

## CLIENT ADVISORY

## SEC ELIMINATES US GAAP RECONCILIATIONS FOR FOREIGN PRIVATE ISSUERS USING IFRS

On November 15, 2007, the SEC adopted a proposal to accept from foreign private issuers financial statements prepared in accordance with the English language version of International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"), without reconciliation to US generally accepted accounting principles ("US GAAP"). To be eligible, the foreign private issuer's financial statements must include a prominent footnote asserting that its statements are in compliance with IFRS as published by the IASB, and an independent auditor must opine similarly.

The new rules are intended to facilitate capital-raising by foreign private issuers in the US. Currently, financial statements filed by foreign private issuers that register securities with the SEC and that file periodic reports under the Securities Exchange Act have to be reconciled to US GAAP if they are prepared using a basis of accounting other than US GAAP. The reconciliation identifies and quantifies the material differences between the foreign private issuer's financial statements and the requirements of US GAAP and Regulation S-X.<sup>1</sup> Many foreign private issuers view the existing reconciliation requirement as expensive, burdensome and time-consuming.

It is unclear how many foreign private issuers will choose to satisfy the SEC's standard for IFRS. Countries in the European Union are required to use IFRS, and over 100 countries worldwide either mandate or allow the use of IFRS, but not all versions are the English language version of IFRS as adopted by the IASB.<sup>2</sup>

NOVEMBER 2007

**Washington, DC**  
+1 202.942.5000

**New York**  
+1 212.715.1000

**London**  
+44 (0)20 7786 6100

**Brussels**  
+32 (0)2 517 6600

**Los Angeles**  
+1 213.243.4000

**San Francisco**  
+1 415.356.3000

**Northern Virginia**  
+1 703.720.7000

**Denver**  
+1 303.863.1000

<sup>1</sup> The reconciliation to US GAAP is provided pursuant to Item 17 or Item 18 of Form 20-F, as applicable.

<sup>2</sup> The recent movement to IFRS outside the US has resulted in an increase, from a relative few in 2005 to approximately 110 in 2006, of SEC filings by foreign private issuers that represent that their financial statements comply with IFRS as published by the IASB. Approximately 70 foreign private issuers stated that their financial statements were prepared in accordance with solely a jurisdictional variation of IFRS. Approximately 50 foreign private issuers that are incorporated in jurisdictions that have moved to IFRS included financial statements prepared in accordance with US GAAP. The SEC expects to see the number of foreign private issuers that represent that their financial statements comply with IFRS as published by the IASB continue to increase, particularly now that Canada has announced a move to IFRS. There currently are approximately 500 foreign private issuers from Canada. See "Concept Release On Allowing US Issuers To Prepare Financial Statements In Accordance With International Financial Reporting Standards," Release Nos. 33 8831; 34-56217 (Aug. 7, 2007), available at [www.sec.gov/rules/concept/2007/33-8831.pdf](http://www.sec.gov/rules/concept/2007/33-8831.pdf).

*This summary is intended to be a general summary of the law and does not constitute legal advice. You should consult with competent counsel to determine applicable legal requirements in a specific fact situation.*

**arnoldporter.com**

However, the SEC is not aware of any jurisdiction that mandates or permits IFRS that prohibits use of the English language version of IFRS. With one limited exception,<sup>3</sup> the new rules do not change the existing reconciliation requirement for foreign private issuers that are not in full compliance with the IASB's English language version of IFRS or that file financial statements under other sets of accounting standards.

Domestic issuers should take note—IFRS is coming their way. The new rules represent a significant milestone for both foreign private issuers and domestic companies because they are a significant step toward adoption of a unified set of international accounting standards. The SEC is considering a proposal, nicknamed "IFRS-US," that would allow US issuers to use IFRS as issued by the IASB instead of US GAAP.<sup>4</sup> The SEC will hold two roundtables next month, on December 13 and December 17, to discuss the proposal. While the proposal would allow US domestic issuers to use IFRS instead of US GAAP on a voluntary basis, the eventual goal is to move US reporting companies to a unified set of international accounting standards, which would replace US GAAP.

<sup>3</sup> The final rules will include a two-year transition period for any existing registrant from the European Union that currently applies the optional EU accommodation with respect to international accounting standard 39 but complies with IFRS as issued by the IASB in all other respects. The IAS 39 accommodation allowed by the EU excludes certain provisions relating to hedging and accounting for financial instruments. The transition period would apply to the first two financial years ending after November 15, 2007. Subsequently, such issuers would report in the same manner as any other foreign private issuer.

<sup>4</sup> See "Concept Release On Allowing US Issuers To Prepare Financial Statements In Accordance With International Financial Reporting Standards," *supra* n.2. The comment period closed on November 13, 2007.

