SEC Considers Throwing Out U.S. GAAP Reconciliation For Foreign Private Issuers Using International Financial Reporting Standards

The Securities and Exchange Commission has proposed accepting from foreign private issuers their financial statements prepared in accordance with International Financial Reporting Standards (IFRS) published by the International Accounting Standards Board (IASB) without reconciliation to generally accepted accounting principles as used in the U.S. (U.S. GAAP).[1] The SEC is thus proposing to amend Form 20-F[2] and Regulation S-X,[3] with conforming amendments to other forms and regulations. Current GAAP reconciliation requirements will not change for a foreign private issuer that uses a basis of accounting other than the English language version of IFRS as published by the IASB.[4] The proposed amendments would apply to an eligible issuer regardless of whether it complies with IFRS voluntarily or in accordance with requirements of its home country regulator or an exchange on which its securities are listed.[5]

The SEC has accepted non-U.S. GAAP without reconciliation before, such as with respect to cash flow statements prepared in accordance with IAS No. 7, "Cash Flow Statements," under a rule change proposed in 1993 and adopted in 1994.[6] As early as 1988, an SEC Policy Statement recommended establishing mutually acceptable international accounting standards to reduce regulatory impediments from disparate national accounting standards.[7] In a 2000 Concept Release, the SEC sought public comments on the elements necessary to encourage convergence towards a high quality global financial reporting framework.[8] The goal of working towards internationally acceptable standards has been confirmed recently by the SEC Chairman.[9]

In a Concept Release, the SEC goes even further in seeking to determine "the public's interest in allowing U.S. issuers, including investment companies subject to the Investment Company Act of 1940, to prepare financial statements" using IFRS.[10]

1 Securities and Exchange Commission, "Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP," SEC Releases 33-8818, 34-55998, International Series Release 1302, File S7-13-07, 72 Fed. Reg. 37962 (July 11, 2007). Comments on the proposal were due by September 24, 2007.

2 17 CFR 249.220f ("registration of securities of foreign private issuers pursuant to section 12(b) or (g), annual and transition reports pursuant to sections 13 and 15(d), and shell company reports required under Rule 13a-19 or 15d-19" (17 CFR 240.13a-19 or 240.15d-19)).

3 17 CFR Part 210.

4 An issuer that files financial statements that include deviations from IFRS as published by the IASB would not be able to avoid reconciliation, nor would an issuer using a jurisdictional or other variation of IFRS unless an audit firm opined that the statement comply with IFRS as published by the IASB. 72 Fed. Reg. 37970. One commenter has argued that the proposed rule should be extended to U.S. domiciled consolidated subsidiaries of foreign businesses that are subject to reporting requirements under the Exchange Act. Letter of Bruce E. Stern, General Counsel and Managing Director, FSA, A Dexia Company to the SEC (August 17, 2007) (www.sec.gov/comments/s7-13-07/s71307-9.pdf).

5 72 Fed. Reg. 37970.

6 The change was proposed in Release 33-7029 (November 3, 1993) and adopted in Release 33-7053 (April 19, 1994). See Form 20-F, Item 13, Instruction 4.

7 SEC, "Regulation of the International Securities Markets," Release 33-6807 (November 14, 1988). See also the study, "Pursuant to Section 509(5) of the National Securities Markets Improvement Act of 1996 Report on Promoting Global Preeminance of American Securities Markets" (October 1997) (www.sec.gov/news/studies/acctgsp.htm) (noting, however, that "the issues that remain open are among the most complex and controversial".

8 SEC Concept Release, "International Accounting Standards," Release 33-7801 (February 16, 2000) (www.sec.gov/rules/concept/34-42430.htm).

9 SEC Press Release No. 2006-17, "Accounting Standards: SEC Chairman Cox and EU Commissioner McCreevy Affirm Commitment to Elimination of the Need for Reconciliation Requirements" (February 8, 2006) (www.sec.gov/news/press/2006-17.htm).

10 SEC, "Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance With International Financial Reporting Standards," Releases 33-8831, 34-56217, IC-27924, File S7-20-07, 72 Fed. Reg. 45600 (August 14, 2007).

Foreign Private Issuer. A foreign private issuer is defined in Exchange Act Rule 3b-4, as: any foreign issuer other than a foreign government except an issuer meeting the following conditions:

(1) More than 50 percent of the issuer's outstanding voting securities are directly or indirectly held of record by residents of the United States; and
(2) Any of the following:
   (i) The majority of the executive officers or directors are United States citizens or residents;
   (ii) More than 50 percent of the assets of the issuer are located in the United States; or
   (iii) The business of the issuer is administered principally in the United States.[11]

In 2006, 110 foreign private issuers represented in footnotes to their financial statements that the statements complied with IFRS as published by the IASB. Approximately 70 more foreign private issuers prepared financial statements in accordance with a jurisdictional variation of IFRS. Since Canada has announced adoption of IFRS, approximately 500 Canadian foreign private issuers can be expected to file using IFRS.

