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Elimination of US GAAP Reconciliation in SEC Reports for Companies that use IFRS: A Guide for the 2007 Financial Reporting Season (and beyond)

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This year, for the first time in more than a quarter-century, many non-U.S. companies that file annual reports and registration statements with the United States Securities and Exchange Commission will not have to reconcile their financial statements to United States Generally Accepted Accounting Principles, or US GAAP.

Under a new SEC rule that was published in the Federal Register in January 2008, the SEC eliminated the US GAAP reconciliation requirement for most companies that prepare financial statements in accordance with International Financial Reporting Standards (IFRS). The new rule also makes it easier for companies that are not listed in the United States and that publish IFRS financial statements to offer shares or to grant stock options to their U.S. employees.

While the new rule is a very favorable development that is likely to save time, effort and expense for eligible companies, a number of practical questions relating to the details of the new rule will require some thought and advance planning, particularly during the new rule's first year of implementation. This memorandum addresses a number of those questions.

1. Eliminating US GAAP Reconciliation for Companies that use IFRS (but not every form of IFRS)

The SEC's new rule amends Form 20-F, the basic disclosure form for annual reports and registration statements of non-U.S. companies, as well as certain other SEC forms and rules. The amendments eliminate the requirement that non-U.S. reporting companies reconcile their financial statements to US GAAP, so long as they prepare their financial statements in accordance with IFRS "as issued by the International Accounting Standards Board." The International Accounting Standards Board (or IASB), based in London, is responsible (together with related bodies) for issuing and officially interpreting IFRS.

IFRS financial statements are currently required or permitted in over 100 countries, including most notably in the European Union, where all listed companies are required to use a version of IFRS to prepare their financial statements. Many other countries, including Canada, India, Brazil, Korea and Japan, are actively moving towards the adoption of a version of IFRS.

All of the countries that currently require IFRS financial statements, including the European Union, mandate the use of a so-called "jurisdictional variant" of IFRS, rather than IFRS as issued by the IASB. In these countries, after the IASB adopts an accounting standard, a regulator or national standard-setter must approve the standard before it becomes part of the official body of accounting principles. The same is true for official interpretations initially adopted by IASB-related bodies. Companies and their auditors are generally required to confirm in home country reports that the financial statements conform to the relevant jurisdictional variant.

The SEC's new rule does not recognize any jurisdictional variant, but instead applies only to companies that use the version of IFRS that is issued by the IASB. The SEC says that it limited the new rule to IFRS as issued by the IASB in order to encourage the ultimate adoption of a single, global accounting standard, and that it fears the acceptance of multiple jurisdictional variants of IFRS would run counter to this objective.

Fortunately, there currently is no substantive difference between IFRS as issued by the IASB and the major jurisdictional variants of IFRS (including the variant adopted in the European Union, with the exception of a hedge accounting option available as a practical matter only for financial institutions).[1] Nonetheless, companies will need to plan carefully, because the SEC's rule requires not only substantive compliance with IFRS as issued by the IASB, but also an explicit statement regarding such compliance in the notes to the company's financial statements, and in the related auditor report.

It is important that companies take this into account as they make plans for the 2007 annual report season. Companies seeking to take advantage of the new rule should make sure that they confirm compliance with <u>both</u> their home country variant and IFRS as issued by the IASB, or they might find themselves having to publish slightly different financial statements in their Form 20-F compared to their home country annual report. Similarly, they should make sure that their auditors will be in a position to confirm compliance with both standards in their audit reports.

Companies from non-English speaking countries will have to consider an additional issue. The SEC made clear in the adopting release that, in referring to IFRS "as issued" by the IASB, it means the official version that is issued by the IASB in the English language.[2] Companies that use a translation of IFRS should consult with their

1 The new rule includes a two-year transition provision designed to accommodate European financial institutions that use this option by allowing them to provide an audited reconciliation to IFRS as issued by the IASB. After the two-year transition period, they will need to comply fully with IFRS as issued by the IASB in order to avoid a US GAAP reconciliation.

2 The initial version of the rule proposed by the SEC in June 2007 would have required companies to confirm explicitly that their financial statements were prepared in accordance with the English version of IFRS. The final rule does not contain this explicit reference, but the SEC made clear that, by confirming compliance with IFRS "as issued" by the IASB, financial statements and audit reports will be considered to confirm compliance with the official English version.

auditors to ensure that there are no translation discrepancies that might prevent the auditors from confirming compliance with IFRS as issued by the IASB in a Form 20-F.