<sup>5</sup> See "SEC Eases Accounting Requirement For Foreign Companies; Investor Advocates Raise Objections," The Associated Press (Nov. 15, 2007), available at [www.iht.com/articles/ap/2007/11/15/business/NA-FIN-US-SEC-Accounting.php](http://www.iht.com/articles/ap/2007/11/15/business/NA-FIN-US-SEC-Accounting.php)

## A UNIFIED SET OF INTERNATIONAL ACCOUNTING STANDARDS—IS THE SEC RUSHING THE GOAL?

The rule amendments will facilitate capital-raising by foreign private issuers in the United States because it will permit them to present financial information to US investors using a common internationally accepted platform while at the same time eliminating the reconciliation process, which is both time-consuming and expensive. Financial information prepared in this manner will facilitate investor comparisons of investment opportunities on a global basis.

The new rules address the need for a single set of international accounting standards to allow investors to better understand and draw comparisons among investment options. Roughly two-thirds of American investors own securities of foreign companies, a 30% increase from five years ago. At the same time, companies are increasingly seeking capital outside of their home markets. These trends heighten the need for a single set of high-quality, globally-accepted accounting standards.

The SEC has long supported the reduction of disparity between US accounting and disclosure practices and those of other countries. But critics charge that the SEC is putting the cart before the horse by eliminating the reconciliation requirement even though convergence is far from finished. On November 14, the day before the SEC's vote, Senator Christopher Dodd (D-Conn.), Chairman of the Senate Banking Committee, and Senator Jack Reed (D-RI), who heads the Senate Subcommittee on Securities, Insurance and Investment, sent a letter to the Chairman of the SEC, Christopher Cox,<sup>5</sup> which stated that because the convergence of GAAP and international standards is not expected to be achieved until 2011, the elimination of the reconciliation requirement is premature and being unduly rushed. But SEC Commissioner Kathleen Casey stated at the meeting that "only by taking this step will we be able to make progress toward" the goal of a single set of high-quality accounting standards.

In addition, some commenters have argued that allowing foreign private issuers to file financial statements using IFRS without reconciliation to US GAAP will remove the incentive for convergence between IFRS and US GAAP. During the November 15, 2007 meeting, Chairman Cox reassured listeners that the SEC, regulators, and the market would continue to provide an ongoing incentive for continued convergence.

Critics are also concerned about the funding, governance, and accountability of the IASB, an independent, private sector body that develops and maintains IFRS. The IASB relies for funding on voluntary contributions from private companies, accounting firms, central banks, and international organizations. Chairman Cox attempted to address these concerns by noting that SEC staff are working with other regulators around the world to ensure that the IASB is accountable to the public and to investors.<sup>6</sup> Senators Dodd and Reed claim that the SEC has done an end-run around Sarbanes-Oxley. The SEC disputes the notion that it lacked authority to act.<sup>7</sup>

<sup>6</sup> On November 6, 2007, the Trustees of the International Accounting Standards Committee Foundation, the oversight body of the IASB, announced proposals to enhance the organization's governance arrangements and reinforce the organization's public accountability. The following day, the European Commission, the Financial Services Agency of Japan, the International Organization of Securities Commissions (IOSCO) and the SEC issued a joint release announcing their support for these efforts.

<sup>7</sup> The letter that Senators Dodd and Reed sent Chairman Cox on November 14 challenged the SEC's authority, noting that while "the Sarbanes-Oxley Act preserved the SEC's authority to set its own accounting standards, the SEC's proposal to treat standards set by the IASB as generally accepted, whether expressly or impliedly, is an end-run around Congress's intent in establishing the independent funding mechanism and other qualifications necessary to justify reliance on a standards-setter other than the SEC itself." However, John Heine, an SEC spokesman, has indicated that the SEC has "full authority under the securities laws as amended by the Sarbanes-Oxley Act to accept foreign private issuer financial statements prepared in accordance with IFRS as published by IASB." See "Cox's SEC Thumbs Its Nose at Sarbanes-Oxley Act," Jonathan Weil, available at [www.bloomberg.com/apps/news?pid=20601039&refer=columlist\\_weil&sid=avzNDH8ytPg0](http://www.bloomberg.com/apps/news?pid=20601039&refer=columlist_weil&sid=avzNDH8ytPg0).

<sup>8</sup> See Charlie McCreevy, "State of The Union," Wall Street Journal (Nov 18, 2007).

Charlie McCreevy, EU Internal Market and Services Commissioner, praised the SEC's move, indicating that EU firms can save up to €2.5 billion annually now that the reconciliation requirement has been eliminated. Calling the SEC's decision an "extraordinary breakthrough," McCreevy said that he intends to propose that US companies with shares listed in the EU be permitted to report in the EU using US GAAP, with a formal regulatory decision to be made in 2008. He noted that over the last few years EU and US standard-setters have worked on "converging" IFRS and US GAAP to make them compatible with each other, but there have been skeptics on both sides of the Atlantic. Many in the EU (falsely) predicted that the SEC would never go along with these plans. They pressed the EU to abandon IFRS and take a more insular approach by setting up an EU accounting standards body to design specific European accounting rules. He hopes that other nations, such as Japan, China, India, and Russia, will come on board as well and feel encouraged to address regulatory cooperation.<sup>8</sup>

Despite the critics, the SEC's decision appears to be a sound one. Many reconciliations are 30 pages long and difficult for investors to understand, so most investors do not appear to be reading them anyway. Some institutional investors commented that they are familiar and comfortable with IFRS financial statements without the reconciliation and believe investors are already making use of IFRS financial statements. However, the SEC will need to take steps to encourage the education of US issuers and investors about IFRS.