RECONCILIATION REQUIREMENTS

Foreign private issuers that register securities with the SEC and report periodically thereafter under sections 13(a) or 15(d) of the Exchange Act[12] must file audited statements of income, financial position, and changes in shareholders' equity and cash flows generally for each of the past three financial years, prepared on a consistent basis of accounting. Such financial statements must be reconciled to U.S. GAAP. Reconciliations in Item 17(c0 of Form 20-F include:

- A narrative discussion of reconciling differences.
- A reconciliation of net income for each year and any interim periods presented.
- A reconciliation of major balance sheet captions for each year and any interim periods.
- A reconciliation of cash flows for each year and interim periods.

In a reconciliation to U.S. GAAP, the foreign private issuer identifies and quantifies material differences from the requirements of U.S. GAAP and Regulation S-X. Reconciliations to U.S. GAAP may be made under Items 17 or 18 of Form 20-F, as follows:

- *Item 17.* Issuer provides a narrative description of differences and a quantitative reconciliation of specific financial statement line items from non-U.S. GAAP to U.S. GAAP, but without all U.S. GAAP and Regulation S-X disclosures. *May be used for financial statements in Exchange Act registration statements or annual reports filed on Form 20-F, or as part of a Securities Act registration statement for investment grade, non-convertible securities or certain rights offerings.*

- *Item 18.* Issuer provides reconciling information of Item 17 as well as disclosures required by Regulation S-X and U.S. GAAP. *Must be used when filing financial statements in a Securities Act registration statement for offerings of equity, convertible, or other securities.*

Reconciliation requirements were first issued in 1967,[13] expanded in 1979,[14] with the current requirements adopted in 1982.[15]

INTERNATIONAL FINANCIAL REPORTING STANDARDS

In 2001, the IASB succeeded the International Accounting Standards Committee (IASC), which was created in 1973 to develop International Accounting Standards (IAS). The IASB continues to recognize IAS issued by the IASC, which form part of the IFRS.[16] See Figure 1: International Financial Reporting Standards of the IASB and International Accounting Standards of the IASC. The 22 trustees of the IASC Foundation appoint the 12 full-time and two part-time IASB members.[17]

[11] 17 CFR 240.3b-4(c). An instructional note describes the determination of the percentage of outstanding voting securities.

[12] 15 U.S.C. 78m(a), 78o(d).

[13] SEC Releases 8067 and 8068 (April 28, 1967). Prior to 1967, foreign private issuers were required only to present financial statements consisting of a balance sheet as of the close of the most recent fiscal year and a profit and loss statement for the fiscal year preceding the date of the balance sheet. The statements did not have to be certified.

[14] SEC Release 34-16371 (November 29, 1979).

[15] SEC Release 33-6437 (November 19, 1982), following a 1981 proposal, SEC Release 33-6360 (November 20, 1981).

[16] Eight IFRS and 41 IAS summaries are available on the IASB website (www.iasb.org/Summaries+of+International+Financial+Reporting+Standards/IFRS+and+IAS+Summaries+-+English/IFRS+and+IAS+Summaries-+English.htm).

[17] The Board members are listed on the IASB website (www.iasb.org/About+Us/About+IASB/Board+Members.htm), and include James J. Leisenring, former chair of the FASB Derivatives Implementation Group.

More than 100 countries, including the 27 EU member states,[18] now require or allow the use of IFRS, and many are replacing their national standards. Australia[19] and New Zealand have mandated the use of IFRS by public companies. Canada, Chile, Israel, and Korea have announced plans to abandon national standards for IFRS.[20]

SEC staff have long been familiar with IAS and IFRS, having reviewed and contributed to comments on many exposure drafts of standards published by the IASC and the IASB. SEC staff as an IOSCO[21] representative participates as a non-voting observer at the International Financial Reporting Interpretations Committee (IFRIC), IASB's interpretive body,[22] and is an observer of the IASB Standards Advisory Council.[23]

Regulation S-X requires substantial specificity regarding items to be presented in the balance sheet and income statement, but IFRS does not provide specific conventions as to format or content of the income statement. The SEC staff has analyzed IFRS financial statements filed under reconciliation requirements and has described variations from its expectations.

