

Featured Article

The IFRS are Coming! International Accounting Convergence: Implications for Securities Lawyers and Other Professionals

Article contributed by:

Barry Jay Epstein, Ph.D., CPA, Russell Novak & Company LLP
and Eva Jermakowicz, Ph.D., CPA, Tennessee State University

Introduction

The movement toward convergence between U.S. generally accepted accounting principles (U.S. GAAP) and International Financial Reporting Standards (IFRS) has been widely noted over the last several years. IFRS are the less-detailed financial reporting rules that have been developed by the London-based International Accounting Standards Board (IASB) over the past 35 years, and which recently have become widely mandated, adopted or emulated in about 100 countries.¹ Most notably, IFRS have been formally mandated for publicly held companies chartered by EU member nations.² Two agreements (in 2002 and 2006) between the Financial Accounting Standards Board (FASB), which sets U.S. accounting rules, and IASB, its overseas counterpart, memorialized these standard-setters' commitment to eliminate all major discrepancies between the standards by the end of this decade. Among the most ardently hoped-for results of this anticipated convergence is the Securities and Exchange Commission's (SEC) eventual acceptance of IFRS for U.S. securities filings by foreign registrants. A recent SEC proposal signals the progress that has been made on this undertaking. SEC acceptance appears to be literally upon us now, with the tantalizing prospect that U.S.-based registrants will also be offered the option of filing their financial statements under IFRS. Essentially, what will happen is either there will be the option to permit IFRS-based reporting, or – perhaps in the not-too-distant future – to mandate IFRS in the U.S. If this happens, there will not only be a need to retrain accountants, auditors and corporate preparers of financial statements, but there are also other implications that should be pro-actively addressed by the securities bar and their clients. In the following paragraphs, certain of these potential ramifications will be discussed.

SEC Proposal Regarding Acceptance of IFRS-based Financials from Foreign Filers

Currently, foreign filers choosing not to comply with U.S. GAAP may report financial statements under local GAAP (e.g., Japanese accounting principles) or IFRS. In either case, two key financial statement captions (net income and total stockholders' equity) must be reconciled from the basis on which they are presented to the corresponding amounts under U.S. GAAP.³ Depending on which foreign GAAP is being reconciled, there are greater or fewer individual reconciling items set forth in these schedules.

Despite efforts to converge standards over the past five years, there remain a number of such differences, making financial statements prepared under IFRS not identical to those under U.S. GAAP.⁴ Examples of significant differences include accounting for development expenditures and inventory costing, as well as revaluations of long-lived assets.

In June 2007, the SEC proposed rule amendments that would eliminate the requirement to reconcile financial statements prepared under IFRS to U.S. GAAP (Proposal).⁵ If adopted, this would give foreign private issuers a choice of three reporting strategies: reporting under IFRS without reconciliation; reporting under U.S. GAAP; or reporting under their local GAAP reconciled to U.S. GAAP. The proposed changes would go into effect for 2008 annual reports.

The SEC also said it would take a step toward exploring the possibility of allowing U.S. companies to file financial statements under either U.S. GAAP or IFRS – good news for U.S. companies seeking reporting parity with foreign peers and competitors.⁶ The fact that SEC Chairman Christopher Cox called this “a significant next step on the road to a single set of globally accepted accounting standards” clearly signals the SEC's desire to bring about an end to the era of multiple sets of financial reporting regimes.⁷ Currently, only U.S. and Japanese stock exchanges bar IFRS-based financial reporting.⁸

In order to be eligible to omit U.S. GAAP reconciliation in accordance with the proposed amendments to Form 20-F under Rule 701 of Regulation S-X, and various Securities Act of 1933 forms, a foreign issuer would have to state “unreservedly and explicitly” that its financial statements comply with IFRS as published by the IASB. This is an allusion to “Euro-IFRS,” the slightly modified version of certain standards imposed by the EU.⁹ The independent auditors' report would similarly have to opine on full compliance with IASB-IFRS in connection with a foreign issuer's financial statements.¹⁰

In an effort to ensure that IFRS are interpreted and used consistently, the SEC, through a work plan with the Committee of European Securities Regulators (CESR), is entering into bilateral arrangements with securities regulators in countries that allow or require IFRS. The goal is to achieve consistency, but the SEC is, wisely, being careful to avoid any implication that it is attempting to dictate specific interpretations of the standards. The Proposal includes a number of questions intended to elicit a broad set of comments, including whether or not to shorten the current six-month deadline foreign private issuers are granted to file their annual reports with the SEC.¹¹ In addition, as expressed in the Proposal, the SEC is seeking comment on perceived problems that might arise as a consequence of requiring auditors' opinions on whether a foreign issuer's financial statements comply with the “full” IFRS – i.e., as published by the IASB.

