SEC Proposes Roadmap for U.S. Issuers to Switch to IFRS

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On November 14, 2008, the U.S. Securities and Exchange Commission (SEC) published its long-awaited "roadmap" to a potential future mandatory requirement for U.S. issuers to prepare and issue financial reports under International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB) instead of U.S. generally accepted accounting principles (U.S. GAAP). Comments on the rule proposal are due no later than February 19, 2009.

The SEC's proposed rulemaking represents a significant step in the ongoing collaborative effort among the SEC, IASB, Financial Accounting Standards Board (FASB), and other international securities and accounting regulators to promote the development of a single high-quality set of global accounting standards to keep pace with the increasingly global nature of the financial marketplace, where even the most unsophisticated U.S. investor can purchase foreign equity securities listed on a non-U.S. stock market through a U.S. broker or even via the internet. The SEC's proposed rulemaking is designed to provide a level accounting playing field on which U.S. investors may make their investment decisions. Given the broad and rapid worldwide acceptance of the IFRS, the SEC acknowledged that IFRS "has the potential to become the set of accounting standards that best provide a common platform on which companies can report and investors can compare financial information."

Companies should begin to prepare now for the potential switch to IFRS and evaluate with their financial and legal advisors how to manage the challenges and issues such an undertaking will involve. As discussed below, the switch to IFRS may produce a number of collateral consequences that issuers should plan for in advance

How We Got Here – The Move to IFRS

Since 2002, the mantra of the FASB and the IASB has been "convergence"—that is, preservation of both U.S. GAAP and IFRS, but elimination of the differences between the two standards so that users of financial statements could confidently compare the financial results of U.S. and non-U.S. issuers without requiring a "reconciliation." The fast-growing acceptance of IFRS around the world appears to have overtaken efforts to harmonize the two different accounting standards. IFRS is now either permitted or required in approximately 113 countries worldwide, including the Member States of the European Union, and approximately 110 foreign private issuers filed financial statements prepared under IFRS in their Form 20-F annual reports. Canada has also announced that it is moving to incorporate IFRS into Canadian GAAP in 2011, adding more than 450 SEC-registered Canadian companies to the IFRS sphere.

Historically, foreign private issuers that filed financial statements with the SEC under foreign GAAP were required to prepare burdensome and costly U.S. GAAP "reconciliations" to include in the footnotes to the audited financial statements. In recognition of the fast-growing acceptance of IFRS, in 2005, the SEC allowed foreign private issuers that switched to IFRS to file two years (rather than the full three years) of audited IFRS financial statements in their SEC registration statements and annual reports. In December 2007, the SEC completed the transition for foreign private issuers by adopting amendments to their Form 20-F rules to accept financial statements prepared under IFRS without any reconciliation to U.S. GAAP.

Recognizing that U.S. issuers, especially those with a large global footprints that compete for capital against non-U.S. competitors, would benefit as much from a transition to IFRS as foreign private issuers, the SEC also issued a Concept Release asking for feedback on the idea of allowing U.S. issuers to similarly prepare their financial statements under IFRS. Based on the feedback it received on the 2007 Concept Release, and the need to lay down a concrete timetable and framework for a transition to IFRS, the SEC published its roadmap.

The Roadmap – Timetable and Milestones

If adopted, the roadmap will require IFRS to replace U.S. GAAP as the basis for financial reporting for U.S. issuers by as early as 2014, assuming certain implementation milestones are deemed to have been achieved by 2011. These milestones relate to the following:

- *Improvements in accounting standards*. Despite more than six years of work towards "converging" IFRS and U.S. GAAP, the SEC acknowledged that further work needs to be done to fill the gaps in IFRS (*e.g.*, IFRS currently provides limited guidance on the accounting for insurance contracts and for extractive enterprises) and eliminate the remaining significant differences between IFRS and U.S. GAAP (discussed further below). The 2011 date in the roadmap conveniently dovetails with the expected date of completion of the joint work plan of the IASB and FASB on the convergence project pursuant to its 2006 Memorandum of Understanding.

- *Shoring up the accountability and funding of the International Accounting Standard Committee (IASC) Foundation*. Unlike the FASB, which has a long history of self-regulation, oversight and funding, the IASB is still a relatively new organization, and its oversight and funding structures are not as well-developed. The IASB is based in London and is overseen by the IASC Foundation, a not-for-profit organization run by 22 trustees with diverse backgrounds. The Foundation has financed the operations of the IASB primarily through voluntary contributions from market participants and governments from across the world's capital markets. The SEC will consider the degree to which the Foundation has secured a stable and sustainable funding mechanism that permits it to function independently. Similarly, the SEC will evaluate whether the oversight mechanism imposed by the Foundation is effective in deciding whether such a body can adequately protect the interests of U.S. investors.