> We noted a number of variations in the language companies and their auditors used to describe IFRS as applied in the financial statements. We raised comments where this language appeared to be inconsistent with the explicit and unreserved statement of compliance with IFRS as called for by IAS 1, Presentation of Financial Statements, and Instruction G to Form 20-F. We asked a number of companies to make the necessary assertion, or a clearer assertion, regarding compliance with IFRS as published by the IASB.[24]

"It was not until the first half of 2006 that a large number of companies published audited annual IFRS financial statements for the first time."

Nevertheless, the staff has not assessed the overall quality of disclosure in the reports.

FASB Committed to Convergence. Under a 2002 memorandum of understanding known as the Norwalk Agreement, the FASB and the IASB acknowledged a joint commitment to the development "as soon as practicable" of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting.[25] The two agencies affirmed this commitment in 2006.[26] The FASB and the IASB have coordinated agendas and have been working on

[18] The Committee of European Securities Regulators (CESR) has been charged by the European Commission with evaluating the implementation of IFRS in the EU (website at www.cesr-eu.org). The group within the CESR focused on financial reporting is labeled CESR-Fin (www.cesr-eu.org/index.php?page=groups…mac=0…id=13). The CESR has established a forum and a confidential database for participants to exchange views and share experiences with IFRS. Some documents on the website are accessible to the public. The "vast majority of listed EU companies, including banks and insurance companies, moved to IFRS in 2005 with the remainder transitioning in 2007." 72 Fed. Reg. 45602. The SEC and the CESR have developed a "work plan" for confidential exchanges of issuer-specific information between CESR members and the SEC. SEC press release 2006-130, "SEC and CESR Launch Work Plan Focused on Financial Reporting" (August 2, 2006) (www.sec.gov/news/press/2006/2006-130.htm).

[19] Australian-listed companies moved to IFRS in 2005. 72 Fed. Reg. 45602.

[20] IASB press release, "IASB Chairman [David Tweedie] Addresses European Parliament" (April 12, 2007) (www.iasb.org/News/IASB+Chairman+Addresses+European+Parliament.htm). In his comments, Chairman Tweedie observed:

> There is clear momentum towards accepting IFRSs as a common financial reporting language throughout the world. Today, companies in the European Union are benefiting from reduced compliance costs associated with the removal of the need for the consolidation of different national accounts into a single statement to meet their home country's requirements. Investors are able to make comparisons of companies operating in different jurisdictions more easily. Regulatory authorities are now more able to develop more consistent approaches to supervision across the European economies.
>
> None of this is to suggest that IFRSs are yet a global standard. Many important economies–for example, Japan and the United States—are still in the process of converging. Therefore, much work remains to be done by all of us involved in the preparation and adoption of IFRSs, if we are to achieve our shared vision of making IFRSs the world's primary financial reporting language.

[21] IOSCO members regulate more than 90% of the world's securities markets. 72 Fed. Reg. 45605.

[22] Successor to the IASC's Standing Interpretations Committee (see www.iasb.org/About+Us/About+IFRIC/About+IFRIC.htm). The 12 voting members of IFRIC are appointed by the IASC Foundation Trustees. The interpretive body for U.S. GAAP is the Emerging Issues Task Force (EITF).

[23] See IASB press release, "Restructured Standards Advisory Council Appointed" (October 1, 2005) (www.iasb.org/News/Press+Releases/Archive/2005/Restructured+Standards+Advisory+Council+appointed.htm).

[24] SEC, "Staff Observations in the Review of IFRS Financial Statements" (July 2, 2007) (www.sec.gov/divisions/corpfin/ifrs_staffobservations.htm).

[25] The MOU resulted from a meeting at FASB headquarters in Norwalk, Connecticut, on September 18, 2002 (www.fasb.org/news/memorandum.pdf).

[26] "A Roadmap for Convergence between IFRS and U.S. GAAP-2006-2008 (February 27, 2006) (http://72.3.243.42/intl/mou_02-27-06.pdf).

Figure 1: International Financial Reporting Standards of the IASB and International Accounting Standards of the IASC.