The SEC staff is, as noted above, also working expeditiously on a previously announced concept release that would allow U.S.

issuers the choice to file in IFRS – widely seen as a companion measure to the reconciliation proposal, and seemingly demanded by those domestic companies envious of the liberalized requirements about to be granted to foreign issuers. This concept release is expected to be published this summer.¹²

The Future of Convergence

The Proposal comes as FASB and IASB continue work on converging their standards by 2010. The so-called Norwalk Agreement binds both organizations to this process, with many older standards of one or the other having been amended or superseded to more closely match the perceived superior corresponding standard of the other body.¹³ Joint efforts are underway to develop new standards that differ from, and are superior to, current IASB and FASB rules.¹⁴

In the longer run, IASB will likely become the standard setter, period.¹⁵ In the interim, the convergence process is useful because it concentrates the efforts of a larger group of the most knowledgeable thinkers on the resolution of remaining financial reporting concerns. The value of these resources justifies continuation of the convergence exercise.

For users and preparers of financial statements, the time to study IFRS has now arrived. To begin this familiarization process, interested parties can usefully direct attention to the U.S. filings of EU-based companies, for which, since 2005, IFRS has been the “native language.” Most foreign issuers using IFRS filed their first annual reports with the SEC in 2006, and reportedly fewer than 200 of such filings have been reviewed by the SEC’s Division of Corporation Finance.¹⁶ Fiscal 2006 annual reports of foreign private issuers were due June 30, 2007.

The SEC has stated its intention to make SEC staff comments related to their IFRS filings publicly available in a more accessible manner via the SEC web site. Review of this information will provide significant insight into how well-received (as gauged by staff comments, or lack thereof) IFRS-compliant financial statements have been.¹⁷ Furthermore, perusing net income and stockholders’ equity reconciliations will provide a greater sense of the nature and magnitude of these reconciling items.

Implications of SEC Proposal for Securities Lawyers and Other Professionals

Securities and corporate lawyers – and many other professionals – will benefit from increased awareness about international legal and financial reporting issues. This is necessary when advising clients entering into financial or other arrangements with foreign-based entities, particularly where there is a need to rely on counterparties’ financial representations, and obviously more so if joint ventures or other formal relationships are being contemplated. Henceforth, if the Proposal is adopted, it will be almost universally the case that such information will be presented on the basis of IFRS, and reconciling information will no longer be offered.

If U.S. companies are, or become, subsidiaries or investees of foreign companies, there will be an increased demand for them to produce IFRS-basis financial statements to upstream to their parent or investor entities. While in the past many of these for-

eign, parent entities were willing to accept U.S. GAAP-based financial reporting packages – and indeed many filed their consolidated (group) financial statements on that basis – this practice will quickly wither away. For large, international law firms, this will not be a problem because resources for such undertakings doubtless already exist, and technical experts from the law firms’ regular accounting firms, or from other consultancies or university faculties, can provide any needed supplementation.

If adopted, the proposed amendments would also impact non-U.S. lawyers or professionals, who may have to develop a greater understanding of current U.S. regulations in order to service corporate clients wanting to benefit from the Proposal. This should present them with an opportunity to educate and otherwise add value for their existing clients, as well as to more effectively promote their capabilities to prospective clients.

Opportunities for U.S. Securities Lawyers

The Proposal may also provide opportunities for domestic law firms. As already noted, if firms have clients which are, or may become, affiliated with foreign companies, education should be scheduled sooner rather than later. To the extent that waiving the former reconciliation requirements does (as widely touted) reduce competitors’ corporate costs – claimed to be, improbably, as high as \$25 million annually – this too can affect domestic clients of securities or corporate attorneys, which might see the elimination of the cost advantage they currently enjoy in carrying on their businesses.

