>
<th>Possible Models</th>
<th>Accounting Framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>IFRS with <em>IFRS for SMEs</em> Option</td>
<td>IFRS exists as GAAP in the U.S. for all entities (public and private)</td>
</tr>
<tr>
<td></td>
<td>U.S. private entities have the option of following <em>IFRS for SMEs</em></td>
</tr>
<tr>
<td>US Adapted Version of <em>IFRS for SMEs</em></td>
<td>The <em>IFRS for SMEs</em> standard is tailored to suit the needs of private entity financial reporting constituents in the U.S.</td>
</tr>
<tr>
<td>IFRS with Differential Reporting</td>
<td>IFRS is modified, to suit the needs of private entity financial reporting constituents, by deleting some requirements or embedding different treatments in the standards</td>
</tr>
<tr>
<td>Separate U.S. Private Entity GAAP – Revised</td>
<td>Current U.S. GAAP is reviewed, modified, and developed into a comprehensive and self-contained set of accounting standards for private entities</td>
</tr>
<tr>
<td>Separate U.S. GAAP – Maintained and Updated in Future</td>
<td>Current U.S. GAAP would be maintained, as is, for use by private companies; and periodically updated for needed changes and improvements. No initial review and significant modification of current U.S. GAAP</td>
</tr>
</tbody>
</table>

According to Paul Pacter, the Director of Standards for SMEs at the IASB in London, there does not appear to be any reason why private companies in the United States could not use *IFRS for SMEs* — provided that the basis of presentation note clearly explains that the financial statements conform to *IFRS for SMEs* (Pacter, 2007). If audited, the auditors would report on conformity with the *IFRS for SMEs*. The AICPA made this option possible by recognizing the IASB as a designated standard setter, along with the FASB. Introduced in 2008, an amendment to Appendix A of AICPA, Rules 202 and 203, give AICPA members the option to use IFRS as an alternative to U.S. GAAP. This move has led some to believe that IFRS implementation in the United States could be actually driven by private entities. This would be a different dynamic than that exhibited in other countries, where the *IFRS for SMEs* option was not available at the time of their first-time IFRS adoption.
Currently, private companies in the United States can prepare their financial statements in accordance with U.S. GAAP as issued by the FASB; another comprehensive basis of accounting (OCBOA), such as cash- or tax-basis; or full IFRS, among others. Now, with the issuance of *IFRS for SMEs*, U.S. private companies have another alternative. According to the AICPA, a U.S. company owned by a foreign private investor or venture partner might be an early candidate for using the new standard. Also, other companies may find the *IFRS for SMEs* an attractive alternative to the more complex and voluminous U.S. GAAP (AICPA, 2009).

A Deloitte survey conducted in June 2009 has found that more than half (51%) of U.S. SMEs (with revenues less than US$1 billion) support separate accounting standards for private and public companies. Deloitte surveyed finance professionals from 225 private companies (various industries and sizes), where two-thirds of the companies had 20 or fewer employees, and 42% had sales less than U.S. $100 million. The results of the survey reveal that 43% of SME respondents are not aware of the IASB’s standard *IFRS for SMEs*, indicating the need for more education; 10% of SME respondents either currently use IFRS or would consider adopting the *IFRS for SMEs* in the near term, while 63% would adopt when required (Deloitte, 2009).

Since it is imperative that international convergence of accounting standards be accompanied by convergence of audit standards, differential accounting for SMEs will affect regulators such as the Public Company Accounting Oversight Board (PCAOB) and the Securities and Exchange Commission (SEC). *IFRS for SMEs* may be a welcome relief for auditors as it will decrease the inherent risk that results from the numerous choices and judgment required by management when utilizing the full version of IFRS. Ultimately, the market will drive demand. The success of the *IFRS for SMEs* will depend on the extent to which users, preparers and their auditors believe the standards meet their needs.

References


I ask you to imagine, if you will, a class of 20 students in a business school, huddled in teams, the words “poverty,” “charity,” “social justice,” “the plight of women,” and “triple bottom line” floating up to your ears as they develop lending strategies for the poorest of the poor in developing countries. Their excitement, palpable to you, mounts as the class period progresses. After the nearly three-hour class is officially over, not one student makes a move to leave the room. They speak with pride of the difference they are making in the world; they refer with apparent expertise to the tenets of microlending that they have gleaned from readings, lectures and guest speakers; they quote Muhammad Yunus liberally and with an almost reverent tone; and they lament that they have only one semester to do the work that they think of as their own: to help lift entire families out of poverty around the world.

This is Globe¹ – a student-managed, academic microlending program. Its student-crafted mission is to “… build a global community (starting here at St. John’s) that is going to contribute to the goal of eradicating poverty within our lifetime.” With the assistance of a large network of Daughters of Charity as field agents, student Globe managers vet loan applications from budding entrepreneurs — people they’ve never met, who come from three continents and seven countries. Each applicant seeks a small loan to create or expand a business that may ultimately bring jobs or economic growth to an impoverished community. But these applicants lack the collateral required by traditional banks or lending agencies.

The students, empowered to supervise all aspects of the program, seek to raise awareness around issues of poverty and social injustice, and offer feasible solutions. They devise the technological and financial means to sustain Globe, making small loans that have large consequences, not only for the people they are helping as far away as Nigeria and Thailand, but also for the learning that goes on right here in Jamaica, Queens. These future leaders are learning to embrace an undertaking that extends beyond the self, and a concept of a business model that accommodates social aims as well as profit goals. Armed with the Globe experience, many of these students will enter their chosen professions as advocates for the ideals that have inspired them to go beyond what is required in order to create transformative change.