International Financial Reporting Standards

- IFRS 1 First-time Adoption of International Financial Reporting Standards
- IFRS 2 Share-based Payment
- IFRS 3 Business Combinations
- IFRS 4 Insurance Contracts
- IFRS 5 Non-current Assets Held for Sale and Discontinued Operations
- IFRS 6 Exploration for and evaluation of Mineral Resources
- IFRS 7 Financial Instruments: Disclosures
- IFRS 8 Operating Segments

International Accounting Standards

- IAS 1 Presentation of Financial Statements
- IAS 2 Inventories
- IAS 7 Cash Flow Statements
- IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors
- IAS 10 Events After the Balance Sheet Date
- IAS 11 Construction Contracts
- IAS 12 Income Taxes
- IAS 16 Property, Plant and Equipment
- IAS 17 Leases
- IAS 18 Revenue
- IAS 19 Employee Benefits
- IAS 20 Accounting for Government Grants and Disclosure of Government Assistance
- IAS 21 The Effects of Changes in Foreign Exchange Rates
- IAS 23 Borrowing Costs
- IAS 24 Related Party Disclosures
- IAS 26 Accounting and Reporting by Retirement Benefit Plans
- IAS 27 Consolidated and Separate Financial Statements
- IAS 28 Investments in Associates
- IAS 29 Financial Reporting in Hyperinflationary Economies
- IAS 31 Interests in Joint Ventures
- IAS 32 Financial Instruments: Presentation
- IAS 33 Earnings per Share
- IAS 34 Interim Financial Reporting
- IAS 36 Impairment of Assets
- IAS 37 Provisions, Contingent Liabilities and Contingent Assets
- IAS 38 Intangible Assets
- IAS 39 Financial Instruments: Recognition and Measurement
- IAS 40 Investment Property
- IAS 41 Agriculture

short-term convergence in certain areas.[27] Similar to the U.S., Japan's accounting standard setter and the IASB have a joint project to reduce differences between the IFRS and Japanese accounting standards.[28]

The SEC proposal states in the preamble: "We fully support continued progress on convergence towards the optimal standard, whether that standard may be based on U.S. GAAP, IFRS, or a jointly developed new approach."[29] The SEC acknowledges, however, a "risk that constituents of the two boards may not continue to support convergence if IFRS financial statements are accepted by the Commission without reconciliation to U.S. GAAP." The agency also notes that wide-scale use of IFRS is less than two years old and "it was not until the first half of 2006 that a large number of companies published audited annual IFRS financial statements for the first time."[30] Also, the SEC's relationship with the IASB is "different

[27] According to the FASB website on the page devoted to short-term international convergence, "[p]rojects falling under the heading 'short-term convergence' are limited to those that would address differences outside the scope of a major project for which convergence around a high-quality solution appears to be achievable in the short term, usually by selecting between existing IFRS and U.S. GAAP." (At www.fasb.org/project/short-term_intl_convergence.shtml.)

[28] 72 Fed. Reg. 45602. See IASB press release, "IASB and Accounting Standards Board of Japan Agree to Next Steps in Launching Joint Project for Convergence" (January 21, 2005) (www.iasb.org/News/Press+Releases/Archive/2005/IASB+and+Accounting+Standards+Board+of+Japan+agree+to+next+steps+in+launching+joint+project+for+conv.htm).

[29] 72 Fed. Reg. 37967.

[30] 72 Fed. Reg. 37968. The International Organization of Securities Commissions (IOSCO) provides a database, for IOSCO members and other approved regulators, for cataloguing IFRS interpretations and sharing decisions (www.iosco.org/ifrs/).

and less direct" than its oversight role with the FASB.[31]

PARTIAL ACCOMMODATIONS DELETED

Partial accommodations contained in sub-paragraphs of Item 17(c)(2), relating to reconciling disclosure for issuers that rely on certain IAS, were made available to issuers using home country GAAP or IFRS but were rarely relied upon in practice. These accommodations, which are no longer needed and would be eliminated under the proposal, include:

- Items 17(c)(2)(iv)(B) and (C), relating to reconciling disclosures to be provided by issuers that rely on IAS 21, "The Effects of Changes in Foreign Exchange Rates."
- Item 17(c)(2)(viii), relating to reconciling disclosures to be provided by issuers using IAS 22, "Business Combinations." IAS 22 has been superseded by IFRS 3, "Business Combinations," and may no longer be used by an issuer preparing financial statements under IFRS.

[31] 72 Fed. Reg. 37970.

> The Commission oversees the activities of the FASB as part of its responsibilities under the securities laws. These oversight responsibilities include the Commission reviewing the FAF's and the FASB's annual budget and the FASB's accounting support fee, providing views regarding the selection of FASB members, and, in certain circumstances, referring issues relating to accounting standards to the FASB or the EITF. The Commission and its staff do not, however, prohibit the FASB from addressing topics of its choosing and do not dictate the outcome of specific FASB projects, so long as the FASB's conclusions are in the interest of investor protection.