## EFFECTS ON FOREIGN PRIVATE ISSUERS; EFFECTIVE DATE

Raising capital in the US will now be easier and cheaper for those foreign private issuers that can eliminate the reconciliation to US GAAP by using IFRS as issued by the IASB. However, not all foreign private issuers use this version of IFRS, so it is unclear how many will choose to satisfy the SEC's standards.

The text of the final amendments<sup>9</sup> has not yet been published, but the SEC staff has indicated that the rule amendments will go into effect 60 days after they are published in the Federal Register and will be applicable to financial statements covering fiscal years ended after November 15, 2007. Thus, foreign private issuers whose 2007 financial years have not yet ended will be able to file IFRS financial statements without reconciliation to US GAAP in their next annual reports or registration statements, so long as they state and an independent auditor opines that the financial statements comply with IFRS as issued by the IASB.

To the extent interim period financial statements are required in an SEC filing such as a registration statement, foreign private issuers that are eligible to omit the US GAAP reconciliation in their audited annual financial statements also would be eligible to omit a reconciliation from their unaudited interim period financial statements. Such interim financial statements would have to be prepared in accordance with IFRS as published by the IASB.

## THE ROAD AHEAD

Allowing foreign private issuers to use IFRS as issued by the IASB without a reconciliation to US GAAP moves the international markets one step closer to an important goal—the creation of a single set of internationally accepted accounting standards. Both the US and the EU are committed to that vision. While the SEC acted in

the face of criticism, the SEC's bold move will hopefully encourage other jurisdictions to join the US and EU in this effort. Though that result is not assured, the SEC's decision paves the way for a broader level of global cooperation. A single set of international accounting standards would facilitate cross-border capital formation by reducing compliance costs and regulatory burdens, and enable US and foreign investors to better understand and compare investment options on a global basis.

The elimination of the reconciliation requirement to US GAAP likely foreshadows the eventual elimination of US GAAP. Don Nicolaisen, the original author of the SEC's IFRS "roadmap," has stated that the SEC should consider requiring that all US companies use the same accounting standard as foreign companies.<sup>10</sup> In addition, Robert Herz, Chairman of the US Financial Accounting Standards Board (FASB), said at the end of September that he expects all US companies to eventually follow a single accounting standard and that he expects this standard to be IFRS, not US GAAP. Herz has called for a national plan, consisting of timetables, tasks and education efforts, to wean US companies off of "rules-based" GAAP, and onto a single global standard. He does not support offering a GAAP-IFRS choice to US companies because he believes it undermines the goal of getting to a single standard.<sup>11</sup>

US issuers should be paying close attention to these developments. IFRS is gaining traction as a global accounting standard, and if the SEC decides to allow domestic issuers a choice between IFRS and US GAAP, some US companies may wish to convert to IFRS in order to stay competitive with foreign issuers. For example, it is difficult for investors to compare the results of US financial institutions against foreign competitors because most financial institutions throughout the world use IFRS. In

<sup>9</sup> The SEC adopted amendments to Form 20-F and conforming changes to Rules 1-02, 3-10 and 4-01 of Regulation S-X, Forms F-4 and S-4, and Rule 701 under the Securities Act.

<sup>10</sup> See "Remarks Before the IOSCO Annual Conference," by former SEC Commissioner Roel C. Campos (Apr. 12, 2007), available at [www.sec.gov/news/speech/2007/spch041207rcc.htm](http://www.sec.gov/news/speech/2007/spch041207rcc.htm).

<sup>11</sup> FASB's current codification project will bring US GAAP, which is rules-based, closer in line with the principles-based IFRS system. The project is scheduled to be completed by 2009, but the FASB still has a significant amount of simplification work remaining, especially in the area of pensions, leases, revenue recognition, and financial-statement presentation. See "Sweeping Away Gaap, Fasb's Herz Calls For A National Plan To Wean US Companies From Their Current Rules-based Accounting System," available at <http://cfo.com/article.cfm/9891584?f=search> (Sept. 28, 2007).

addition, US issuers with a large number of subsidiaries reporting in other countries based on IFRS may incur lower costs preparing their consolidated financial statements using IFRS rather than GAAP. Although IFRS needs to be improved before it supplants US GAAP, US issuers will eventually move from US GAAP to a set of international accounting standards, which is likely to be a revised version of IFRS. Therefore, it is not too soon for all US reporting companies to educate themselves about IFRS and monitor developments in this area.

---

*We hope you found this information useful. If you would like more information, please contact your Arnold & Porter attorney or:*

**Gregory Harrington**

+1 202.942.5082

Gregory.Harrington@aporter.com

**Laura Badian\***

+1 202.942.6302

Laura.Badian@aporter.com

---

\* Admitted only in Illinois; practicing law in the District of Columbia pending approval of application for admission to the DC Bar and under the supervision of principals of the firm who are members in good standing of the DC Bar.