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REPORT FROM COUNSEL

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WHO CARES ABOUT INTERNATIONAL ACCOUNTING STANDARDS?

By Gary Philip Nelson, Esquire and Lesley C. Gannon, Esquire

While at first glance, International Accounting Standards seem as relevant to your business as the migration pattern of black storks, these standards will soon change how you, and those individuals and companies vital to your business, perform financial reporting, raise capital, and invest.

Right now, the influence is subtle, but important. U.S. securities laws, designed to protect investors, require financial results to be reported in accordance with the U.S.'s Generally Accepted Accounting Practices ("GAAP"). In order to comply with the U.S. securities laws, therefore, securities issued in the U.S. by foreign companies must be supported by financial accounting reports prepared, or reconciled, in accordance with GAAP. At the same time, advances in communication and technology are compelling a tighter, more interconnected global capital market, with which U.S. securities laws, written in the 1930s, do not easily integrate.

In 1999, the International Accounting Standards Board proposed International Accounting Standards ("IAS") to replace domestic accounting practices of participating countries and level the playing field between foreign and domestic issuers of securities. Since proposed in 1999, accounting, market and regulatory authorities in the European

Union, New Zealand, Norway, Pakistan, Panama, Russia, Singapore, and South Africa, among many other jurisdictions, have begun accepting financial statements prepared under IAS, without reconciliation to domestic accounting principals. By 2005, all companies listed on exchanges in European Union countries must prepare their consolidated financial statements using IAS.

For these and other systemic reasons, changes in U.S. securities law are anticipated, which could result in increased reliance upon IAS--and the impact of IAS would be dramatic. While GAAP and IAS are generally similar, and a comprehensive summary of the differences between GAAP and IAS is not our goal in this article, consider the following differences:

The differences between GAAP and IAS could lead to very different results in financial statements. For example, goodwill is recognized differently under IAS than under GAAP. IAS presume that goodwill will be amortized over twenty or fewer years unless that presumption is overcome; while GAAP require that companies periodically review goodwill for impairment. Whether goodwill may be expensed will have a significant effect on financial results--a company that does not amortize will report higher earnings.

The book value of certain unrecoverable assets must be written down under both IAS and GAAP. However, IAS would require such "impairment losses" to be reversed if the financial conditions that originally indicated impairment reverse. GAAP, however, prohibit reversal of an impairment loss regardless of subsequent circumstances. Therefore, the book value of assets could depend on which accounting standards are used.

Under IAS, an entity may choose to measure its fixed assets at either cost less accumulated depreciation or at fair value as determined from time to time. Under the latter alternative, revaluation increases are added directly to shareholders' equity as a revaluation surplus or recognized as income, depending on the circumstances. Revaluation decreases are first charged against equity, then against income. GAAP permit no fixed asset revaluation; all fixed assets are carried at original cost less accumulated depreciation. The differences in the two methods of accounting for fixed assets may result in significantly differing statements of financial position.

GAAP provide specific accounting guidance for several specialized industries, such as insurance, not-for-profit, oil and gas, entertainment, and employee stock-compensation plans. IAS currently do not have such guidance. IAS provide a set of standards for accounting for the receipt of government assistance, but GAAP does not. These differences in guidance provided affects the ability of an investor to compare companies.

GAAP and IAS both use the "purchase" method to account for the acquisition by one enterprise of another. "Purchase" method accounting requires acquired assets and liabilities to be recorded at fair value, with any excess of the purchase price over the fair value of the assets resulting in goodwill. "Purchase" method accounting is required to be used under GAAP in all acquisitions. IAS, however, provide an alternative method, the

"pooling-of-interests" method, to be used only if the business combination is structured such that the acquiring enterprise would be impossible to identify following the acquisition. The "pooling-of-interests" method treats the combination of two enterprises as a uniting of the companies, and the assets, liabilities, and equity of the two companies are added together, with no resulting goodwill. The effects of using the pooling method for a business combination, rather than the purchase method, will cause discrepancies in companies' reported results, and these discrepancies are extremely difficult to identify from an examination of financial statements.