2. First-Year Transition Issues

In 2005, the SEC's then Chief Accountant announced an objective of eliminating the US GAAP reconciliation requirement, with a proposed timeline of "2009 or sooner" for the staff to recommend a rule for adoption by the Commission. Remarkably, the new rule will become effective two years earlier than originally expected. The accelerated timetable is a favorable development, but it raises a few transition issues.

- Effectiveness. The new rule becomes effective for filings made on or after March 4, 2008 (60 days after its publication in the Federal Register). A company that files its Form 20-F prior to that date is technically required to include a US GAAP reconciliation. However, the Chief Accountant of the Division of Corporation Finance has recognized that the SEC does not want to discourage earlier filings of annual reports, and has advised companies that the staff will accept written requests by eligible companies to file earlier without a US GAAP reconciliation.[3]

- To Which Financial Statements Does the New Rule Apply? The SEC's release says that the new rule applies "to annual financial statements for financial years ending after November 15, 2007" contained in filings made after the effective date. Read literally, this would mean that a calendar year company would not have to reconcile its 2007 financial statements to US GAAP, but that it would still be required to publish a reconciliation of its 2005 and 2006 financial statements, contained in its 2007 annual report. This could present a significant burden for companies that have applied new accounting pronouncements, reclassified businesses as discontinued activities or otherwise changed their historical financial statements. Based on an informal conversation with the staff, however, we understand that the SEC intended to eliminate the reconciliation for all financial statements included in 2007 reports, and that the staff does not expect companies to include US GAAP reconciliations for prior years.[4]

- Selected Financial Data. Companies are typically required to include five years of selected financial data in their annual reports filed with the SEC. The new rule eliminates the requirement to present US GAAP selected

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[3] An email message to this effect from the Chief Accountant has been posted on the SEC's website (it is available at http://www.sec.gov/divisions/corpfin/guidance/cf20fgaap.htm).

[4] The statement that the relief is only applicable to financial statements for financial years ending after November 15, 2007 is not in the rule, but only in the adopting release, which should provide additional comfort to companies with respect to this point.

financial data for companies that prepare financial statements in accordance with IFRS as issued by the IASB. However, most companies that adopted IFRS in 2005 will not have five years of IFRS financial data in 2007. In particular, the European rules implementing the transition to IFRS, which became mandatory in 2005, required companies to publish IFRS financial information for 2004 for comparative purposes, but not for 2003. Commenters on the SEC's rule proposal did not address this technical issue, as they expected the new rule to become effective for the 2008 financial year, which would have made this issue irrelevant.

Form 20-F provides that selected financial data for either or both of the two earliest years may be omitted by companies that represent to the SEC that the data cannot be produced without unreasonable burden. Based on informal conversations with the staff, it appears that the SEC will accept annual reports with only four years of selected financial data from companies that cannot produce the data for 2003. Companies may consider submitting a representation to the SEC regarding the burden of producing 2003 data, in order to comply strictly with the terms of Form 20-F and its instructions. In addition, companies should include a brief explanation for the omission in their annual reports.[5]

3. Continuing Issues

In addition to transition-related issues, companies seeking to use the new rule will need to keep in mind a number of other issues when they file annual reports or conduct registered offerings. Those issues include the following:

- Financial Statement Disclosure. Before the text of the rule was published, a number of companies expressed concern that the SEC would require them to include disclosure that they currently furnish along with their US GAAP reconciliations, but that is not required under IFRS (for example, disclosure required under SEC Regulation S-X that technically is not part of US GAAP). In the final version of the new rule, the SEC amended Item 18(b) of Form 20-F to make clear that no such additional disclosure is required.