- *Improvements in the ability to use interactive data for IFRS reporting (e.g., XBRL)*. In May 2008, the SEC proposed rules requiring companies to provide financial statements in an interactive data format using eXtensible Business Reporting Language (XBRL) to improve the usefulness of such financial statements to investors. In order to comply with this new reporting system, the IASB must have completed its work on the taxonomy of "tags" that are required under XBRL by 2011.

- *Improvements in the education and training of investors, accountants, auditors and others involved in the preparation and use of financial statements in the United States relating to IFRS*. Colleges and universities must have adapted their curriculum to accommodate the teaching of IFRS, and the Uniform CPA Examination will need to be modified as well. In addition to the training of accounting and finance professionals, audit committee members will also need to understand IFRS in order to discharge their financial oversight responsibilities.

- *Experience of the U.S. issuers who participate in the SEC's voluntary pilot program*. As discussed below, the SEC will assess the experience of the U.S. issuers who elect to participate in a voluntary pilot program that will commence in 2009 to determine whether the U.S. market is in fact ready for a move to IFRS.

In addition to the express milestones listed above, the SEC has stated that it will continue to assess, from now until 2011, when a decision is expected, whether IFRS is, in fact, as globally accepted and consistently applied across companies, industries and countries as the SEC hopes. The SEC will also monitor the collateral impacts of a shift to IFRS financial reporting, including the tax impact to issuers (discussed in more detail below), the impact on internal controls, the impact on the auditing profession, and the impact on U.S. issuers and the U.S. capital markets of ceding power to a "foreign" accounting standard setter.

Although no specific date is proposed, the roadmap states that the SEC will review these milestones and other considerations in 2011 and determine whether to proceed with mandatory rules requiring U.S. issuers to file financial statements prepared in accordance with IFRS by as early as 2014. The roadmap notes that the SEC is currently considering implementing IFRS reporting through a staged transition whereby IFRS filing requirements would apply initially only to large accelerated filers for fiscal years ending on or after December 15, 2014; then accelerated filers for fiscal years ending on or after December 15, 2015; and finally to non-accelerated filers, including smaller reporting companies, for fiscal years ending December 15, 2016.

In the first year of IFRS reporting, issuers would be required to file three years of audited financial statements in accordance with IFRS. In other words, a large accelerated filer reporting in IFRS for the first time in its annual report for the fiscal year ended December 31, 2014, would need to provide audited financial statements prepared in accordance with IFRS for the years ended December 31, 2014, 2013 and 2012. Thus, issuers would need to keep two sets of books and records (one under U.S. GAAP and one under IFRS) and implement internal accounting controls with respect to IFRS accounting a full three years prior to actually reporting under IFRS.

The IFRS Pilot Program

The SEC also proposed a voluntary early adoption program for certain eligible issuers. The eligible issuers will be limited to those issuers that are in the top 20 by market capitalization of their industry globally. In addition, within the industry group, IFRS must be the most common basis for financial reporting among the top 20 companies by market capitalization. No one set of industry classifications will be deemed dispositive, and issuers are free to use any "widely accepted" industry classification scheme. The SEC estimates that, based upon a review of companies according to SIC code, there exist approximately 110 companies that would be eligible to participate in the pilot program.

Issuers that are interested in participating in the pilot program will be required to assess their eligibility and to obtain a "no objection" letter from the SEC prior to reporting in IFRS. Pilot program participants will be required to provide a reconciliation of their IFRS financial statements to U.S. GAAP. The SEC has not yet decided how such a reconciliation requirement should be formulated, so it proposed two alternative approaches in the roadmap:

- A one-time reconciliation from U.S. GAAP to IFRS for the transition year only

- An annual ongoing audited reconciliation between U.S. GAAP and IFRS

Commenters are asked to provide their view as to the preferable approach for both preparers and users of financial statements. In addition, the SEC is seeking comment on the impact for pilot program participants should the roadmap not be adopted; in other words, should participants be entitled to continue to report in IFRS rather than readjust their financial statements to U.S. GAAP?

Assuming adoption of the roadmap in 2009, the SEC anticipates that eligible pilot program participants would begin to report under IFRS in their annual reports for fiscal years ending on or after December 15, 2009.

The SEC Staff will closely monitor the experience of issuers in the IFRS pilot program, their auditors and their investor markets, to determine whether the milestones to implementation have been met.

The Concerns and Challenges Associated with a Shift to IFRS

The switch from U.S. GAAP to IFRS presents U.S. issuers with many concerns and challenges that issuers should begin considering immediately (and, if appropriate, communicate to the SEC through the open comment process). U.S. issuers are well advised to begin considering and assessing these concerns and challenges in order to avoid an eleventh hour scramble. Among the principal concerns and challenges already identified are the following:

PROJECT MANAGEMENT AND COST CONCERNS

Shifting financial reporting within an enterprise from U.S. GAAP to IFRS will be a huge corporate undertaking that will require time and resources from a project management standpoint, participation at the highest levels within the enterprise (including the audit committee and the board) and a considerable amount of capital expenditure. How much will it cost issuers to train and hire accounting and finance professionals? How much will it cost to maintain two parallel sets of books and records during the IFRS transition phase? Do we currently have adequate software and information technology to support the transition to IFRS? What changes will be required in the area of disclosure controls and internal controls over financial reporting? How much will it cost to implement these controls changes, and how much more will our auditors charge us to audit these new controls?