At second glance, it is clear that International Accounting Standards would change how one performs financial reporting and analysis, considers capital transactions and makes investment decisions. Increased global commercial activity requires an awareness that different accounting standards exist and we expect it to become more common to see a standard other than U.S. GAAP applied to the preparation of financial accounting reports. Eventually, one might become familiar enough with these other accounting standards to think one could, without assistance, understand a company's financial reports. Until then, however, there is a need to ask which accounting standards were followed in the preparation of the financial accounting statements and what affect does that have on the results reported. The answers to these questions will inform every decision to do business with or to invest in a company that does not report in accordance with U.S. GAAP.

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DEVELOPMENT DITCHED

Developers bought 12 acres in a hilly, rural area, with plans to build homes on the property. Because surface water pooled on a large central part of the land after heavy rains, the owners channeled the excess water into a roadside ditch. The roadside ditch was connected to a series of waterways that eventually reached a river eight miles away.

The developers' plan hit a major snag when they were sued by the United States Army Corps of Engineers. The Corps contended that the roadside ditch was a waterway of the United States that fell under the protection of the Clean Water Act and the jurisdiction of

the Corps. With that premise, the developers first needed a permit from the Corps before digging the drainage ditch on their property.

While the Corps exercises no control over isolated wetlands, it has jurisdiction over wetlands that are adjacent to navigable waters and their tributaries. In particular, the Clean Water Act requires a permit from the Corps for the discharge of fill material into waters that are in the Corps' jurisdiction. When the contractors piled the excavated dirt on each side of the 1,100 foot-long drainage ditch, this constituted the "discharge" of fill material into wetlands without a permit.

A federal court took the side of the Corps in holding that a permit was required. First, the court deferred to the Corps' interpretation of the regulation under which the tract to be developed was regarded as having wetlands. Second, the adjacent roadside ditch was a tributary of navigable waters, even though water from the ditch flowed through several other nonnavigable watercourses before reaching the river and later the Chesapeake Bay. The court accepted the Corps' interpretation of "tributary" as encompassing all of the streams whose water eventually flows into navigable waters.

The court required the developers to fill in the drainage ditch on their property and restore their wetlands to their pre-violation condition. It rejected the developers' argument that a more reasonable remedy would have been to allow the ditch to stay by removing the fill to a nonwetlands part of the property.

Developers are well advised to carefully evaluate whether any existing ditches or drainage swales are linked to navigable water, however indirectly, before dredging or filling what might appear to be an isolated wetland beyond the jurisdiction of the United States Army Corps of Engineers.

INNOCENT SPOUSE TAX RELIEF

For most married couples, filing federal income taxes jointly rather than separately results in a lower tax bill. However, this "all for one, one for all" approach can have a downside if questions arise about the accuracy of the return. The general rule is that both taxpayers will be responsible, individually as well as collectively, for any taxes, interest, and penalties owed, even if only one spouse was earning the income. It may be that in a couple's division of labor only one spouse is in fact responsible for understating income or erroneously claiming deductions, but by law each spouse can be made to answer to the IRS.

It is always good advice for anyone signing a tax return to do so only after carefully reviewing and understanding every line of it. But even such common-sense measures cannot prevent mistakes and/or deception from happening. To avoid unfairness in such circumstances, the Tax Code has provisions designed to protect "the innocent spouse."

Under this general heading, there are three kinds of relief: innocent spouse relief, relief by separation of liability, and equitable relief. To request relief, a taxpayer must file the appropriate form with the IRS no later than two years after the IRS first tries to collect the tax. An attached statement must explain why the taxpayer believes he or she qualifies for relief. If the IRS rejects the claims for the first two types of relief, it will automatically determine whether equitable relief is warranted.