While there may be some lost business for accounting firms, since foreign issuers adopting IFRS would no longer be required to provide reconciled numbers, improved access to capital markets should (if basic economic theory holds true) result in expanded opportunities and new business for law firms. For example, as entities attempt to complete securities offerings in U.S. capital markets, U.S.-based securities lawyers would then be called upon to advise an expanded number of registrants.

There are other paths to promotional opportunities for legal professionals. The waiving of reconciliation requirements, if adopted, may prompt some criticism from domestic registrants and others, including academicians who have yet to master IFRS. This could incite some intemperate responses, including claims about the purported inferiority of IFRS. It is important not to fall prey to such ill-considered reactions; and those undertaking to instead educate users of financial statements – including bankers, financial analysts, and institutional investors – may well be able to distinguish themselves and showcase their service offerings. In some cases, teaming with accounting practitioners or academicians might usefully serve to wrap these efforts in an educational cloak. Counsel, together with accounting advisors, might offer clients and prospects aids such as “accounting convergence checklists” to further assist them in this process.

Threats or Challenges for Securities Attorneys and their Clients

Ignoring the importance of international issues, and presuming they will not impact how U.S. corporations conduct their businesses would be a mistake. The Proposal may have a deeper reach, and consequences that managers or investors might need to anticipate. The most likely of these possible actions is that

U.S. corporations will accelerate lobbying the SEC to allow them to also commence reporting under IFRS. Conversely, they may petition foreign exchanges to permit them to publish under U.S. GAAP in international markets. Counsel will need to be aware of, and involved in, these or various actions by their clients.

Implications for the U.S. Securities Markets from Securities Law and International Capital Markets Perspectives

A fully-internationalized securities market would permit issuers in public primary markets to issue securities to investors worldwide, using financial statements prepared in accordance with one global set of high-quality disclosure requirements. Additionally, issuers should be subject to one set of optimal distribution procedures, as well as a single set of liability standards and enforcement remedies. Optimal standardized issuance across borders would reduce the costs of issuance of securities that are in international demand, a benefit that would be shared by both issuers and investors. Also, optimal standardized issuance would result in more perfect competition in the issuance market for such securities (just as in the goods markets, the laws of economics apply here), and result in a more efficient allocation of capital worldwide.

At the present time, harmonization has no prospect of insuring standardized distribution and enforcement procedures, and with respect to disclosure there are significant problems in harmonizing language, non-financial disclosures, and accounting standards.

There are also significant problems with harmonization of disclosure rules. The International Organization of Securities Commissions' rules¹⁸ – adopted by the U.S. for foreign issues, and recommended by the EU Prospectus (Directive 2003/71/EC) to be required when securities are offered to the public in primary markets or admitted for trading in secondary markets – do not deal with contentious issues like segmented market reporting or safe harbors for forward looking statements. In addition, there is the language problem: disclosure documents must be distributed in the local language, thus requiring significant translation costs and potential liabilities due to discrepancies in meaning among various language versions.

The biggest issue, of course, is one of enforcement. While the EU has enforced IFRS, other host countries (and perhaps soon, the U.S.) are moving forward with plans to do the same. This could lead to conflicting interpretations of IFRS, since interpretation is necessarily a part of the enforcement process. The EU is currently experiencing such problems because it lacks a centralized European securities regulator to consistently enforce IFRS.

Ultimately, the role of independent auditors will have to be elevated, and auditors will have to be empowered to strictly enforce financial reporting standards, and be accountable for the consequences of their enforcement decisions. Some have attributed the decline of audit rigor to the presumed U.S. GAAP reliance on rules-based standards, with the implication being that under the putatively more principles-based IFRS, auditors would once again assume their storied roles as U.S. GAAP strict constructionists. This may or may not be true. The diminished performance of auditors in recent decades could well be interpreted as evidence that U.S. GAAP has been insufficiently rules-

based, and also that there has been a decline in professionalism among auditors. In any event, the wider use of IFRS and the diffusion of authority among various national and international regulatory authorities, will probably only succeed in improving access to capital if greater reliance is placed on the work of auditors, and if that reliance proves to be warranted.