72 Fed. Reg. 45602.

However, the SEC is not changing Item 17(c)(2)(iii) relating to IAS 7, "Cash Flow Statements." Nor will any change be made to Item 17(c)(2)(vii) relating to disclosures issuers using proportionate consolidation may omit from U.S. GAAP reconciliation.[32]

ALLOWING U.S. ISSUERS TO USE IFRS

As noted above, the SEC has issued a Concept Release on allowing U.S. issuers to use IFRS. Reasons for such an idea include:

First, as a growing number of jurisdictions move to IFRS, more non-U.S. companies will report their financial results in accordance with IFRS. If a critical mass of non-U.S. companies in a certain industry sector or market reports in accordance with IFRS, then there may be pressure for U.S. issuers in that industry sector or market to likewise report in accordance with IFRS to enable investors to compare U.S. issuers' financial results more efficiently with those of their competitors.

Second, as more jurisdictions accept financial statements prepared in accordance with IFRS for local regulatory or statutory filing purposes, U.S issuers' subsidiaries based in these jurisdictions may be preparing and filing their local financial statements using IFRS as their basis of accounting. If U.S. issuers have a large number of subsidiaries reporting in this manner, then these U.S. issuers—most likely large, multinational corporations—may incur lower costs in preparing their consolidated financial statements using IFRS rather than U.S. GAAP. If an issuer can and does reallocate any financial statement preparation cost savings to higher earning opportunities and does not suffer a relatively greater increase in the cost of its capital as a result of using IFRS, investors will benefit in terms of a better rate of return. [33]

[32] The preamble notes that an issuer using IFRS as published by the IASB would satisfy the requirements of Item 179(c)(2)(vii) by providing IAS 31 disclosures ("Interests in Joint Ventures").

SEC: "We believe it is an appropriate time to propose and solicit comment on acceptance, in the filings of foreign private issuers, of financial statements prepared in accordance with IFRS as published by the IASB without reconciliation to U.S. GAAP."

The SEC acknowledges downsides:

> If the Commission were to accept financial statements prepared in accordance with IFRS as published by the IASB from U.S. issuers, then investors and market participants would have to be able to understand and work with both IFRS and U.S. GAAP when comparing among U.S. issuers because not all U.S. issuers are likely to elect to prepare IFRS financial statements. On a more practical level, a U.S. issuer may have contracts such as loan agreements that include covenants based upon U.S. GAAP financial measures or leases for which rental payments are a function of revenue as determined under U.S. GAAP. Similarly, U.S. issuers may use their financial statements as the basis for filings with other regulators and authorities (*e.g.*, local and federal tax authorities, supervisory regulators) that may require U.S. GAAP financial information.[34]

[33] 72 Fed. Reg. 45603.
[34] 72 Fed. Reg. 45603.

Also, not many accountants in the U.S. have been taught IFRS.[35] The SEC notes that different regulators, with different experience with IFRS, might make different and even potentially inconsistent comments on U.S. issuers using IFRS. IOSCO's efforts to bring uniformity should control such issues.[36] One commenter has observed:

IFRS does not provide an exemption from consolidation of subsidiaries in an investment company, whereas U.S. GAAP provides such exemptions, which could result in different treatment of master-feeder funds.

> The unstated but possibly serious price would be a false sense of global comparability from a veneer of nominal uniformity—uniformity in written standards could disguise considerable diversity in actual practice. Comparability requires not only uniform standards but their uniform application. It would be surprising if participants in the 100 countries endorsing IFRS actually achieved uniform application, considering the varying political, economic and cultural environments that exist throughout the world and the absence of any global enforcement authority that could overcome them.[37]

Investment Companies. The Concept Release specifically contemplates that the ability to file financial statements using IFRS could be available to investment companies. Nevertheless, the SEC notes that differences between IFRS and U.S. GAAP that would result in different presentations.

> For example, IFRS does not require a schedule of investments or financial highlights; however, U.S. GAAP requires this information in an investment company's financial statements. As another example, IFRS does not provide an exemption from consolidation of subsidiaries in an investment company, whereas U.S. GAAP provides exemptions from consolidating subsidiaries in certain areas which could result, for example, in different treatment for master-feeder funds.[38]

CONCLUSION

More than a dozen comments have been received by the SEC concerning this proposal, and not all are favorable. Nevertheless, the recognition of convergence is likely to continue, and the SEC is certain to continue to study IFRS prepared statements before making a final decision. ■

[35] 72 Fed. Reg. 45607.

[36] See IOSCO press release, "Regulators to Share Information on International Financial Reporting Standards" (October 5, 2005) (www.iosco.org/news/pdf/IOSCONEWS92.pdf).

[37] Letter from Professor Lawrence Cunningham to the SEC (regarding File S7-20-07) (August 10, 2007).

[38] 72 Fed. Reg. 45608.