Closing the GAAP

Regulators' recent acceptance of International Financial Reporting Standards has eased access to US capital markets for foreign private issuers and is a welcome step toward a set of globally-accepted rules say STEVEN G TEPPER and LAURA BADIAN

For a European issuer preparing to raise capital in the United States, US accounting requirements have been a significant hurdle. The US Securities and Exchange Commission (SEC) has long required that a foreign private issuer provide a reconciliation of its financial statements to US generally accepted accounting principles (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 the SEC's accounting regulations.

For most foreign issuers, the US GAAP reconciliation has been difficult, time-consuming and expensive to prepare. At the same time, we see little evidence that US investors value, or even understand, the reconciliation. Fortunately, for foreign private issuers who are traded in the US, or are considering tapping the US capital markets, relief has arrived.

On 15 November, 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 GAAP. To be eligible, the foreign private issuer must state without reservation that its statements are in compliance with IFRS as published by the IASB, and an independent auditor must provide an opinion to that effect. The new rules will be applicable to financial statements covering fiscal years ended after 15 November 2007.

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 foreign private issuer filings with the SEC representing that their financial statements comply with IFRS as published by the IASB. Approximately 50 foreign private issuers incorporated in jurisdictions that have moved to IFRS included financial statements prepared in accordance with US GAAP.

It is unclear how many foreign private issuers will choose to satisfy the SEC's standard for IFRS. EU countries are required to use the EU version of 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. However, it appears that none of the jurisdictions that mandate or permit IFRS would prohibit use of the English language version. With one limited exception relating to hedging and accounting for financial instruments, 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.

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Toward unified international standards

The new rules will facilitate capital-raising in the US by permitting foreign private issuers to present financial information to US investors using a common internationally-accepted platform, while at the same time eliminating the burdensome and complicated reconciliation process. Perhaps even more importantly, companies that adopt the English language version of IFRS can use the same financial statements for offerings in the two largest capital markets in the world, the United States and Europe.

The new rules address the need for a single set of international accounting standards to allow investors better to understand and draw comparisons among investment options. Roughly two-thirds of American investors own securities of foreign companies, a 30 per cent 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.

Interestingly, the new rules were adopted before completion of the 'convergence process', in which the US Financial Accounting Standards Board and the IASB have been working towards harmonisation of US and international standards. Critics charge that eliminating the reconciliation requirement was premature because convergence is far from finished. The SEC has acknowledged that differences between US GAAP and IFRS remain – indeed, a review of selected reports from foreign issuers that currently file under IFRS with a reconciliation to US GAAP reveals that the two accounting systems can yield dramatically different results, even in such fundamental line items as 'net income'. However, the SEC, in adopting the new rules, expressed its confidence in US investors' ability to understand and work with the two different systems.

Critics have also voiced concerns about the funding, governance and accountability of the IASB, which relies on voluntary contributions from private companies, accounting firms, central banks and international organisations. The SEC, however, expressed confidence in the IASB, and noted that it is working with other regulators around the world to ensure the IASB's accountability to the public and to investors.

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. He noted that over the last few years EU and US standard setters have worked on 'converging' IFRS and US GAAP, but there have been sceptics on both sides of the Atlantic. Many in the EU (incorrectly) predicted that the SEC would never go along with these plans. They pressed the EU to abandon IFRS and take a more insular approach. He hopes that other nations, such as Japan, China, India and Russia, will come on board.

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US issuers and IFRS

On the domestic front, the SEC has issued a 'concept release', seeking comment on whether US issuers should also be permitted to prepare their financial statements in accordance with IFRS. US issuers are paying close attention to the advance of IFRS as a global standard and, given the option, some US companies may choose 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. Additionally, US issuers with subsidiaries reporting in other countries based on IFRS may incur lower costs preparing their consolidated financial statements using IFRS rather than US GAAP.

The road ahead

The new rules represent a significant milestone for *both* foreign private issuers and US domestic companies. Both the US and the EU are committed to the vision of a unified set of international accounting standards. The SEC's decision paves the way for a broader level of global co-operation, and may foreshadow the eventual elimination of US GAAP. A single set of international accounting standards would facilitate cross-border capital formation by reducing compliance costs and regulatory burdens, enabling US and foreign investors better to understand and compare investment options on a global basis. ■

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