- Auditing Standards and Review. The new rule does not change the requirement that audits be conducted under the auditing standards of the Public Company Accounting Oversight Board. This should not present a

[5] The same issue may arise in the future for companies in countries that switch from local accounting principles to IFRS. As discussed below, General Instruction G to Form 20-F would allow such companies to provide only two years of IFRS selected financial data in the first year in which they apply IFRS. However, General Instruction G does not by its terms apply in the second year. As a matter of practice, however, in 2006 most European companies omitted selected financial data for 2002 and 2003 from their Form 20-F filings, without any explanation of the omission of the two earliest years.

significant issue for a company whose auditor traditionally plans its auditing work so as to complete the PCAOB audit before home country financial statements are published. Companies that hope to file their 20-F annual reports at the same time as, or soon after, they publish home country reports should check the feasibility of their timetable with their auditors. This is particularly true since applicable PCAOB standards (particularly so-called "Appendix K") continue to require review of foreign issuer SEC filings by the auditor's U.S. national office, even though one main purpose of the requirement was to ensure review by an auditor familiar with US GAAP. As the adopting release notes, the PCAOB is aware that the elimination of US GAAP reconciliation may have implications for auditing standards.

- Market Risk and Other Information. Form 20-F, like its counterpart for annual reports of U.S. companies, requires non-U.S. companies to provide significant amounts of quantitative information on issues such as market risk and off balance sheet items. Unlike U.S. companies, many non-U.S. companies (particularly in Europe) provide identical information in the notes to their financial statements. The new rule allows companies to incorporate by reference information that appears in the notes to the financial statements, rather than reproducing it. This should allow some companies (particularly banks, which must provide large amounts of statistical information in their annual reports) to streamline the process of preparing their U.S. annual reports.[6]

- Interim Financial Statements. The new rule eliminates the US GAAP reconciliation requirement for registration statements that include interim financial statements prepared in accordance with IAS 34. The SEC had requested comment as to whether companies should be required to provide additional disclosure, such as the information required by Article 10 of Regulation S-X, but the SEC ultimately decided that compliance with IAS 34 is sufficient. This is particularly important for companies with regular issuance programs, which will no longer suffer "blackout" periods while awaiting a US GAAP reconciliation of interim financial statements.

- Acquisition-Related Issues. Companies relying on the new rule will have to be particularly vigilant when they make significant acquisitions. If the

[6] To the extent that this disclosure includes or is based on "forward-looking information," the liability safe harbors of the Securities Act of 1933 and the Securities Exchange Act of 1934 would not apply if the information were contained in audited financial statements, while they would apply if the information were contained in the body of the documents (the SEC is considering further rulemaking with respect to this issue). It is not clear whether the safe harbors would apply if the information were contained in both places. Companies may want to consider this issue in determining whether to include the disclosure directly in their annual reports or whether to incorporate it by reference from their financial statements.

target's financial statements are not prepared in accordance with IFRS as issued by the IASB, then:

- If the acquisition takes the form of a registered exchange offer or merger, the SEC-registered prospectus or merger document will have to include the target's financial statements reconciled to US GAAP (or a narrative description of differences will have to be provided, if a reconciliation cannot be obtained without unreasonable burden or expense). Reconciliation to IFRS as issued by the IASB will not be possible, although a restatement in accordance with IFRS as issued by the IASB would be possible (with an appropriate audit report).

- Pro forma financial statements will have to be prepared on the basis of IFRS as issued by the IASB, meaning that the target's financial statements will have to be converted to IFRS as issued by the IASB as part of the pro forma adjustments. In addition, the significance tests used to determine if pro forma financial statements are required (which are triggered if certain financial statement items of the target exceed 20% of the same indicators of the acquirer) must be performed on the basis of financial statements of the target prepared in accordance with IFRS as issued by the IASB. This means that the target's financial statements must be converted to IFRS as issued by the IASB to determine whether any pro forma financial statements are required.

- If the acquirer files a registration statement after the acquisition, then separate financial statements of the target for one, two or three years, prepared under IFRS as issued by the IASB, might be required depending on the level of significance. As for pro forma financial statements, the significance testing would be done on the basis of IFRS as issued by the IASB, requiring a conversion to determine if any pro forma financial statement presentation is required.

The requirement to provide target financial statements and pro forma financial statements generally does not apply to an annual report on Form 20-F. However, if a company is considering an acquisition through a registered exchange offer, or if a company otherwise expects to file a registration statement (for example, for a debt issuance program or the refinancing of acquisition debt) following a significant acquisition, it will be important to consider these issues early in the planning process. In particular, if a target already prepares IFRS financial statements in accordance with a jurisdictional variant, the acquirer should carefully consider whether a conversion to IFRS as issued by the IASB would be feasible.

