

SAYING GOODBYE TO U.S. GAAP

BY RAMONA DZINKOWSKI

“One of America’s early icons, a rough-and-tumble frontier lawyer who was Tennessee’s first congressman, once memorably said, ‘It’s a damn poor mind indeed that can’t think of at least two ways to spell the same word.’ Old Hickory, as he came to be known, was our seventh President, and Andy Jackson’s folk wisdom is appreciated today by some of the Americans who work in the Division of Corporate Finance in the Office of the Chief Accountant.”

—SEC Chairman Christopher Cox

On March 6, 2007, the Securities & Exchange Commission (SEC) held a Roundtable on the Roadmap to International Financial Reporting Standards (IFRS) Convergence. Essentially, the day-long event was designed to gather information from the capital markets community, investors, and the foreign and domestic issuer community on what impacts are to be expected if the SEC drops the IFRS-U.S. GAAP reconciliation requirement in 2009. If I read the look on the faces of the SEC commissioners correctly, I think what they learned was not only unanticipated but downright shocking.

DROPPING RECONCILIATION

Is dropping the reconciliation a good idea? According to the panel of roughly 20 or more experts, not only is the general consensus a resounding, YES, but reconciliation to U.S. GAAP is looked upon as a mostly futile and expensive exercise for many involved (with perhaps the exception of the audit community) and, for the most part, acts as a barrier to entry for foreign firms that may want to list on large public exchanges in the United States.

First, most investors both inside and outside the U.S.

aren’t relying on the reconciliation to U.S. GAAP to make investment decisions; they use IFRS or local country GAAP. According to Trevor Harris, managing director and vice chair of Client Services at Morgan Stanley, “I have never found, both in my buy side clients and working with sell side analysts in two institutions, anyone who actually makes a forecast based on those reconciliations. They forecast in the local GAAP, and then they look to the disclosures to see what else they can learn.”

For the rating agencies, reconciliation to U.S. GAAP isn’t particularly useful either. Most foreign issuers are rated using IFRS in order to compare global oranges to global oranges and for the simple reason that most analysts who rate international companies don’t speak U.S. GAAP. Says Gregory Jonas, managing director of Moody’s Accounting Specialist Group, “Our analysts don’t use the reconciliation in their day-to-day work of analyzing companies....For most IFRS filers, our lead analyst is not based in the U.S. and has not grown up with U.S. GAAP....Let me give you a couple of statistics that underscore this point. We rate about 165 foreign private issuers who file financial statements from countries that

have adopted some form of IFRS. Of those 165 companies, in only 13 cases is the analyst inside the U.S. In the vast majority of cases, the analyst is outside the U.S. and is thinking in a language that is very different [from] U.S. GAAP....The second reason why our people don't use the reconciliation is, for the typical foreign private issuer, its peer group is not based primarily in the U.S., so converting foreign private issuers to U.S. GAAP would not result in comparable data across the peer group anyway."

Furthermore, the reconciliation is annual, which doesn't help fund managers or the rating agencies. Jonas adds, "...the reconciliation is filed too late for our purposes. Most companies, of course, file the 20F very near the filing deadlines, a full six months after their year-end, and long before that time they have reported their financial results in their international or local GAAP. By that time we have updated our analysis of the company. We have decided whether to hold a rating...we have made the decisions, and life has moved on. So, it's interesting information, but it's too late for our purposes."

In addition, investors will be at least no worse off without reconciliation, and perhaps they will be better. After all, reconciliation to U.S. GAAP doesn't necessarily imply more transparency. Notes Ken Pott, head of Morgan Stanley's Capital Markets Execution Group, "I totally agree that the quality of information that investors are getting is going to be no less than under the current standard, and, with the combination of convergence and SEC review of financial statements, investors are going to be just fine. After all, U.S. GAAP has not exactly distinguished itself over the course of the last few years."

Finally, the time required to prepare the IFRS-U.S. GAAP reconciliation can exclude foreign companies from accessing U.S. capital markets. As Denis Duverne, CFO of AXA, a French-based wealth management company, explains:

"We currently have a very limited window through which to access the U.S. markets because we typically file our 20F sometime in June due to the time required to prepare the U.S. GAAP reconciliation and other required U.S. GAAP disclosures...and our year-end financial statements go stale at September 30. We do not prepare a half-year U.S. GAAP reconciliation; consequently, our window for accessing U.S. markets is between mid- or end of June and the beginning of July. We publish our IFRS statements in the first 10 days of August, which means that we have a blackout period of one month ahead of that. We can access the capital markets between sometime at the end of June and the 10th of July, and then we are in the closed-window period because of the half-year IFRS

accounts. August is not a good time to issue equity, as you know, and then we have September, which is available. When we do a rights offering, we really have no option because it is usually at the occasion of an acquisition, and we are rarely in that opportune window, so we have not used our ability to tap the U.S. markets."