HUMAN RESOURCES AND BOARD COMPOSITION CONCERNS

Will there be enough trained accounting and finance professionals to staff both the registrants and the auditing firms? Given the bargaining leverage of the Big Four firms for accounting talent, will second-tier auditing firms be driven out of the public accounting business, thereby providing even greater pricing leverage for the Big Four? Will boards be able to locate audit committee members (and "audit committee financial experts") who have familiarity with IFRS?

IMPACT ON FINANCIAL RESULTS

Despite the efforts to "converge" the two accounting standards, there remain several significant differences between IFRS and U.S. GAAP that may have a material impact on the way certain U.S. issuers report their financial results:

- *Revenue recognition*. U.S. GAAP provides highly prescriptive, often industry-specific revenue recognition guidance, whereas IFRS has just two primary revenue standards and a handful of revenue-related interpretations that capture all revenue transactions. U.S. companies would be advised to calculate whether a switch to IFRS will result in a decrease in reported revenue and consider how to communicate such a decrease to its shareholders and the marketplace.

- *Expense recognition*. There are many differences between U.S. GAAP and IFRS with respect to when and in what amounts expenses should be recognized. For example, IFRS may significantly accelerate the expense recognition of certain stock options with graded vesting schedules.

- *Consolidation.* IFRS effectively does not permit "off balance sheet" transactions. Under IFRS, many U.S. issuers will be required to take back "on balance sheet" assets that may have originally been intended to stay "off balance sheet."

- *Loss contingencies*. U.S. GAAP (SFAS 5) requires issuers to accrue a reserve for any loss contingency that is "probable" to occur (as long as the amounts are "reasonable estimatable"). "Probability" under SFAS 5 is normally understood to mean a 75 percent likelihood. IFRS (IAS 37) requires a loss accrual when the contingent loss is "more likely than not" to occur, which is normally understood to mean a 50 percent or greater likelihood. In addition, while SFAS 5 requires that issuers accrue at the low end of any estimated range of losses, IAS 37 requires issuers to accrue at the midpoint of such range.

- *Write-downs*. IFRS uses a single-step method for impairment write-downs rather than the two-step method used in U.S. GAAP.

IMPACT ON TAXES

Issuers should also consider whether the transition to IFRS will result in any adverse tax consequences. IFRS does not permit the last-in, first-out (LIFO) method of accounting for inventory; therefore, LIFO issuers changing to a first-in, first-out (FIFO) method of accounting in connection with a transition to IFRS may experience a change in taxable income.

IMPACT ON LITIGATION

One of the primary advantages of IFRS over U.S. GAAP, according to the accounting professionals, is the fact that IFRS is more "principles based" than U.S. GAAP and provides for greater "optionality" (*e.g.,* more than one accounting approach is available depending on the facts and circumstances of a given transaction). However, an accounting standard that relies heavily on the subjective judgment of management is also an accounting standard that leaves management open to being second guessed later by plaintiffs in a shareholder class action. Since Europe does not share the United States' taste for business litigation, this aspect of IFRS implementation by U.S. companies presents a particulary scary unknown for U.S. issuers.

IMPACT ON INDENTURE COVENANTS AND OTHER CONTRACTUAL ARRANGEMENTS

Many issuers have issued debt securities under indentures or have entered into credit agreements that may contain financial covenants based upon U.S. GAAP financial measures or covenants obligating such issuers to provide financial reports in accordance with U.S. GAAP. In addition, performance-based executive compensation arrangements might be based on U.S. GAAP. Issuers will need to consider the ability and costs to obtain bondholder consent, amendments or waivers in order to participate in the pilot program, or in the event the SEC ultimately mandates IFRS reporting.

CONCERNS OVER THE IASB AS A REGULATOR

Will the IASB be able to establish itself as a worthy and reliable replacement for the FASB?

Will U.S. issuers be able to trust that this London-based organization can function as an independent, self-sufficient and sustainable global regulator?

Conclusion

If adopted, the impact of a potential mandatory shift to IFRS reporting, or a voluntary exploration into IFRS reporting through the proposed pilot program, should receive attention at the highest levels within an organization, and the concerns raised above should all be considered. U.S. issuers are urged to discuss the movement towards IFRS with their audit committees, their auditors and their outside counsel so that the potential pros and cons can be fully considered and addressed. Those U.S. issuers that are interested in the voluntary pilot program should consult with their outside counsel to discuss their eligibility and the process for submitting a "no objection" request to the SEC.

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