SEC FLASH REPORT

SEC's Proposes Roadmap for IFRS Adoption in the United States by 2014

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On August 27, the five SEC commissioners of the Securities and Exchange Commission (SEC) voted unanimously to publish for public comment a proposed roadmap that could lead to the voluntary or mandatory use of International Financial Reporting Standards (IFRS) by all U.S. issuers beginning in 2014. Under this plan, about 110 companies could start following international rules even earlier. Public comment on the SEC's proposing release should be received by the Commission no later than 60 days after its publication in the Federal Register.

For several years, the Commission has been discussing the potential for adoption of IFRS with issuers and their external auditors at various conferences. Since March 2007, the Commission and its staff have held three roundtables to examine IFRS, including one in August regarding the performance of IFRS and U.S. generally accepted accounting principles (U.S. GAAP) during the subprime crisis. Last year, the Commission issued a concept release on allowing U.S. issuers to prepare financial statements using IFRS. As a result, the proposed roadmap has been expected for some time.

SEC Chairman Christopher Cox described the proposed plan as “careful and cautious” in response to critics who have questioned whether the agency risks outsourcing its oversight role to less-aggressive regulators by making this change. Chairman Cox indicated the plan is the result of two things – (1) increasing worldwide acceptance of financial reporting using IFRS and (2) U.S. investors' increasing ownership of securities issued by foreign companies that report financial information using IFRS.

Meshing U.S. financial regulations with rules adopted by other countries has been a priority for the SEC for some time. The Commission's point of view is that companies will be able to reduce costs by eliminating either duplicate accounting at some or all of their international subsidiaries or extensive reconciliation to US GAAP in either filings or subsidiary-level internal reporting. Investors should benefit because they ultimately bear the burden of higher compliance costs. Analysts should be more readily able to drill down into comparable financial information due to the additional disclosures required by some elements of IFRS. Today, more than 100 countries around the world, including all of Europe, currently require or permit IFRS reporting. Approximately 85 of those countries require IFRS reporting for all domestic, listed companies.

The proposed plan sets out several milestones that, if achieved, could lead to the use of IFRS by U.S. issuers in their filings with the Commission, resulting in a common accounting language around the world to give investors greater comparability and greater confidence in the transparency of financial reporting worldwide. Based to some extent on the achievement of those milestones, the Commission intends to make a decision in 2011 on whether adoption of IFRS is in the public interest and would benefit investors. Some might, consequently, view the “milestones” as, for all intents and purposes, “conditions”.

The SEC's plan would require adoption of IFRS in its totality, just as it does for foreign filers which no longer need to reconcile to U.S. GAAP if they do so (i.e., no "local flavors"). The plan establishes a framework by which IFRS use would be either permitted or required by 2014, with "permitted" vs. "required" to be decided in 2011. There are several key milestones under the plan:

- IFRS standards must be improved, such as the current convergence of IFRS with Financial Accounting Standards Board standards like 141R and 160. Note that there were "hints" during the SEC's open meeting last week that IFRS may need to be "beefed up" on some of the grey areas – areas where it provides for more judgment as juxtaposed to the rules set forth by U.S. GAAP.
- Independence and funding of the International Accounting Standards Board must address current concerns about the objectivity of the standard-setter.
- There must be XBRL-like interactive data availability and taxonomy under IFRS.
- Training on IFRS must take place in the U.S. in sufficient time so that preparers, certifying officers and external auditors are competent to apply the new standards.
- There must be evidence of success in the limited early use of IFRS.
- The timing of SEC action is open at the present time, e.g., do they act in 2011 or do they delay (or could they perhaps act sooner)?
- There is the potential for staging IFRS implementation based on market capitalization (similar to Sarbanes-Oxley Section 404 implementation) such that some entities might not have to comply until as late as 2016.

During last week's open meeting, there was heavy emphasis by the Commissioners during the question and answer session with the SEC staff on the milestones as, essentially***, conditions*** for them to ultimately decide in 2011 whether IFRS adoption will be in the public interest. Also, there was some discussion of the implementation "barriers." For example, the following points were discussed:

- Some of the SEC's own rules and regulations, and their dependence on references to U.S. GAAP will require revisiting.
- LIFO application and the need to work with the Internal Revenue Service to address the book/tax conformance issue currently proscribed by the U.S. Internal Revenue Code
- The existence of references to U.S. GAAP in various state and local laws and regulations (not to mention in company contracts and agreements)
- The need for training for preparers and executives responsible for signing the Section 302 certifications and/or external audit opinions
- The potential implementation issues when it comes to "principles" vs. "rules" and the possible ambiguity and its impact
- The need for changes to the uniform CPA exam so that future professionals hit the ground running with relevant knowledge they can apply in practice.

With respect to early use, the SEC's proposed criteria are twofold:

(1) The company has to be one of the 20 largest, based on market cap in its industry, on a global basis

(2) IFRS would have to be used by the most of the top 20 companies, by market cap, in the company's industry

Based on the above criteria, at least 110 U.S. issuers would be eligible for early use according to the SEC's study (note that companies which believe they are eligible would have to seek the SEC's concurrence with that eligibility). As more companies and countries (such as Canada in 2010 or Japan in 2011) adopt IFRS, more issuers become eligible according to these criteria (note the interrelationship between points (1) and (2) above). In addition, as companies become larger in their market cap ranking due to the market being potentially volatile, they may become eligible.

According to the proposal, there are two potential ways to implement IFRS – both for early users and future users. First, IFRS can be adopted for all statements, current and prior, with a one-time reconciliation. Second, the SEC may allow or require an unaudited reconciliation of the prior period financial statements to IFRS in a footnote for the years up to the year of implementation, covering the years leading up to the year of adoption (and, if necessary, providing a "way back to U.S. GAAP" for early adopters if the Commission were to decide to pull the plug on IFRS in 2011). These options are not intended to be available on an "either/or" basis in the final rule. As a result, it is unclear at the present time as to the state of readiness in which companies will need to be with respect to their prior historical financial statements. That state of readiness will have a huge impact on when companies must begin the IFRS conversion project should they choose to take advantage of early adoption.

In summary, the key dates in the roadmap are:

- 2009 – Some special early adopters could be allowed to implement IFRS very soon starting with their 2009 financials, resulting in filings during early calendar 2010. This group of large (presumably global) companies is a limited universe of potential early adopters.
- 2011 – The SEC would act to permit or require IFRS for all companies in 201X, and also potentially let others start to phase in IFRS before or by 201X.
- 2014 – At the present time, 2014 is the suggested solution for "201X", although market-cap-based phasing could lead to an adoption date of 2016 for smaller entities.

Thus, by 2011 the SEC will recommend action; by 2014, IFRS adoption will be permitted or required. The key message, as articulated by the SEC Commissioners during last week's open meeting, seems to be "progress on the milestones." Therefore, to the extent there is success or failure in meeting expectations, it may affect the timing or extent of adoption. For example, the SEC's decisions in 2011 will be influenced by the progress on resolving the hurdles noted, such as standards convergence efforts, movement on the LIFO tax conformance issue and consideration of references to U.S. GAAP in laws, contracts and regulations, among other things. Companies considering their next steps should engage in a diagnostic effort to understand the extent to which IFRS might affect their financial reporting. This effort should consider the people, processes and technology which enable ongoing compliance with financial reporting requirements and related internal controls. From that point, and with the benefit of a diagnostic exercise in hand, companies will be able to properly map out a project management plan which can be executed in the periods leading up to their permitted or required adoption of IFRS. For more information, see Issue 3 of Volume III of *The Bulletin*.