Innocent Spouse Relief

An innocent spouse must meet the following conditions to qualify for relief: (1) a joint return understated taxes because of erroneous claims by the requesting party's spouse, such as unreported or underreported income, or unjustified deductions or credits; (2) when the return was signed, the innocent spouse did not know or have reason to know that there was an understatement of tax. If the spouse knew, or should have known, that there was an understatement, but did not know by what amount, partial relief may be given; and (3) in light of all of the surrounding circumstances, it would be unfair to hold the requesting party liable for the understatement of tax. Among the factors taken into account by the IRS are whether the taxpayer benefited from the erroneous return in the form of a higher standard of living and whether the joint filers later were divorced or separated.

Separation of Liability

Separation of liability means an allocation between the spouses of unpaid liabilities resulting from the understatement of taxes owed. Either of the following requirements must be met: The parties filing the joint return are no longer married or are legally separated, or the joint filers were not members of the same household at any time during the 12-month period before the relief is sought. This relief is not available if spouses transfer assets between themselves to avoid tax or as part of a fraudulent scheme. Another disqualifying factor is actual knowledge of the other spouse's erroneous items on a return that gave rise to the deficiency.

Equitable Relief

As a last resort, equitable relief may be available when there has not been any fraud and, all things considered, it would be unfair to hold the spouse seeking relief liable for the understatement or underpayment of tax. A broad range of "fairness" factors may be considered by the IRS. There is no exhaustive list, but some examples include separation or divorce, economic hardship if relief is not granted, and the fact that the tax for which relief is sought is attributable to the other spouse. Weighing against equitable relief would be factors such as knowledge of the items causing the understated tax, receiving a significant benefit from that understatement, or not making a good-faith effort to comply with federal income tax laws for the tax year in question.

FAMILY AND MEDICAL LEAVE ACT UPDATE

Margaret worked in a clerical position for a hospital. During the first three years of her employment, she was disciplined several times for unexcused absences, and she risked termination if her absenteeism continued. Then, Margaret slipped and fell while at work, fracturing her elbow and ankle and aggravating an existing wrist condition. Over the next 10-day period, she worked only one complete workday. Margaret missed parts of the remaining workdays because she had medical appointments, or was not feeling well, or both.

The hospital, seeing these absences as the straw that broke the camel's back, fired Margaret for excessive absenteeism. Margaret sued her ex-employer, contending that her absences after her fall were protected leave under the federal Family and Medical Leave Act (FMLA). A federal court ruled that the hospital was free to fire Margaret without running afoul of the FMLA.

The outcome in Margaret's case turned on a fine distinction about language in the FMLA and a regulation issued under it. The FMLA provides that an eligible employee can take up to 12 workweeks of leave during any 12-month period because of a "serious health condition" that makes the employee unable to perform the functions of the employee's job. After taking such leave, an employee must be reinstated to the position held before the leave. Part of the statute's definition of "serious health condition" is a condition that involves "continuing treatment by a health care provider." That phrase is not defined in the FMLA itself, but a Department of Labor regulation describes it as including "a period of incapacity . . . of more than three consecutive calendar days." Incapacity refers to the inability to work or perform other regular daily activities.

Margaret argued to no avail that she had been incapacitated for more than three consecutive calendar days, and that she therefore had taken only protected leave for a "serious health condition." The problem was that she missed work for only a part of all but one of the days in question. The court reasoned that a "calendar day" is commonly understood to mean a whole day, from midnight to midnight. Thus, to be afforded protection under the FMLA, the period of incapacity must last for more than 3 whole days, that is, 72 consecutive hours. In addition to parsing the language from the regulation, the court ruled that the incapacity either extends for over 72 straight hours, or it does not. By contrast, under the interpretation argued for by Margaret, more issues would arise about how much incapacity on a given day is enough for that day to count toward the requirement in the regulation. The court was "loathe to adopt a strained interpretation of a regulatory provision that would result in employers, employees, and courts facing an uncertain and ever-shifting legal landscape."