Now, with nearly $60,000 in their coffers — raised over a period of only one year — students have made their first loans, constructed a Globe website, organized university-wide fundraising events, and issued newsletters to an increasing number of interested supporters. In the near future Globe Student Fellows, nominated by their peers and sponsored by the Tobin College of Business, will travel to countries to witness and examine, first-hand, the effect that microfinance can have in the lives of the impoverished.

As with all worthwhile endeavors, the road to accomplishment is not neatly paved and is bordered by the inevitable thorny issues that can occur despite students’ best efforts. How can we distribute loans equitably? How do we measure success? How do we overcome the technological barriers that isolate marginalized regions of the globe from our reach? How do we conquer the attendant social concerns that can make even the best microlending programs fail — concerns related to health, access to education, abuse of women, availability of clean water, and sustainability. All of these
challenges serve as learning opportunities for the students, and each challenge, when tackled by these young, creative and determined minds, results in greater effectiveness and resiliency in this program of increasing complexity and richness.

While my business ethics research has inspired my work with and in developing GLOBE, so has GLOBE inspired my ongoing research. I have been able to take these experiences to the Academy in papers and presentations around topics such as the ethics of microfinance, the relationship between the goals of microfinance and those of sustainability, empirical studies of the impact of microfinance on the empowerment of women in rural communities, and the development of assessment tools for evaluating the effects that microfinance has on the lives of those it is destined to help.

Indeed, GLOBE embodies “authenticity in action” — active learning, rendering authentic and personal the lessons and theory of the static classroom; action research, bringing authenticity to a research agenda that I was beginning to lament had no real positive impact on the interface between business and society; and active service, reaching across sectors, disciplines and geographic borders to work on seemingly intractable problems.

GLOBE has partnerships with Daughters of Charity in Bolivia, Ghana, Kenya, Madagascar, Mozambique, Nigeria and Thailand, with pending agreements in a number of other countries in Latin America, Asia and Africa. The program and associated course were officially launched in Spring 2009 and the first set of loans were provided in late Fall 2009 to four entrepreneurs, all women, from Nigeria. Seven more loan applications are currently being vetted by this semester’s GLOBE student managers, and more are being solicited.

The program typically lends amounts between $60 and $500 USD to borrowers, depending upon the nature of the business being funded. Examples of micro enterprises funded or being considered for funding include: petty trade businesses and small trade businesses, a chemist who would sell health products from a home-based shop, a seamstress who is buying a sewing machine with the loan to make clothing for sale in her community, and a computer training facility seeking to expand with the addition of one or two more machines. All GLOBE loan applicants must include on the loan application a description of the business, and the purpose for which the loan is to be used.

Each semester, students review applications from the seven countries that we work with, and select the entrepreneurs who will receive loans, assessing eligibility on the basis of the described business plan and the local Daughter’s recommendation, which is used as ‘alternative collateral’ (reputation, rather than assets). These students also apply loan terms. All student recommendations are then vetted by the GLOBE governing Steering Committee. Students also engage in marketing and fundraising, tracking fund flows, auditing results and maintaining and improving communications, including those offered through electronic media.

GLOBE loans all include a five percent flat rate fee to allow for the education of our students and borrowers, in accordance with the concept of interest rates for microloans, in addition to providing a cushion for potential defaults and a pool of funds for social interventions in borrower communities. These loan fees are quite low in comparison to other microfinance programs, which charge anywhere between 18 percent and 35 percent, and sometimes even more.

Steven D. Papamarcos, the Dean of The Peter J. Tobin School of Business, who first generated the idea of a student-managed microfinance program at St. John’s University, is committed to continued support of GLOBE, which is providing benefits to needy, hard-working people abroad, as well as to the students who run this worthwhile program.

These future leaders are learning to embrace an undertaking that extends beyond the self, and a concept of a business model that accommodates social aims as well as profit goals.
About the Review of Business

The *Review of Business* was first published in 1968 as a journal that concentrated on the New York economy, but it rapidly evolved to focus on business research that favors the practical and applicative side of inquiry. While we still prefer research that leads to pragmatic applications, the papers that our global review board accepts may also contain a high degree of statistical and theoretical analysis. Articles covering issues from all business sciences are welcomed, including those that focus on law, poverty and ethics.

The articles received by the journal are reviewed by the Editor and two independent reviewers. Furthermore, each article is checked for originality and accuracy of citations.

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New at the Review of Business

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Occasionally columns such as INVITED COMMENTARY or TEACHING POINTS will be presented in order to engage a broader audience. INVITED COMMENTARY is designed to encourage researchers to think about the latest events in a business field; each column will be written by an expert. TEACHING POINTS will explain interesting and effective ways a topic can be presented, or suggest a different approach for illustrating an issue within a specific topic. While papers in this section may sometimes be shorter, they will all be peer reviewed.

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1. Eighteen pages with double-spaced text is the maximum length free of charge.
2. Include within these pages all tables or charts (Exhibits), and a list of References at the end of the article.
3. Two or three excess pages are permitted, but there will be a $50 charge for each double-spaced page. Make your check payable to St. John’s University.

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2. A clearly stated Objective (research question).
3. The importance of the topic, and your contribution to it.

**Citations and References:**
1. Put citations within the text immediately after you quote or paraphrase someone else’s statement or original idea. Put the citation inside parentheses, using the standard format. For example: (Smith, 2008, p.43).
2. Put an alphabetical list of your bibliographical References at the end of the text. Include only references that are used in the text.
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Place the Exhibits within your article where they are to appear. In addition, please send separate files of your original Exhibits, in case revisions are necessary.

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3. When the reviewers are satisfied, our Editors will check for accuracy of citations and originality.
4. Lastly, the Editors will perform a final check for grammar and punctuation.

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