Potential Impact on Securities Litigation

Clearly, any changes to reporting standards (even routine changes to U.S. GAAP) can engender disputes that may evolve into securities litigation. A change from U.S. GAAP to IFRS reporting standards would create a greater risk of misunderstandings, and of improper application of unfamiliar rules by preparers and even by auditors. Thus, the change could exacerbate the already serious litigation risks, where investors or other users of financial statements claim harm flowing from reliance on improperly prepared or inadequately explained financial reports. On the other hand, awareness that these risks might exist should stimulate the exercise of greater care and caution, which would, to a degree, ameliorate the dangers.

In our opinion, taking into account one author's experience with securities litigation, the expanded use of IFRS-based reporting will, in the near term at least, create expanded litigation risk. This warrants careful attention by corporate and securities lawyers, who should take steps to educate and protect their clients. Expert advice and counsel should be utilized, particularly if clients are making use of others' IFRS-based financial statements to make economic decisions – or if they are reporting to parent or affiliated companies on the basis of newly-adopted financial reporting standards.

The expanded use of IFRS combined with the rapidly growing use of fair value information in both U.S. GAAP and IFRS, adds further to the difficulties faced by users of financial information, and thus to litigation and other risks.¹⁹ Together with several other fundamental financial reporting developments, this further underscores the importance of – and the remarkable opportunity for – communicating these changes to clients at this time.

Governance Implications for the Board and/or Audit Committee

Recent experience with Statement of Financial Accounting Standards No. FAS 123[R] stock option expensing, and alleged abuses involving backdating of option grants, have heightened investor awareness of the implications of complex and arcane accounting standards. This continues a trend that notoriously included the "off the books" partnerships of Enron Corporation, and the multiple abuses of expense and revenue recognition rules by WorldCom Inc. There may now need to be more active involvement by directors, particularly by audit committee members, in the selection and application of financial reporting standards. Specifically, the risk of "opportunistic behavior" by management, in deciding between U.S. GAAP or IFRS adoption in order to affect key financial ratios and performance measures, potentially affecting bonus awards and option grants, may demand greater board scrutiny. Assistance from special counsel or outside accountants – explicitly authorized under Section 301

of the Sarbanes-Oxley Act of 2002 – may be useful in this regard.²⁰

Internationally, corporate governance plays a lesser role vis-à-vis consistent application of accounting standards: greater attention has been given to the work done by external auditors, and the approach taken by enforcement agencies. Both the SEC and the Financial Services Authority²¹ have recently played leading roles in the reform of the process whereby international auditing standards are set, as they had done a few years earlier in respect of the process for setting international accounting standards. We expect that the result will be a more transparent and accountable process for setting international standards on auditing and auditor independence, although this may still be some years in the future.

To facilitate uniform enforcement of IFRS in EU member states, CESR issued a standard containing 21 high-level principles of enforcement that member states should adopt in enforcing IFRS. Also, in 2003, the International Audit and Assurance Standards Board (IAASB) issued additional guidance regarding audits of IFRS financial statements.

In December 2003, CESR published “Recommendation for Additional Guidance Regarding the Transition to IFRS,” which provides insights into application of IFRS.²² In this guidance, CESR suggests that the complex process of transitioning towards IFRS be accompanied by supplementary financial communications that gradually prepare the markets to assess the impact of the transition on an issuer’s consolidated financial statements. Furthermore, first-time adopters are encouraged to explain the impact of switching from their national accounting standards to IFRS as soon as reasonably practicable. These communications, outside of the financial statements, are intended to educate users and avert misunderstandings that, using past experience as a guide, can escalate to threatened or actual litigation.

Concluding Thoughts

The next few years will be a time of challenges and opportunities, with major changes in financial reporting regimes, particularly in the U.S., being extremely likely. Corporate counsel, supported by accounting experts, can provide valuable services to their clients. Litigation counsel will be faced with complex but significant opportunities to assist securities litigants and companies to sort through the changing financial reporting landscape. Gaining a basic understanding of IFRS and how they will affect various segments of the financial reporting communities should be seen as a priority for each of these sectors of the bar.