THE ELEPHANT(S) IN THE ROOM

Is the U.S. moving toward adopting IFRS outright? SEC Chairman Christopher Cox envisions a system where the two accounting systems could operate side by side until such time as they converged....when "there is truly one global accounting standard." He explains:

"It [committing to the IFRS Roadmap] meant that IFRS and U.S. GAAP would someday compete freely in America's capital markets and that two accounting systems would operate side by side at least until the process of convergence completes—with actual convergence—and there is truly one global accounting standard and seamless international comparability of reporting. It meant that issuers, markets, and investors would have a choice because they, not the government, decide between IFRS and U.S. GAAP, and it meant that the SEC was seriously contemplating a system in which not only foreign issuers but also domestic issuers will have that choice."

To some people, this might suggest that IFRS have a way to go until they please the SEC or are potentially close enough to U.S. GAAP to pass for U.S. GAAP. What seemed to be missing in the above, however, was an understanding that the rest of the world thinks that the International Financial Reporting Standards already *are* the "one global accounting standard," (or at least so think the EU, Canada, Australia, New Zealand, and Hong Kong, to name a few) and that it is the U.S. who has to get with the program.

Most of the panelists at the forum seemed to agree that IFRS are indeed the "one global standard" and appeared to be quite fine with the idea. Moreover, the original author of the SEC's famous "IFRS Roadmap," former SEC Chief Accountant Donald Nicolaisen (who expressly notes that SEC Deputy Chief Accountant Julie A. Erhardt was an invaluable contributor to the writing of the Roadmap), goes even further to suggest that U.S. firms should simply be required to adopt IFRS rather than having two parallel and voluntary systems operating simultaneously. He says, "If you think about looking ahead a number of years, what's more likely to be accepted broadly around the globe? Would it be IFRS, or would it be U.S. GAAP? I think it is clear that it is going to be IFRS."

Furthermore, he adds:

“Do you accept using international accounting standards in the U.S. for U.S. companies? That is probably a deeper question. As opposed to making that a voluntary election, I would rather see it be a requirement. The reason I say that is because, in the intervening period, you have a creeping system that is hard for investors to really follow as to who is using what, when, and where....What you might end up with are endless questions of what things would look like using an alternative accounting model. My vision of the future is along the line of we ought to adopt a good accounting model; we ought to do that broadly for all companies. Then we ought to be looking where we spend our time on how we make this better....I would go to a single standard.”

IFRS IN AMERICA: WHAT'S NEXT?

If the SEC takes the recommendations that resulted from this forum, we can expect the reconciliation requirement to be dropped soon, potentially before 2009. To this end, Chairman Cox has recently announced that the SEC plans to issue a Proposing Release, the preliminary regulatory document that will propose eliminating the reconciliation, this summer. The Release will request comments on potentially allowing foreign private issuers to file under IFRS. In addition, the SEC will issue a Concept Release surrounding the possibility of allowing U.S. domestic public companies to use IFRS in their financial reports. Comments are due in fall 2007.

What are the implications for market participants (and the regulators) of having two parallel systems at work? Going one step further, what are the implications for firms switching to U.S. GAAP either by choice or by mandate? Finally, and perhaps most important, can all this be audited in a consistent way when currently we don't have one global set of auditing standards?

Although these major details have yet to be sorted out, it's clear that IFRS are coming to America perhaps sooner than we think. Therefore, it is strongly recommended that U.S. companies begin recruiting and training personnel in IFRS and start thinking about what other organizational changes will be required if and when IFRS are upon them. They also need to think about the cost. (More specifically: What process changes will have to be made in order to be able to support IFRS? Will IT systems and data-gathering processes give the right information? What's the potential impact on performance evaluation and management compensation? Will the flow of information to the treasury management function be

sufficient to allow it to continue doing its job? What information will be needed to revalue intangibles?) Clearly, the accounting certification bodies and educators will play a critical role in providing quality training in IFRS as well as taking the lead on informing U.S. companies about the organizational and process implications of adopting the standards in the U.S.

At the same time, foreign issuers must realize that although no longer having to reconcile to U.S. GAAP could mean significant savings (US\$25 million per annum in the case of AXA), this doesn't come without risk. According to AXA's Denis Duverne, there could be significant consequences for foreign firms if the SEC were to require them to restate under IFRS, whereas under U.S. GAAP reconciliation, this would typically go unnoticed. Duverne explains:

“...the SEC has been quite active to impose restatements to issuers, both domestic and international. We know that you are aware that those restatements may have different consequences in different jurisdictions. What happens for us, at least in France, is our accounts are approved by our shareholders. If we are forced to do a restatement, it is an admission of false accounts, which has penal consequences. This needs to be looked at quite seriously. A restatement of our U.S. accounts, and we had that situation once, is unnoticed. It was unnoticed as far as we are concerned. A restatement of our IFRS accounts would have penal consequences for the manager of the company, so that's an important point from our standpoint.”

Finally, the SEC has to be mindful that once foreign filers don't have to reconcile to U.S. GAAP, there's no turning back for them. As William F. Widdowson, head of UBS Group accounting policy, co-head of the UBS Group finance function, and a member of the UBS Group managing board of UBS AG, explains, for foreign firms rolling up their accounting systems in essentially two languages, it's a flick of the switch. He says, “Please remember that, for an organization operating bottom-up accounting, which I think is the preferred way to go if one really believes that to report and control a transaction properly you should do that as close to the point of the transaction as you can...for companies preparing accounts in that way, once we switch the system off, we switch it off.”

We'll see what happens next. ■

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