- First-time Filers. The SEC has indefinitely extended General Instruction G to Form 20-F, an accommodation for first-time IFRS filers, which was scheduled to expire after the 2007 financial year. The accommodation permits companies preparing financial statements for the first time under IFRS as issued by the IASB to present only two years of audited financial statements, rather than three years (and two years of selected financial data, rather than five years). As a result, when new countries adopt IFRS as a required or permitted body of accounting principles, companies from those countries will be able to use the accommodation in their first year of IFRS reporting (assuming they comply with IFRS "as issued by the IASB" and not only a jurisdictional variant).[7]

- Employee share offerings and stock options (companies not listed in the United States). The new rule could prove to be particularly beneficial for companies that are not listed in the United States (including companies that previously deregistered), but that have significant numbers of U.S. employees. Under Securities Act Rule 701, such a company must deliver financial statements to its employees if it sells (including by granting options) more than $5 million worth of shares to employees in a 12-month period. The new rule eliminates the US GAAP reconciliation requirement for those financial statements, if they are prepared in accordance with IFRS as issued by the IASB. In contrast to Form 20-F, amended Rule 701 does not explicitly say that the notes to the financial statements and the auditor report must express compliance with IFRS as issued by the IASB. It would be prudent, however, for companies hoping to use the new rule to include such a statement in the notes to their financial statements, and to request that their auditors do the same.[8]

Additional technical issues will undoubtedly arise as companies prepare their annual reports and register securities offerings. In some cases it may be necessary to contact the SEC staff in order to confirm the appropriate resolution of these issues.

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7 A company listing in the United States for the first time (for example, in an IPO) could thus present two years of financial statements under IFRS as issued by the IASB in its initial registration statement, if it is adopting those principles for the first time. On the other hand, the staff has informally indicated that a company that used IFRS as issued by the IASB in its home country before its U.S. listing could not use the accommodation, and would have to present three years of financial statements. The staff has indicated that it would be willing to listen to a request for the use of the accommodation if the company were to switch from a jurisdictional variant to IFRS as issued by the IASB, if the switchover were particularly burdensome or expensive.

8 The requirements of Rule 701 regarding the date of the financial statements and the timing of their delivery are complex. Those requirements are beyond the scope of this memorandum.

4. Regulatory Oversight: the Future Role of the SEC

When European companies commented on the proposed version of the new rule, one of their arguments in favor of the acceptance of jurisdictional variants of IFRS by the SEC was that IFRS as published (or issued) by the IASB is not approved by any regulator anywhere in the world. Indeed, the rule is available to a company that voluntarily uses IFRS, even if it does not do so (or is not allowed to do so) in its home country. As a result, a company could use accounting principles that are not approved by a regulator to prepare financial statements that are not reviewed by a home country regulator, and file those financial statements in the United States.

The SEC has made quite clear that it expects to fill the gap, and more broadly that it intends to continue its practice of conducting a substantive review of the IFRS financial statements filed by non-U.S. companies. Most companies that have filed IFRS financial statements with the SEC in recent years have received detailed comment letters on those financial statements, and in many cases those companies have changed their financial statements in subsequent years in response to those comments. The SEC staff has also published a summary of its comments on IFRS financial statements.[9]

As a result, the SEC is likely to have a significant influence over the future interpretation of IFRS, particularly given that some other regulators around the world do not have the same tradition of commenting in detail on audited financial statements and the related "MD&A" disclosure. This influence may expand if the SEC allows U.S. companies to publish IFRS financial statements, as it has proposed in a concept release published in July 2007.

The SEC has also expressed a strong desire to work with international regulators and accounting standard setters to promote convergence towards a single, global accounting standard. The FASB (the U.S. standard setter) and the IASB have also publicly supported this objective. If it is achieved, then companies and investors are likely to realize significant benefits. In the meantime, the elimination of the US GAAP reconciliation is an important, positive step.

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Questions about the new rule and its implications for foreign private issuers can be directed to your regular contacts at the firm or to any of our partners and counsel listed under Capital Markets in the "Our Practice" section of our web site, http://www.clearygottlieb.com.

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9 The report is available on the SEC website at http://www.sec.gov.divisions/corpfin/ifrs_staffobservations.htm.

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