Barry Jay Epstein, Ph.D., CPA, (Bepstein@RNCO.com) is Partner in the Chicago, Illinois firm, Russell Novak & Company, LLP, where his practice is concentrated on technical consultations on GAAP and IFRS, and as a consulting and testifying expert on civil and white collar criminal litigation matters. Eva K. Jermakowicz, Ph.D., CPA, (Ejermakowicz@Tnstate.edu) is Professor of Accounting and Chair of the Department of Accounting at Tennessee State University, Nashville, and is author or co-author of many scholarly works. Drs. Epstein and Jermakowicz co-author Wiley IFRS 07 and the forthcoming IFRS Policies and Procedures. Dr. Epstein is also co-author of Wiley GAAP 07 and other books.

1 For a detailed list of IFRS status by nation, see <http://www.iasplus.com/country/useias.htm>

2 The EU announced its intention to mandate IFRS in 2000, and the requirements for public company reporting came into effect in 2005. See Regulation (EC) No. 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards.

3 The current requirements were adopted in 1982. A requirement to reconcile the cash flow statement was terminated after IAS No. 7 was revised in 1992.

4 A number of FASB or IASB standards have already been “converged” to the other standard-setter’s positions. These include revised U.S. GAAP requirements regarding inventory costing, reporting corrections of errors, nonmonetary exchanges, the use of fair value for financial assets and liabilities, and stock based compensation. IASB is amending its standard on segment reporting to mirror that under U.S. GAAP and considering other changes.

5 SEC Release Nos. 33-8818 and 34-55998; International Series No. 1302; File No. S7-13-07 (Proposal); comments due by Sept. 24, 2007.

6 A concept release is expected later in 2007 and, depending on comments received, an actual proposal could be issued in 2008 or 2009.

7 SEC Proposes: No More IFRS Reconciliation (Compliance Week, Jun. 26, 2007).

8 *Id.*

9 The EU endorsement mechanism for new or revised IFRS means that further divergence between Euro-IFRS and “full” IFRS could evolve over time.

10 Thus, if the financial statements conform to “Euro-IFRS,” rather than “full” IFRS, reconciliation to U.S. GAAP will not be waived.

11 This generous period was intended to give issuers time to prepare their reconciliation statements which, once that duty is eliminated, would no longer be warranted. Filing deadlines then might reasonably be reduced to the same 60 to 90 days that U.S. companies are given to file their financial statements.

12 See Proposal.

13 The Norwalk Agreement was signed in September 2002. Following meetings in 2005, IASB and FASB reaffirmed their commitment to convergence in the February 2006 Memorandum of Understanding, setting forth a detailed list of projects to be addressed in the undertaking. The SEC outlined the steps necessary for elimination of the reconciliation requirement (roadmap) as early as 2005.

14 Current short term convergence projects of note include those addressing asset impairment, income taxes, investment properties, research and development costs, government grants, joint ventures, and segment reporting. Major projects being jointly developed are those on leases, revenue recognition, financial statement presentation, and business combinations.

15 A U.S. version of IFRS might be formally promulgated, just as is the case now with Australian GAAP, which is entirely consistent with IFRS.

16 See Proposal.

17 See *id.*

18 International Organization of Securities Commissions, a body comprised of individual nations’ securities regulators, makes recommendations on uniform rules and procedures, but has no ability to force any regulator to adopt them.

19 Fair value measures are invoked under many extant financial reporting standards, but until recently the term “fair value” had been ill-defined. U.S. GAAP recently added detailed guidance in the form of a “fair value hierarchy” set forth by Statement of Financial Accounting Standards No. 157. IFRS has a standard currently in the discussion draft stage, and it incorporates SFAS No. 157. U.S. GAAP also recently promulgated a “fair value option” for financial assets and liabilities (SFAS No. 159), mirroring an earlier-adopted IFRS standard.

20 This amended Section 10A of the Securities Exchange Act of 1934 to provide that “each audit committee shall have the authority to engage independent counsel and other advisers” and that “each issuer shall provide for appropriate funding, as determined by the audit committee”

21 The U.K. Financial Services Authority is charged with promoting efficient orderly and fair markets, among other objectives. The enforcement regime in the U.K. has traditionally been far weaker than in the U.S., where the SEC vigilantly polices the securities markets.

22 Committee of European Securities Regulators (CESR). 2003b. Recommendation for additional guidance regarding the transition to IFRS. European regulation on the application of IFRS in 2005. CESR/03-323e (Dec. 2003). Paris, France: CESR.

Dr. Epstein can be reached at
Bepstein@RNCO.com or 312-464-3520.